



Australian  
Competition &  
Consumer  
Commission

# Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries

July 2008





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ISBN 978 1 921393 84 6

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Produced by the ACCC 07/08

EXECUTIVE OFFICE



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31 July 2008

The Hon Chris Bowen MP, Assistant Treasurer  
Minister for Competition Policy and Consumer Affairs  
Parliament House  
CANBERRA ACT 2600

Dear Minister

**Inquiry into the competitiveness of retail prices for standard groceries**

On 22 January 2008 you directed the Australian Competition and Consumer Commission (ACCC) to hold a public inquiry into the competitiveness of retail prices for standard groceries, pursuant to section 95H(1) of Part VIIA of the *Trade Practices Act 1974* (the Act).

The inquiry was conducted by Commissioners John Martin, Stephen King and myself. The inquiry was to be completed and a report submitted to you by 31 July 2008.

Please find enclosed a copy of the ACCC's report.

Yours sincerely

A handwritten signature in blue ink that reads 'Graeme Samuel'.

Graeme Samuel  
Chairman



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# Glossary

Bundled trading terms	Where one comprehensive rebate is negotiated between supplier and retailer instead of a number of separate rebates.
Category average margin	A target margin used by the MSCs to measure the performance of products across a category. The margins made by the retailer across all particular products in a category defined by the retailer are averaged margins obtained by various products in the category are then compared to this figure.
Dry groceries	Dry category consisting of non-perishable food products and certain non-food products. Typically shelved, these are most grocery items excluding fresh, perishable products such as baked items, dairy, deli, meat, frozen foods and fresh produce. Examples of dry grocery products would include biscuits, toilet paper, pasta, rice, dishwashing detergent and canned products.
Gross margin	Sales revenue less COGS (usually expressed as a percentage of sales).
List price	The basic wholesale price set by the supplier that applies to all customers, before any customer -specific trading terms are accounted for.
Packaged groceries	Includes dry, frozen and chilled groceries.
Percentage point	The unit used for the arithmetic difference of two percentages. For example, if a company's EBIT margin in one year was 2 per cent, and in the next year was 3 per cent, the EBIT margin has increased by one percentage point.
Private label	Also known as home brands, own brands, store brands or generic products. These are products that are manufactured or provided by one company (which may also produce its own proprietary branded products in competition with the private label) for sale under a retailer's brand.
Settlement period/terms	The period following invoicing or delivery in which a retailer is required to pay or settle their account with the supplier.
Trading terms	The agreements which set out the conditions, such as discounts, rebates and fees, upon which products will be purchased from a supplier by a retailer or wholesaler.
Ullage	A rebate negotiated by a retailer to compensate them for products which are damaged during transport and rendered unsaleable.
Vertical integration	The undertaking by a single firm of successive stages in the process of production and supply of a particular good.
Wholesale list price	A list of prices compiled by suppliers for the products that they sell to retailers. The wholesale list price is common to all retailers selling the product and is the starting point for price negotiations.



## List of shortened forms

ABA	Australian Beef Association
ABARE	Australian Bureau of Agricultural and Resource Economics
ABS	Australian Bureau of Statistics
ACC	Australian Country Choice
ACCC	Australian Competition and Consumer Commission
ACCC red meat report	<i>ACCC, Examination of the prices paid to farmers for livestock and the prices paid by Australian consumers for red meat, February 2007</i>
Act (the)	<i>Trade Practices Act 1974 (Cwlth)</i>
AFGC	Australian Food and Grocery Council
AHBIC	Australian Honey Bee Industry Council
AIW	Australian Independent Wholesalers
ALFA	Australian Lot Feeders Association
ALIC	Agriculture & Livestock Industries Council
ANRA	Australian National Retailers Association
APAL	Apple and Pear Australia Limited
ASP	average selling price
ASX	Australian Stock Exchange
BITRE	Bureau of Infrastructure, Transport and Regional Economics
CALC	Consumer Action Law Centre
CFS	Colonial First State
CODB	cost of doing business
COGS	cost of goods sold
CPI	consumer price index
DAFF	Department of Agriculture, Fisheries and Forestry
EBIT	earnings before interest and tax
EBIT margin	EBIT divided by sales
EBITA	earnings before interest, tax and amortisation
EBITDAR	earnings before interest, tax, depreciation, amortisation and rent
EDLP	everyday low prices
EU	European Union

FAL	Foodland Associated Limited
FGV	Fruit Growers Victoria
FPI	food price index
FTC	Federal Trade Commission
GST	goods and services tax
GWF	George Weston Foods
HAL	Horticulture Australia Ltd
HES	Household Expenditure Survey
HHI	Herfindahl-Hirschman index
HSCW	hot standard carcase weight
IGA>D	IGA Distribution
KVI	key value items or known value items
MGA	Master Grocers Association
MLA	Meat and Livestock Association
MSC	major supermarket chain
NARGA	National Association of Retail Grocers of Australia
NFF	National Farmers Federation
OECD	Organisation for Economic Cooperation and Development
PGICAC	Produce and Grocery Industry Code Administration Committee
PGIO	Produce and Grocery Industry Ombudsman
PPI	producer price index
PPP	purchasing power parity
PTUA	Public Transport Users Association
QCA	Queensland Consumers Association
RBA	Reserve Bank of Australia
RGICC	Retail Grocery Industry Code of Conduct
ROFE	return on funds employed
SCCA	Shopping Centre Council of Australia
SIW	Statewide Independent Wholesalers
SKUs	stock keeping units
SSRA	Southern Sydney Retailers Association
VFF	Victorian Farmers Federation
WAIGA	WA Independent Grocers Association

# Overview

Most Australians are regular visitors to supermarkets for their grocery needs. As the average Australian household spends around 12 to 14 per cent of its after tax income on standard groceries, increasing prices for these goods have been strongly felt.<sup>1</sup> The high level of media interest and consumer apprehension about grocery prices reflects this sentiment.

Farmers, processors, manufacturers and individuals in the transport, storage and retail sectors all contribute to the grocery supply chain. A significant concern raised during the inquiry is whether the gap between farm gate and check-out prices for groceries has been widening in recent times, such that farmers and suppliers are getting less, while retailers are getting more.

Concerns about the long-term future of small family-run independent supermarket operators and smaller retailers such as butchers, bakeries and greengrocers have also been raised. Their ability to compete with the major supermarket chains (MSCs)—Coles and Woolworths—has come under public scrutiny.

This report focuses on competition in the Australian grocery sector. Specifically, the report asks whether a lack of competition is an explanation for the concerns identified above. The report analyses the extent to which competition (or a lack of it) has contributed to increased grocery prices. The supply chain and bargaining power of Coles, Woolworths and Metcash (the major wholesaler to the independent sector) are given detailed attention. The competitive position of independent retailers also comes under close scrutiny, with an analysis of the factors that may make it difficult for independent grocery retailers to compete aggressively with Coles and Woolworths on price.

Supermarkets sell a diverse range of products. This report concentrates on basic staple products essential to households. These products do not include items such as liquor, cigarettes and stationery, although they are found in most Australian supermarkets.

## The inquiry process and key findings

The inquiry held hearings around Australia, received over 250 public submissions and obtained vast quantities of data, information and documents from Coles and Woolworths, other retailers, Metcash and many suppliers. The ACCC would like to thank all those organisations that provided information to the inquiry.

In scrutinising the information before the inquiry, it has become clear that some industry participants, representative groups and commentators have made unsupported claims to the inquiry and in the media. These claims were based on generalisations and there was a failure to provide facts to support the claims.

In addition, certain claims have been based on inappropriate information sources. For example, while the rate of food price inflation in Australia has increased significantly in recent years, it appears that Australian Bureau of Statistics (ABS) figures have been misinterpreted in the media, which has had

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<sup>1</sup> The 12 to 14 per cent figure is based on the Household Expenditure Survey (ABS cat. no. 6530.0) and Census of Population and Housing (ABS cat. no. 2003.0) data.

the effect of exaggerating the size of the problem. More specifically, retail price data for some food products such as milk, bread and eggs have been compared over time despite clear warnings by the ABS that these price statistics are not fit for such purposes.

The ACCC has focused on making evidence-based findings and recommendations. On the basis of careful analysis of all the material available to the inquiry, the ACCC has made the following key findings:

- Grocery retailing is workably competitive, but there are a number of factors that currently limit the level of price competition, including:
  - high barriers to entry and expansion, particularly in relation to difficulties in finding new sites for development.
  - the limited incentives for Coles and Woolworths to compete aggressively on price.
  - limited price competition that Coles and Woolworths face from the independent sector. Independent supermarkets tend to focus on convenience and service. A key factor inhibiting price competition from the independent retailers is the wholesale prices of packaged groceries supplied by Metcash.
- Price competition is strongest on promotions of key value items (which are products known by the supermarkets to be used by consumers to assess value). This is to be expected, given that the pricing of these products is most likely to encourage consumers to change where they buy groceries.
- ALDI has been a vigorous price competitor since its entry into Australia and has the incentive and ability to engage in sustained price competition. This has had a dynamic impact on the grocery sector and brought about competitive responses from Coles and Woolworths on many products.
- Any possible weakening in the level of competition in retailing is unlikely to have been a substantial contributor to food price inflation in Australia. The gross margins of Coles, Woolworths and Metcash have increased over the last five years. However, ACCC analysis indicates that these increases in gross margins could have only made a small contribution to overall food price inflation.<sup>2</sup> In other words, the vast majority of grocery price increases in Australia are attributable to other factors, such as supply and demand changes in international and domestic markets, increases in the costs of production and domestic weather conditions.
- The ACCC has not identified anything that is fundamentally wrong with the grocery supply chain. Evidence provided to the inquiry does not support the proposition that retail prices have risen while farm-gate prices have stagnated or declined. While there may be some instances where this has occurred, generally movements in farm-gate pricing are set by supply and demand in competitive markets. Changes in the wholesale prices that Coles, Woolworths and Metcash pay suppliers are reflected in movements in shelf prices over time.
- Coles, Woolworths and Metcash have significant buyer power in relation to many packaged grocery products because many suppliers effectively have little option other than to deal with these buyers. Competition between retailers is, however, sufficient to ensure that Coles and Woolworths cannot simply retain all of the benefits of the lower wholesale prices they extract—at least some of the benefits flow to consumers in the form of lower retail prices.

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<sup>2</sup> Increased gross margins may not reflect increased prices for consumers, and may reflect other factors such as lower wholesale prices or increased efficiencies in retailing.

## The grocery retail sector today

The following provides a brief description of the players in the industry:

- Coles and Woolworths, two large vertically integrated retailers (meaning that they operate at the wholesale level and retail level) operating throughout Australia
- ALDI, a vertically integrated retailer operating in Victoria, New South Wales, the Australian Capital Territory and Queensland, which is growing quickly and has a targeted product range
- Franklins, a vertically integrated retailer, with 80 stores in New South Wales
- independent supermarket operators, which generally operate relatively small stores, although there are a number of large-format independent supermarkets. Nearly all independents are supplied with packaged groceries by Metcash. Fresh produce is generally sourced by these stores directly from suppliers or via wholesale markets
- small specialty stores, such as bakeries, butchers, greengrocers, fishmongers, Asian grocers and delicatessens, which sell standard groceries but only a small part of the overall grocery range.

Coles and Woolworths are seen as dominating the grocery sector. Nevertheless, there is a need for some caution when looking at figures used to describe market concentration because a variety of statistics are used. Also, it is clear from the analysis by the ACCC that there are local markets as well as wider regional and national markets.

Statistics analysed by the ACCC suggest that Coles and Woolworths account for approximately 70 per cent of packaged grocery sales in Australia and approximately 50 per cent of fresh product sales, such as meat, fruit and vegetables.

Coles and Woolworths have maintained a fairly consistent share of supermarkets above 1000 m<sup>2</sup> over the last 10 years, with each having just over 30 per cent of stores nationally. Coles and Woolworths are much more significant in relation to larger stores, accounting for around 87 per cent of all supermarkets above 2000 m<sup>2</sup>.

There is little evidence to suggest that Coles and Woolworths have simply 'bought out' the competition. Millions of Australian consumers shop at Coles and Woolworths in preference or addition to a number of alternatives—the local independent, the specialty bread shop, the Saturday market and/or the corner shop. High concentration levels alone do not dictate the nature of competition. There are other markets internationally that are more concentrated but appear to be more competitive.

## What has caused increased food prices in Australia?

High rates of food price inflation are a key motivation for this inquiry. The ACCC has examined food price inflation in Australia and in comparison with OECD countries. There is little doubt that food prices have increased significantly in recent times in Australia. The evidence shows that a range of domestic and international factors have significantly contributed to food price inflation.

For example, the implications of the drought and supply disruptions caused by natural disasters in Australia have been considerable. The duration of the drought and the extent of the decline in stored water levels have reduced agricultural production and affected the prices of a broad range of food products. Adverse weather conditions have affected food prices and caused considerable price volatility, particularly for fruit and vegetables. Further, where the supply of fruit or other food products

could not be readily supplemented by food imports as a result of quarantine restrictions, prices were more susceptible to sharp price increases when local supply disruptions occurred.

Also, as a result of the world commodities boom, the cost of doing business for many food producers has increased substantially and subsequently put upward pressure on food prices in Australia. For example, raw materials and other inputs into farm production, such as petrol and fertiliser, have risen at an increasing rate since the early 1990s. In this regard, the ACCC notes its contemporaneous examination of fertiliser prices, which finds that the increasing domestic fertiliser prices reflect international prices.

Further, increased international food commodity prices affect the domestic food market. Suppliers consider the returns that can be achieved from exporting their products into the world market against returns that can be achieved from the domestic market.

It is difficult to be precise about the extent to which these domestic and international factors explain the food price inflation experienced by Australian consumers. However, the potential contribution of any weakening of price competition in grocery retailing/wholesaling to food price inflation is limited. In the ACCC's assessment, at most, roughly one-twentieth of the increases in food prices over the last five years could be directly attributable to the increase in the gross margins achieved by the major grocery players.

## Competition in grocery retailing

Most grocery retailers and suppliers compete to deliver value on price and quality. Price competition is the strongest on key value items.<sup>3</sup> This is not surprising as the prices of these items are most likely to influence where consumers shop. Price competition is also intense for the types of products stocked by ALDI, indicating the dynamic effect that ALDI has had on the grocery sector in Australia.

Viewed overall, supermarket retailing is workably competitive, but there are a number of factors that currently limit the effectiveness of price competition. These include high barriers to entry for large-format supermarkets, a lack of incentives for Coles and Woolworths to compete strongly on price and the limited price competition from the independent sector.

It is the ACCC's view that the appropriate policy response is to attempt to lower barriers to entry and expansion, in both retailing and wholesaling to independent supermarkets and potential new entrants. The most significant underlying factor explaining the nature of competition in the grocery sector is the high barriers to entry.

The lack of incentives for Coles and Woolworths to compete strongly across the board on prices reflects the high levels of concentration in the industry and frequent monitoring of competitors' prices. Evidence indicates that if one player attempts to lead prices down, the other will follow, making it extremely difficult for either to win significant numbers of customers from the other through an aggressive pricing strategy. There is little incentive (and perhaps limited capability on the part of Coles) to upset the existing balance. Australian consumers would significantly benefit if Coles and Woolworths faced more competitive threats that encouraged more aggressive pricing strategies.

In contrast, ALDI has been a significant influence on Australian grocery retailing. ALDI has forced Coles and Woolworths to react by reducing prices—specifically in states and localities where ALDI is present. Even if a customer does not shop at ALDI, they obtain significant benefits from having an ALDI in their local area or state, as the Coles and Woolworths stores price more keenly. ALDI creates a strong

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<sup>3</sup> As noted earlier, key value items are products known by the supermarkets to be used by consumers to assess value.

competitive dynamic on the products it stocks and puts pressure on Coles and Woolworths to offer many of their private label products at prices not seen before ALDI's entry.

The entry of ALDI provides an example of how barriers to entry can be overcome, particularly for new styles of retailing. Although there are still very significant barriers to entry for large-format, one-stop-shop supermarkets that would compete across the range with Coles and Woolworths, ALDI has demonstrated that a new player does not have to be a full-service supermarket to generate a significant competitive reaction from Coles and Woolworths. Entry of further grocery retailers with differentiated business models poses a potential competitive threat to Coles and Woolworths.

## Metcash and the independent retailers

Coles, Woolworths, ALDI and Franklins have their own wholesale operations. Nearly all other supermarkets in Australia are supplied with their packaged groceries by Metcash. Most of these stores are smaller stores, which largely compete on the basis of convenience, service and local community ties rather than on the basis of price. Almost half the stores are below 500 m<sup>2</sup> in size and only about a quarter are above 1000 m<sup>2</sup>. While small independent retailers provide a competition alternative, they do not contribute significantly to price competition.

There are a reasonable number of independent supermarkets that have the size and location that should give them the ability to compete strongly with Coles and Woolworths on price. Indeed, some independent supermarkets do compete on price. However, the ACCC considers that the prices Metcash sets for its wholesale packaged groceries are a significant factor holding many independent retailers back from more aggressive price competition.

Metcash is the only significant wholesaler to independent supermarkets in Australia. Metcash sets its wholesale prices for packaged groceries in such a way that independent retailers can only compete with Coles and Woolworths on price by earning low net margins on the goods supplied by Metcash. Evidence suggests that those independent retailers that attempt to compete on price make their profits on fresh products and individual items sourced directly from suppliers.

Although Metcash is the only significant wholesaler to independent retailers, there are two significant threats that constrain Metcash's pricing behaviour. First, independent stores can either individually or collectively establish their own wholesaling operations for packaged groceries, as Franklins has done. Secondly, there is the threat of the independent supermarkets losing sales to Coles and Woolworths. Both these factors are constraints on Metcash's pricing to independent supermarkets. However, they are limited constraints.

Establishing a rival wholesale operation would involve overcoming many barriers and taking significant financial risk. Further, the agreements that Metcash has with independent retailers and suppliers, which restrict choice in dealing with players other than Metcash, may be protecting Metcash's position and preventing the establishment of rival wholesalers.

If Metcash raised its wholesale prices by a significant amount, many of the larger independent supermarkets that attempt to compete on price would struggle to survive and would lose sales. While sales to smaller independents that tend to compete on convenience rather than price would probably be less affected, overall the loss of sales would hurt Metcash. This constrains Metcash's wholesale pricing to independents to some extent. However, Metcash has an incentive to set its wholesale prices to independent retailers under the pricing 'umbrellas' set by Coles and Woolworths. This limits the ability of independent retailers to compete aggressively on price.

It is often thought that the reason for the higher wholesale prices for the independent sector is the lack of scale. From the evidence available to the ACCC, this may not be the case. The ACCC's analysis indicates that although Metcash buys certain products from suppliers on inferior terms, on some products it buys on equivalent or occasionally better terms than Coles or Woolworths. It is likely, however, that Coles and Woolworths are able to achieve greater efficiencies than Metcash by spreading operating costs over greater volumes.

The ACCC considers that Metcash earns higher margins than it would if it faced direct competition in wholesaling. Unless Metcash faces greater competitive constraints in wholesaling, the potential for larger independent stores to compete with Coles and Woolworths on price may be limited. However, the implications of another large-scale wholesaler entering the industry are unclear. As the only national wholesaler to the independent sector, Metcash can take advantage of significant economies of scale. If there were two large-scale wholesalers, it is possible that neither would achieve the same economies of scale that Metcash has achieved.

## Is access to sites a problem?

Access to suitable sites is a critical barrier to entry or expansion. Many new site options are associated with shopping centre developments. The ACCC has accordingly investigated the relationship between Coles and Woolworths, and shopping centre developers very closely.

Because of the reputation that Coles and Woolworths have in driving sales, both retailers are considered almost 'must have' tenants for any successful, large-scale shopping centre. While the preference of centre owners to have Coles and/or Woolworths as tenants reflects the importance of Coles and Woolworths to the success of the centres, it does create a significant barrier to entry for other supermarket operators.

The inquiry heard evidence that Coles and Woolworths engage in deliberate strategies designed to ensure they maintain exclusive access to prime sites. In particular, both supermarket chains include terms in their leases which effectively prevent centre managers leasing space in centres to competing supermarkets. These restrictive provisions usually take the form of an outright prohibition on the centre owner introducing a second, or third, supermarket into the centre for a specified period (commonly around 10 years) or make provision for a sufficient financial penalty, in the form of reduced rent payable, that renders it commercially unviable for the centre owner to introduce a competing supermarket.

A number of supermarket operators provided the inquiry with specific and credible evidence of leases between the major supermarket chains and shopping centres which, they contended, have prevented or delayed their entry into a centre. The ACCC also used its information-gathering powers to obtain leases from Coles, Woolworths and shopping centre owners which confirmed that such restrictive provisions are often included in leases.

The ACCC accepts that there are circumstances where centre developments are occurring, particularly in areas of projected future population growth, where a guarantee of a period of exclusivity is necessary to encourage a supermarket operator to enter. Accordingly, these restrictive provisions play a role in attracting an anchor tenant to a complex that may not otherwise be built without that anchor tenant.

However, in the vast majority of leases in larger metropolitan centres, there appears to be little justification for these clauses other than to prevent competitive entry. In these cases it would appear that such clauses are sought to maximise the profitability of the incumbent supermarket by restricting its exposure to potential competitors.

Restrictive provisions in leases are prohibited under Part IV of the *Trade Practices Act 1974* (the Act) in circumstances where they have the purpose or effect of substantially lessening competition. However, before this inquiry, very few concerns had been raised with the ACCC regarding these lease arrangements and the arrangements have not to date been a focus of the ACCC's enforcement activities.

Given the significant concerns expressed during the inquiry and the information received, the ACCC will be undertaking reviews of specific cases and may take further action. The ACCC encourages independent retailers who have evidence of existing arrangements affecting their ability to establish supermarkets on new sites to contact the ACCC. The ACCC's assessment of the competitive effect of any particular arrangement will depend on the specific nature of the restriction and the characteristics of the market in which the restriction applies.

Concerns were also raised that planning and zoning laws act as a barrier to the establishment of new supermarkets. Independent supermarkets were particularly concerned with impediments to new developments given the difficulties they have in obtaining access to existing sites.

The ACCC also received specific and credible evidence of incumbent supermarkets using planning objection processes to deter new entry in circumstances where the incumbent supermarket had no legitimate planning concerns. When questioned about this practice, Woolworths said such appeals are lodged to protect Woolworths' opportunities for new stores and to protect existing business.<sup>4</sup> Woolworths further stated that this is a practice adopted regularly by other supermarkets.

The ACCC recognises that zoning and planning policies are designed to preserve public amenity. However, zoning and planning regimes, including existing centres' policies, also act as an artificial barrier to new supermarkets being established with the likely unintended consequence of potentially impacting on competition between supermarkets. In particular, existing centres' policies, combined with the strong preference of existing centre owners to lease space to the major supermarket chains rather than independent supermarkets or new entrants, are likely to lead to a greater concentration of supermarket sites in the hands of Coles and Woolworths. Broadly speaking, little regard is had to competition issues in considering zoning or planning proposals.

Further, the complexities of planning applications, and in particular the public consultation and objections processes, provide the opportunity for Coles and Woolworths to 'game' the planning system to delay or prevent potential competitors entering local areas.

Submissions put to the inquiry support planning authorities taking competition issues into account when approving new developments. Given the high barriers to entry in grocery supermarket retailing, including the difficulty in obtaining suitable supermarket sites, the ACCC considers that new ways of incorporating competition analysis into planning decisions should be considered.

### **Recommendation**

The ACCC recommends that all appropriate levels of government consider ways in which zoning and planning laws, and decisions in respect of individual planning applications where additional retail space for the purpose of operating a supermarket is contemplated, should have specific regard to the likely impact of the proposal on competition between supermarkets in the area. Particular regard should be had to whether the proposal will facilitate the entry of a supermarket operator not currently trading in the area.

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<sup>4</sup> ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 64.

## From farm gate to check-out

There is no single ‘story’ that can be told about the grocery supply chain in Australia.

### Fresh products

The relationship between the farm gate and the check-out is quite direct for fresh products, such as meat, fresh fruit and vegetables. Coles and Woolworths often purchase directly from farmers, bypassing wholesalers, and then organise any necessary further processing themselves. The ACCC has not found any evidence to suggest that the major supermarket chains are acting in an anti-competitive way in their dealings with suppliers of fresh products. In particular, there is no across-the-board evidence to suggest that retail prices for fresh products are going up by a greater percentage than farm-gate prices. The gross margins of Coles, Woolworths and Metcash in fresh products have as a whole not increased significantly in recent years. There are some examples of relatively minor increases, as well as examples of falls. It is certainly the case that the large price increases in many fresh items over recent years cannot simply be attributed to the retailers.

The bargaining power of Coles and Woolworths in dealings with providers of fresh products will be strong in some cases. However, for a good proportion of fresh products, farmers have the option of selling to export markets or wholesale markets (which in turn supply independent supermarkets, butchers and greengrocers). This lowers the bargaining power of Coles and Woolworths. As stated earlier, Coles and Woolworths supermarkets account for approximately 50 per cent of fresh produce sold in Australia, which is a significantly lower percentage than for packaged groceries.

The ACCC accepts that many Australian farmers are suffering and low prices for their product may be a significant contributing factor. However, the extent to which the market power of retailers contributes to this problem is limited.

### Packaged groceries

For packaged groceries, generalisations are often made about farmers receiving a small percentage of the final price charged to consumers. In the case of many packaged products, farmers receive very little, but this typically reflects the other costs that occur in the supply chain, including capital-intensive processing, packaging, advertising, delivery and retailing. The price the farmer receives for many agricultural commodities, particularly products such as sugar and wheat, is set by international supply and demand conditions. At the manufacturer/wholesaler level, it has not been possible in the context of this inquiry to investigate in detail every supply chain in the grocery sector to determine if individual wholesalers or manufacturers have market power. However, the ACCC has investigated very closely whether the major players have excessive bargaining or buyer power, which enables them to damage Australian supply industries. Coles, Woolworths and Metcash have significant buyer power in packaged groceries. This reflects the limited options available to many manufacturers—they often have no option but to sell through Coles, Woolworths and Metcash. On the other hand, Coles, Woolworths and Metcash often have many alternative options, including importing, providing more shelf space to different products or selling private label products.

The buyer power of Coles, Woolworths and Metcash may adversely affect individual competitors. However, the role of the ACCC is to consider competition, not individual competitors. There is no significant evidence to suggest that innovation or competition at the supplier level has been damaged. Further, consumers can benefit from buyer power in the form of lower prices.

In addition, retailers are constrained by the choices that consumers make. Consumers do not readily accept all private label products, which therefore limits options and lowers the major supermarket chains' bargaining power in those areas. For those producers that have strong brands with strong consumer loyalty, there are unlikely to be any concerns about the bargaining power of Coles, Woolworths and Metcash, as these producers hold 'must have' products for retail stores.

## Mergers and acquisitions

The inquiry has received a number of submissions alleging that Coles and Woolworths are growing through a strategy of creeping acquisitions of independent supermarkets. The phrase 'creeping acquisitions' generally refers to a series of acquisitions of smaller competitors over time which individually do not raise competition concerns, but which when taken together may have a significant competitive impact. Creeping acquisition might also refer to a player with existing market power making a small acquisition, even though the small acquisition does not substantially lessen competition in itself. Section 50 of the Act, which deals with mergers and acquisitions, is unlikely to be able to deal with creeping acquisitions.

The ACCC does not consider that acquisitions by Coles and Woolworths of smaller competitors over time are a significant current concern in the grocery retail sector. Most of the new growth by Coles and Woolworths in recent years has not come from acquisitions of independent supermarkets. Of all *new* store openings by Coles and Woolworths in the last two years, only 10 per cent have involved acquiring or leasing a site which was previously operating as an independent supermarket. However, that figure has been significantly higher for certain periods in the past.

Although such acquisitions do not appear to be a significant current concern in the supermarket retail sector, the ACCC maintains its support for the introduction of a general creeping acquisition law. The ACCC considers that the supermarket industry, because of the particular structural features of the market, is one where creeping acquisitions are a potential area of concern.

In addition to the issue of creeping acquisitions there has also been interest concerning how the ACCC generally approaches the application and enforcement of s. 50 to supermarket acquisitions.

The ACCC can only oppose a single acquisitions, (or accept a remedy to resolve the ACCC's competition concerns) where it considers that the acquisition, on its own, has the likely effect of substantially lessening competition. The ACCC recently opposed Woolworths' proposed acquisition of the Karabar supermarket in Queanbeyan, New South Wales. This acquisition was opposed based on an analysis of the local retail market, and not on a 'creeping acquisition' approach. It does not reflect any significant change in the ACCC's approach to acquisitions.

The inquiry has, however, revealed a misconception about the ACCC's role and the scope of s. 50. It appears that some industry participants believe that the ACCC can only analyse transactions where there is an acquisition of an existing supermarket business. This is incorrect. The ACCC considers that leases of sites, acquisitions of leases currently held by other parties, and acquisitions of sites that are currently empty or used for other purposes, can all be considered acquisitions of assets under s. 50 or be assessed under other provisions in Part IV of the Act. These transactions may only raise competition concerns in limited circumstances, as new site developments are generally pro-competitive.

## Horticulture Code of Conduct

The recent introduction of the Horticulture Code of Conduct was designed to impose a significant cultural and structural change on the horticulture industry. It is difficult to assess the effectiveness of the Horticulture Code, given that it has only been in place for a short period and given the changes it requires the industry to implement.

The introduction of the Franchising Code of Conduct, for example, was controversial at the time. Years later, with the assistance of the peak body, a cultural change has taken place within the franchise sector. The Horticulture Code is similarly likely to take some time to become fully effective.

The ACCC has made a number of recommendations in relation to improving the effectiveness of the Horticulture Code. These recommendations focus on making the Horticulture Code more workable, given existing industry practice, and ensuring that it applies fairly across industry participants. The ACCC recommends that industry feedback through the Horticulture Code Committee be obtained before implementing the suggested changes to ensure that any unintended consequences are appropriately accommodated in the amendments.

Specifically, the ACCC recommends that the Horticulture Code Committee and government consider the following recommendations.

### ***Recommendations***

- Amend the Act to introduce civil pecuniary penalties and infringement notices in relation to Part IVB provisions, such as the Horticulture Code and introduce random record audits as an enforcement mechanism available under the code.
- Amend the Horticulture Code to regulate first point of sale transactions of horticulture produce between a grower and a retailer, exporter or processor.
- Amend the Horticulture Code to regulate first point of sale transactions between a grower and a trader in horticulture produce, including in relation to agreements made before 15 December 2006.
- Amend the Horticulture Code to require a merchant to provide a grower, before delivery, with either a price or a formula for calculating price. Any agreed method used to calculate price must be by reference to the amount received by the merchant from the sale of the produce to a third-party purchaser.
- Amend the Horticulture Code to require that if a merchant does not reject the produce within 24 hours of physical delivery, the produce is deemed to be accepted.
- Amend the Horticulture Code to enable a merchant to deduct the cost of any services that are required to prepare the produce for resale as part of the price amount or as part of the method for calculating the price amount.
- Amend the Horticulture Code to only permit an agent to recover their commission for services performed under an agency agreement as a deduction from amounts paid by a third-party purchaser.
- Amend the Horticulture Code to exclude persons who may be an agent's competitor from inspecting that agent's records on a grower's behalf.
- Amend the Horticulture Code to ensure that transactions between a grower and a cooperative/packing house, in which that grower has a significant interest, are exempt from regulation under the Horticulture Code.

- Amend the Horticulture Code to permit agents and growers to engage in pooling and price averaging.
- Amend the Horticulture Code to exempt transactions entered into in a grower shed at the central markets from regulation under the code, while permitting parties to these transactions to access the code's dispute resolution procedure.
- The ACCC also recommends that the costs incurred by the parties to a dispute under the Horticulture Code dispute resolution procedure be subsidised by the Australian Government to the same extent as the voluntary Produce and Grocery Industry Code of Conduct (PGICC).
- The ACCC also recommends the implementation of further education initiatives regarding the Horticulture Code and its dispute resolution procedures, including the role of assessors in resolving disputes.

## Unit pricing

As part of the inquiry, the ACCC was asked to investigate the representation of grocery prices to consumers. Unit pricing is the practice of displaying the price by unit of measure (for example, per litre or kilogram) along with the total sale price for each item. Unit pricing can assist consumers by enabling them to readily compare prices between different sizes of the same product, between different branded products and also between stores.

The ACCC recommends that a mandatory, nationally-consistent unit pricing regime be introduced for standard grocery items both on in-store price labels and in print advertising. The ACCC recommends that the unit pricing regime apply to significant supermarkets, including Coles, Woolworths, ALDI and large independent supermarkets. Smaller supermarkets will face higher implementation costs relative to turnover compared to larger supermarkets. The ACCC therefore considers that before unit pricing is introduced a detailed cost-benefit analysis should be undertaken to determine which supermarkets mandatory unit pricing should apply to.<sup>5</sup> Grocery outlets not required to comply with the unit pricing regime should be allowed to display unit prices on a voluntary basis. If they choose to do so, they should be required to comply with the mandatory requirements.

The ACCC has heard evidence that implementation costs of unit pricing will vary depending on the time allowed for implementation. The ACCC considers that a six- to 12-month implementation period will sufficiently reduce costs, while ensuring that unit pricing is implemented in a timely manner. The ACCC recommends that the relevant administrative body, or the Australian Government, consult with industry participants and examine how costs will vary depending on the implementation timeframe.

The ACCC recommends that any legislative mechanisms implemented should also be sufficiently flexible to enable the agency responsible for the unit pricing regime to issue legislative instruments. These legislative instruments should clearly delineate which supermarkets and products are included in the unit pricing regime and allow for appropriate compliance monitoring and enforcement.

The ACCC also recommends that a public education campaign be established to ensure that unit pricing is fully understood by consumers and has the greatest possible impact.

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<sup>5</sup> Further, an assessment of the extent to which unit pricing should apply to non-print advertising and internet retailers that do not have a physical retail store should be conducted.

## **Recommendation**

The ACCC recommends that a mandatory, nationally-consistent unit pricing regime be introduced for standard grocery items both on in-store price labels and in print advertising, for significant supermarket stores.

## **Are other solutions required?**

Many submissions were received suggesting recommendations to address the suspected drivers of price competitiveness for standard groceries. The inquiry has not found evidence to support many of these suggested recommendations. The three areas where recommendations have been made by the ACCC are:

- the Horticulture Code of Conduct
- unit pricing
- planning laws.

Each of the recommendations are explained above and in more detail in the relevant chapters of the inquiry report.

The issue of market concentration was raised in several submissions received by the inquiry. Suggested recommendations included:

- introduction of a creeping acquisitions law
- other amendments to s. 50
- placing a cap on the market share of any single retailer
- separating the wholesale and retail divisions of Coles and Woolworths.

The ACCC supports the introduction of a creeping acquisition law of general application. However, the ACCC does not consider that the evidence to the inquiry supports the need for the other suggestions mentioned above. Several of the suggestions would be likely to have adverse efficiency effects and would be likely to weaken the competitive environment and therefore have the potential to further increase grocery prices for consumers.

Some submissions have expressed support for the introduction of a system to formally monitor the cost of grocery products in Australia, including periodic surveys of prices from the farm gate through to the retail level. Interested parties contended that this would enable consumers to identify where along the supply chain price increases occur. A price index designed exclusively to measure the prices of an average basket of food and grocery items was also proposed.

The Treasurer announced on 13 May 2008 that the Australian Government had asked the ACCC to conduct a monthly survey of the prices for typical grocery baskets (for example, meat, vegetables and dairy products) across Australia, and to publish the survey results on a dedicated consumer website. The new GROCERYchoice website published by the ACCC will provide practical grocery price information to assist consumers in locating the cheapest supermarket chain in their area. GROCERYchoice is discussed further in chapter 1.

Other suggested recommendations included greater transparency throughout the grocery supply chain to ensure that wholesale sellers and buyers, and independent retailers and wholesalers, are able to make informed decisions. Interested parties also recommended the development of a grocery industry code covering price setting principles. The ACCC's recommendations on the Horticulture Code are

relevant to the issue. These recommendations were summarised above and are discussed in detail in chapter 18. Outside of the context of the Horticulture Code, the ACCC does not believe that the issues raised regarding transparency justify a recommendation. This is because:

- the concerns expressed are unlikely to be addressed through increased transparency and instead reflect broader buyer power issues
- confidentiality in transactions can lower the likelihood of tacit collusion or explicit cartelisation
- regulations that demand transparency are very difficult to enforce since they can often be avoided by parties having undisclosed side-agreements.

Certain parties also raised the issue of price discrimination, where a single supplier charges a different price for the same good to different buyers. Interested parties recommended that the former s. 49 of the Act be reintroduced to prohibit this practice where the price differential cannot be attributed to any actual additional cost. The ACCC does not consider that evidence before the inquiry supports such a legislative change and has not made any recommendations in relation to price discrimination.

Predatory pricing was also raised by interested parties as an issue that required legislative attention. A number of suggestions were made in this area. The ACCC discusses changes in predatory pricing laws in the report, but the ACCC does not consider that any specific recommendations on predatory pricing in the grocery sector are warranted.



# 1 Background

## 1.1 Introduction

There has been significant public concern regarding the competitiveness of retail prices in the grocery industry in Australia and the pricing of household grocery products.

In particular there is concern that Australia has a highly concentrated grocery industry, and while inflation has been low in Australia over the last few years, grocery food prices have increased at a significantly higher rate than the headline inflation rate.

In response to these concerns, the Assistant Treasurer and Minister for Competition Policy and Consumers Affairs wrote to the Australian Competition and Consumer Commission (ACCC) on 22 January 2008, directing the ACCC to hold a public inquiry under Part VIIA of the *Trade Practices Act 1974* (the Act) into the competitiveness of retail prices for standard groceries. A copy of this letter is at appendix A.

## 1.2 Terms of reference

The instrument attached to the Assistant Treasurer and Minister for Competition Policy and Consumers Affairs' letter stated:

I, Chris Bowen, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, pursuant to section 95H(2) the *Trade Practices Act 1974*, hereby require the Australian Competition and Consumer Commission to hold an inquiry into the competitiveness of retail prices for standard groceries.

Matters to be taken into consideration by the inquiry shall include, but not be restricted to:

- the current structure of the grocery industry at the supply, wholesale and retail levels including mergers and acquisitions by the national retailers
- the nature of competition at the supply, wholesale and retail levels of the grocery industry
- the competitive position of small and independent retailers
- the pricing practices of the national grocery retailers and the representation of grocery prices to consumers
- factors influencing the pricing on inputs along the supply chain for standard grocery lines
- any impediments to efficient pricing of inputs along the supply chain, and
- the effectiveness of the Horticulture Code of Conduct, and whether the inclusion of other major buyers such as retailers would improve the effectiveness of the code.

In undertaking this inquiry the Commission will consult with retailers, businesses along the supply chain, farmers, consumers groups and other interested parties.

This is not to be an inquiry in relation to the supply of grocery items by any particular person or persons.

The inquiry is to be completed and a report submitted to me by 31 July 2008.

The inquiry commenced on Wednesday, 30 January 2008 with the publication of an inquiry notice in the *Gazette* and in newspapers.

The inquiry was conducted by the Chairman of the ACCC, Mr Graeme Samuel, and Commissioners, Mr John Martin and Dr Stephen King.

## 1.3 Outline of the inquiry process

As noted above, the inquiry into the competitiveness of retail prices for standard groceries was held in accordance with Part VIIA of the Act. Part VIIA empowers the ACCC to conduct monitoring/surveillance activity and, where necessary, to conduct a public inquiry. It gives the ACCC powers similar to those of the Prices Surveillance Authority by introducing into the Act provisions that were formerly part of the *Prices Surveillance Act 1983*.<sup>1</sup>

This is the second inquiry conducted by the ACCC under these provisions.<sup>2</sup>

### 1.3.1 Submissions

The ACCC released an issues paper on 11 February 2008.<sup>3</sup> It outlined the issues on which the ACCC was seeking information and comments and described how submissions to the inquiry could be made. The ACCC received over 250 public submissions from interested parties or persons. A wide range of organisations and people made submissions, including the major grocery retailers, suppliers, farmers, industry representative groups, government bodies and interested members of the public.

A list of parties who made public submissions to the inquiry is at appendix B. All public submissions were placed on the ACCC's website.

A number of parties also provided submissions which they requested be treated as confidential. The ACCC's approach to information for which parties requested confidentiality is discussed below.

### 1.3.2 Request for information and documents

The ACCC also exercised the information-gathering powers of the Act. Among other things, these provisions enable the ACCC to obtain information and documents (s. 95ZK of the Act) and summon a person to appear at an inquiry to give evidence and produce documents (s. 95S of the Act). The ACCC also made a large number of informal requests for information and purchased raw data from a variety of industry data providers. The ACCC did not use external consultants to analyse data, documents or any other information.

### 1.3.3 Hearings/public consultation

As stated, the inquiry was conducted by the ACCC in public hearings. These hearings commenced on 1 April 2008 and finished on 2 June 2008. Twenty-two hearings were conducted across all Australian capital cities and in several regional towns. Seventy-seven scheduled witnesses gave evidence to the inquiry during these hearings. A list of organisations and individuals that gave evidence at the hearings is at appendix C.

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1 These amendments were introduced in 2004.

2 On 15 June 2007 the former Treasurer agreed to the holding of a price inquiry by the ACCC into the price of unleaded petrol pursuant to s. 95H(2) of the Act. The ACCC's report of the inquiry was provided to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs on 14 December 2007. The report was publicly released on 17 December 2007. Copies of the report are available from the ACCC's website, [www.accc.gov.au](http://www.accc.gov.au).

3 ACCC, *Inquiry into the competitiveness of retail prices for standard groceries: issues paper*, 11 February 2008. The issues paper is available from the ACCC's website, [www.accc.gov.au](http://www.accc.gov.au).

Many witnesses who gave evidence to the ACCC were questioned by counsel assisting the inquiry, Mr Damien O'Donovan, a lawyer on a long-term secondment to the ACCC from the Australian Government Solicitor. Witnesses were also questioned by the inquiry members and, on occasion, ACCC staff.

Many witnesses at the hearings were summoned to appear under s. 95S of the Act and did not attend voluntarily. In general the ACCC summonsed all supplier companies. Therefore, no conclusions can be drawn regarding a company's willingness to participate in the inquiry from the company appearing at the hearings.

Some of the material covered in hearing sessions was confidential and commercially sensitive; therefore, parts of the hearings were not open to the public. Generally, questioning started in public, but sessions moved into a confidential phase when the questioning moved onto confidential material relating to the witness.

Transcripts of the public parts of the hearings are available on the ACCC website. The ACCC also disclosed some aspects of the confidential components of the transcripts after hearings where it considered that some of the material should be in the public domain and that such disclosure would be in the public interest. In these instances the ACCC consulted with the relevant witness before doing so.

### 1.3.4 Treatment of confidential information

While the inquiry was a public process, some parties sought to provide the ACCC with information on a confidential basis. In this respect, the ACCC had to be able to investigate issues that are commercially sensitive to witnesses and interested parties providing submissions without damaging the organisation's competitive position and commercial relationships.

In assessing requests for information not to be disclosed because of confidentiality, the ACCC considered whether it was desirable to conduct hearings or receive evidence and submissions in private or to maintain the confidentiality of evidence received. In doing so, the ACCC assessed whether disclosure would damage the provider's competitive position and/or whether disclosure would be in the public interest.

The ACCC was very mindful of the fact that some organisations were concerned about recriminations if they were seen to be assisting the inquiry. Throughout the inquiry the ACCC publicly emphasised that all supplier witnesses were summonsed, so that no conclusions could be drawn from the fact that an organisation was giving evidence. Furthermore, the ACCC agreed to accept information on an entirely confidential basis where it considered the commercial position of the organisation would be damaged if the fact that the organisation was providing information were disclosed.

In relation to submissions, there were some occasions where, although an organisation claimed confidentiality over the information in some parts of its submission, the ACCC considered that it would be in the public interest for the information to be disclosed. In each case the ACCC provided the relevant organisation with an opportunity to comment on possible disclosure. In some cases, the organisation provided further explanation to justify their confidentiality claim and the ACCC accepted the information on this basis. In other cases, the organisation agreed to release the information as part of a submission or as a new submission. If agreement could not be reached, the ACCC also provided an opportunity for the organisation to withdraw the submission or information, but on no occasion was it necessary for any information or submissions to be withdrawn.

Similarly, in relation to the information and documents obtained by the ACCC using its information gathering powers, there were some occasions where organisations claimed confidentiality over a great deal of the information and documents obtained. However, there were some occasions where the ACCC considered that it might be in the public interest for this information, or for evidence received during a hearing conducted in private, to be disclosed. Prior to making a decision on these issues, the ACCC provided the relevant organisation an opportunity to comment on possible disclosure. In some cases, the organisation provided further explanation to justify the confidentiality of the information and the ACCC did not disclose the information. In other cases, the organisation agreed to release the information. If agreement could not be reached, the ACCC considered whether it would be in the public interest for the information to be disclosed notwithstanding the concerns of the organisation. In several instances the ACCC has disclosed information in this report where the organisation has not agreed to the disclosure of their information. In those circumstances, disclosure has occurred because the ACCC considers it to be in the public interest.

## 1.4 Scope of the inquiry report

### 1.4.1 Definition of standard groceries

The ACCC was asked to hold an inquiry into the competitiveness of retail prices for *standard groceries*, which raises the issue of how to define 'standard groceries'.

The ACCC considered that a key driver of the inquiry was the rising cost of basic groceries such as dairy, fresh fruit and vegetables, bread and meat. The ACCC has considered that standard groceries are generally:

- non-durable
- purchased frequently
- not consumed at the retail site.

The ACCC was cognisant of the broad nature of the inquiry, and the need for the inquiry to focus on certain industries if it was to analyse the issues in a meaningful way. The ACCC therefore considered it appropriate that the inquiry should focus on basic or staple products that are typically purchased as part of most, but clearly not all, people's grocery shopping baskets. The broad categories of standard groceries that the ACCC has generally used are:

- dairy
- fruit and vegetables
- meat and seafood
- bread and grain-based products
- other foods
- non-foods.

The 'other foods' category is clearly broad. It covers many types of packaged dry foods, frozen foods and processed foods. It also includes eggs, many delicatessen items, and spreads and condiments. The precise boundaries between the product categories are not important for the purposes of the inquiry.

In the last category, the ACCC has had regard to products such as nappies, personal items,

toilet paper and cleaning products. The ACCC has not had significant regard to products such as stationery products, DVDs, hardware etc, even though many of these products can be purchased in supermarkets. The ACCC did not consider that these types of products should be the focus on an inquiry relating to standard groceries.

Further, the ACCC has not investigated issues relating to alcohol and tobacco products. The ACCC did not consider that such items fell within the scope of standard groceries. Furthermore, to extend the inquiry to include these products would have broadened the inquiry very significantly, particularly given that the competitive dynamic for such products is quite different to other grocery items.

### 1.4.2 A focus on supermarkets

The ACCC considered that in Australia the vast majority of standard groceries are purchased in supermarkets. At the retail level, the focus of the inquiry is therefore on supermarkets. However, many product categories, such as bread, fresh fruit and vegetables, delicatessen items, meat, and fish are also sold through specialist stores, including bakeries, butchers, delicatessens, fishmongers and produce markets.

Standard groceries are also available for purchase in a diverse range of other retail outlets, such as convenience stores, petrol outlets and general merchandise stores. The ACCC has taken into consideration the competitive influence of these outlets and how links between supermarket retailers and these other forms of retailing may affect the price of groceries—for example, the control of petrol outlets by the major supermarket chains (MSCs). However, given the majority of standard groceries are purchased in supermarkets, the main focus of the inquiry is on supermarkets.

### 1.4.3 Issues not covered

The ACCC's expertise lies in consumer protection, competition, regulation and industry analysis. Specifically, in the context of this inquiry, the ACCC has been asked to consider the competitiveness of retail prices for standard groceries.

Some submissions to the inquiry discussed issues outside the scope of the inquiry and outside of the scope of the ACCC's expertise. For example, a number of submissions discussed increases in the prices of healthy foods compared to prices of unhealthy foods. While the ACCC has had regard to all information that indicates rising prices for standard groceries, the report does not comment or make recommendations on policies relating to the encouragement of healthy eating.

Other submissions raised concerns about the quantity of imports entering Australia. The report does not comment on the quantity or quality of imports, and the effect this can have on local producers, as an issue in and of itself. However, the competitive influence of imports and how this can be a factor in increasing competition is an issue that the ACCC has taken into account.

Some submissions have brought into question the entire process of micro-economic reform over the last 30-odd years and the introduction of market forces into many formerly regulated markets. The report analyses the industry in the context of these reforms having occurred and does not comment on the broader reforms themselves.

Further, a large amount of correspondence the ACCC receives, both in relation to the inquiry and more generally, presumes or implies that the ACCC sets grocery prices. The ACCC has no role in directly setting grocery prices; the ACCC's role primarily relates to attempting to ensure there is adequate competition so that prices are determined through competitive market forces.

A number of specific instances of alleged breaches of the Act were raised during the inquiry, either during hearings, in submissions or in other information the ACCC received. To the extent that such alleged breaches are relevant to considering the competitiveness of retail prices for standard groceries, they have been considered in preparing this report. However, this report does not discuss in depth specific potential breaches of the Act. Each potential breach has been referred to the enforcement arm of the ACCC to be considered in accordance with the ACCC's normal procedures.

## 1.5 Approach to recommendations

The ACCC has made a number of recommendations which reflect the findings of this report. Each of these recommendations was summarised in the executive summary and is further explained in the relevant chapter of the report.

There is no formal legislative requirement setting out how the ACCC should approach recommendations when conducting a public inquiry under s. 95R of the Act.

The ACCC considered it appropriate that it should approach recommendations with the following matters in mind:

- Recommendations should be proportional to any competition problems identified.
- Recommendations should relate to the competitiveness of retail prices for standard groceries.
- Consideration should be given to the detriment of recommendations, particularly any possible:
  - lessening of competition between retailers or lessening of competition in any other market
  - increase in price in groceries
  - increased costs of operating in the grocery supply chain or a reduction in efficiencies in the supply chain
  - reduction in quality of groceries
  - reduction in the quality of retail stores
  - reduction in innovation in product development or retail store developments.
- This report makes recommendations on the basis of the evidence and information available to the ACCC during the course of the inquiry. Recommendations should be practical and the cost of implementing any recommendations should be considered.
- The ACCC will not generally be the appropriate organisation to consider issues that do not relate to consumer and competitive harm.
- Recommendations should reflect the object of the Act, which is to 'enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection.' The object of the Act is not to protect individual competitors from vigorous competition. Competition, by its very nature, will involve damage to some competitors and the success of other competitors.

## 1.6 Structure of the report

This report is presented in three sections. The first section, which is the focus of chapters 2 through to 10, focuses on competition between retailers. This is predominantly a 'horizontal' analysis in that it focuses on the level of competition at a specific level in the chain of production—i.e. competition between retailers.

The second section, which is the focus of chapters 11 through to 18, analyses issues arising in the chain of production, which the ACCC describes as a ‘vertical’ analysis because it focuses on all sections of the supply chain for a product—from farm gate to retail store—rather than focusing on the level of competition between retailers. Analysis of various supply chains and analysis of buyer power issues are the focus of these chapters. Discussion of the Horticulture Code, which relates to vertical relationships between farmers and purchasers, is also part of this analysis.

Although there are broadly two areas of focus, the horizontal retail competition and the vertical chain of production analysis, the two areas are very closely linked. The level of competition at the retail level will influence buyer power through the supply chain. The nature of the supply chain will also influence the level of competition between retailers.

The third section of the report, which is the focus of chapters 19 and 20, focuses on the role of the ACCC and the Act in addressing impediments to competition and the discreet issue of unit pricing.

## 1.7 Related roles of the ACCC

The ACCC is responsible for administering the Act. The main purpose of the Act is to promote competition and efficiency in markets within Australia and to protect consumers from unlawful anti-competitive conduct and unlawful market practices.

The ACCC has had previous involvement in the retail grocery sector and related industries that supply grocery products to retailers largely flowing from:

- ensuring compliance with the provisions of the Act prohibiting anti-competitive practices and unfair practices (such as misleading and deceptive conduct and false and misleading representations)
- examining mergers proposals
- assessing applications for authorisation (particularly collective bargaining) and notifications (particularly for petrol shopper docket arrangements)
- ensuring compliance with the Horticulture Code.

The government has also recently asked the ACCC to conduct and publish monthly surveys of the prices of typical grocery baskets. Each of these functions is briefly summarised below.

### 1.7.1 Grocery price monitoring

On 13 May 2008 the Treasurer announced that the government had asked the ACCC to conduct a monthly survey of the prices for typical grocery baskets (for example, meat, vegetables and dairy products) across Australia, and to publish the survey results on a dedicated consumer website.

The website, called GROCERYchoice, will provide practical grocery price information to assist consumers in locating the cheapest grocery prices and supermarket chain in their area.

It is very difficult for consumers to compare prices for hundreds of grocery items at supermarket chains to get a general picture of which supermarket chain provides cheaper overall prices. This issue is explored in chapter 4 of this report. GROCERYchoice will assist with this by helping consumers compare the general price levels of supermarket chains in their area.

Each month, the price of typical grocery baskets, made up of approximately 500 products, will be published for a range of supermarket retailers located in 61 different metropolitan, regional and rural

regions across Australia. These retailers include: Woolworths/Safeway, Coles/BI-LO, ALDI and other supermarket retailers such as IGA and Franklins.

Price information will be obtained from an independent monthly survey of approximately 600 supermarket outlets across Australia. The results of each monthly survey will be made available on the GROCERYchoice website on the first business day of the following month.

Further information about GROCERYchoice will be available at [www.grocerychoice.gov.au](http://www.grocerychoice.gov.au).

## 1.7.2 Anti-competitive practices, unconscionable conduct and unfair practices

### Part IV Anti-competitive conduct

A key objective of the Act is to prevent anti-competitive conduct, thereby encouraging competition and efficiency in business, resulting in greater choice for consumers in price, quality and service. Broadly speaking, Part IV of the Act prohibits the following anti-competitive trade practices:

- anti-competitive agreements and exclusionary provisions, including primary or secondary boycotts
- misuse of market power
- exclusive dealing
- resale price maintenance
- mergers which would have the effect, or likely effect, of substantially lessening competition in a substantial market.

In some situations the prohibition is subject to a competition test. Authorisation and notification provisions also enable the ACCC to take into account public benefits in determining whether certain practices should be allowed in the marketplace.

### Part IVA Unconscionable conduct

Part IVA of the Act contains important consumer provisions relating to unconscionable conduct. In particular, these unconscionable conduct provisions prohibit such conduct in dealings between businesses and in consumer transactions. The aim of these provisions is to ensure that the stronger party in negotiations does not take advantage of its position by behaving in an unfair or unreasonable manner. These provisions are particularly important in protecting vulnerable or disadvantaged consumers who are more likely to be the target of such conduct.

### Part V Consumer protection and fair trading provisions

Part V of the Act contains a range of provisions aimed at protecting consumers. These provisions apply generally to regulate the conduct between corporations (and in some cases non-corporate entities engaged in commercial activities) and their trading counterparts—whether those counterparts are private individuals (consumers) or other businesses.

Section 52 of the Act is the cornerstone of the fair trading and consumer protection provisions. It prohibits engaging in misleading or deceptive conduct that may induce consumers to make errors in choosing goods or services to their detriment. Part V, Division 1 of the Act also prohibits traders whose activities fall within the scope of the legislation from engaging in specific forms of deceptive or unfair conduct including:

- making false or misleading representations about important characteristics of products or services including price, place of origin, standard or composition, and sponsorship
- bait advertising
- falsely offering prizes
- accepting payment without intending to supply
- demanding payment for unsolicited goods or services
- pyramid selling
- harassment or coercion.

The main focus of the fair trading and consumer protection provisions of the Act is to ensure that consumers are not tricked by misleading information, thus empowering consumers to participate in competitive markets.

Part V also provides a product safety standard regime and ensures that all consumer contracts include certain basic protections for consumers that cannot be removed by traders. Implied conditions and warranties in consumer contracts include protections such as the right to enjoy quiet possession of the goods, that services must be carried out with due care and skill, and that goods must be fit for their purpose.

Appendix G provides a summary of matters taken by the ACCC under parts IV and V of the Act involving grocery retailers since 1999.

### 1.7.3 Mergers and acquisitions

Section 50 of the Act prohibits acquisitions of shares or assets that would be likely to substantially lessen competition in a market. If the ACCC considers that an acquisition would contravene s. 50 and the parties do not agree to modify or abandon the acquisition, the ACCC may apply to the Federal Court for an injunction, divestiture or penalties.

The ACCC investigates all mergers it becomes aware of that have the potential to raise competition concerns. In most cases, merger parties seek an informal clearance from the ACCC before proceeding with a proposed merger. Informal clearance is essentially a statement that the ACCC does not intend to oppose the proposed merger. Before providing such a statement, the ACCC reviews the proposed merger to determine whether it would be likely to raise competition concerns under s. 50.

Alternatively, merger parties may obtain statutory immunity from s. 50 by seeking either:

- formal clearance, which the ACCC may grant if it concludes that the proposed acquisition is unlikely to substantially lessen competition<sup>4</sup> or
- authorisation for the merger from the Australian Competition Tribunal (ACT) on the grounds that the public benefits from the proposed acquisition outweigh any anti-competitive impact.

Mergers and acquisitions involving supermarkets are considered in detail in chapter 19 of this report.

Appendix F provides a list of all acquisitions of supermarkets publicly reviewed by the ACCC since 2005.

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<sup>4</sup> ACCC decisions may be appealed to the ACT.

## 1.7.4 Collective-bargaining arrangements

Collective bargaining refers to an arrangement where two or more competitors in an industry come together to negotiate terms and conditions (which can include price) with a supplier or a customer. Collective-bargaining arrangements will ordinarily raise concerns under the Act as they involve agreements between competitors, often relating to price.

However, in some circumstances, collective bargaining arrangements may produce public benefits. The Act therefore allows immunity from legal action to be granted to parties to engage in collective bargaining when in the public interest.

Prospective participants in a collective-bargaining arrangement can apply for immunity from the Act for such arrangements through three different processes—authorisation, streamlined collective-bargaining authorisation or collective-bargaining notification.

The ACCC has allowed applications for immunity for collective-bargaining arrangements in a range of industries including applications lodged by:

- chicken meat growers
- dairy farmers
- fruit and vegetable growers.

Further details of the authorisation and notification process and relevant collective bargaining arrangements considered by the ACCC are provided at appendix H.

## 1.7.5 The Horticulture Code

The Horticulture Code (the code) came into effect on 14 May 2007 as a prescribed mandatory industry code of conduct under the Act.

The code regulates trade in horticulture produce between growers and wholesale traders (traders) to encourage greater clarity and commercial transparency in transactions between these parties. The code also provides an alternative to litigation by setting out a mechanism for resolving any disputes that may arise between growers and traders.

The code does not regulate those who purchase produce for the purpose of retail, processing or export. Nor does the code regulate transactions entered into under a written agreement that covers trade in horticulture produce and before 15 December 2006.

The ACCC ensures compliance with the code by helping traders and growers to understand their rights and obligations under the code and the Act. The ACCC does this by developing educational material such as guidelines, articles and fact sheets as well as giving presentations through the ACCC's outreach programs in each state and territory.

The ACCC is also responsible for investigating complaints and, where necessary, taking enforcement action against anyone who fails to comply with the code.

The terms of reference for this inquiry include consideration of the effectiveness of the code and whether the inclusion of other major buyers such as retailers would improve its effectiveness. These issues are examined in detail in chapter 18.

## 1.7.6 Shopper docket

Shopper docket arrangements provide discounts on petrol upon purchasing a minimum amount of groceries or other items from a nominated retailer.

Shopper docket arrangements may raise issues under the exclusive-dealing provisions of the Act. One form of exclusive dealing is third line forcing. In the case of shopper docket arrangements, third line forcing conduct may arise through the provision of discounted fuel on condition that the purchaser has acquired, for example, groceries, from a specified third party. The party at risk of engaging in third line forcing conduct is the party offering the discounted fuel.

While third line forcing is prohibited under the exclusive-dealing provisions of the Act, the Act also provides processes for obtaining immunity for parties proposing to engage in third line forcing conduct that is in the public interest. The main process involves 'notifying' the ACCC of the arrangements. The ACCC may at any stage remove immunity if it is satisfied that the likely benefit to the public from the notified conduct would not outweigh the likely detriment to the public resulting from the conduct.

Under amendments to the Act that came into effect on 1 January 2007, arrangements that involve the offer of goods by one company on condition that the purchaser acquires goods from the company's related body corporate do not fall within the third line forcing prohibitions of the Act.

As a result, the application of the Act to a number of the shopper docket arrangements in the marketplace, including some of those previously notified to the ACCC, is limited.

In 2004, following a period of change in the grocery and petrol sectors, including the commencement of Coles' shopper docket arrangements and the announcement of a joint venture between Woolworths and Caltex for Woolworths' shopper docket arrangements—which had been in operation since 1996—the ACCC conducted a public review of shopper docket arrangements. The ACCC report, released in February 2004, found that there were significant benefits to consumers from shopper docket petrol discount schemes.

The ACCC has also recently considered shopper docket arrangements in its December 2007 report of its inquiry into the price of unleaded petrol. The focus of that report was on the impact of shopper docket arrangements on competition in the retail market for petrol.

The focus of the consideration of shopper docket arrangements in this inquiry is on the impact of these arrangements on grocery prices and competition between grocery retailers. This is discussed in detailed in chapter 9 of this report.



## 2 Grocery prices in Australia and overseas

### Key points

- The rate of food price inflation in Australia has exceeded the overall rate of consumer price inflation in the economy since around 1997.
- The rate of food price inflation has increased significantly since 2006, with larger price increases occurring for fruit, vegetables, eggs, bread, cheese and milk.
- Since the mid-1990s, the rate of food price inflation in Australia has exceeded the rate of food price inflation in many OECD countries.
- A range of domestic and international factors have significantly contributed to the recent increases in food prices in Australia, including:
  - the current drought, which has reduced the supply of many agricultural products and increased the costs of farming
  - natural disasters such as cyclones and floods, which in combination with quarantine restrictions have caused considerable supply disruptions for some fruit and vegetable products
  - the international commodities boom, which has:
    - increased the cost of commodities (such as fertiliser and petrol) used to produce and transport many Australian food products
    - increased the prices at which some Australian farmers and food producers can sell their products in export markets, leading to higher domestic prices.
- It is difficult to be certain about the extent to which the above domestic and international factors account for the observed increases in food prices.
- Despite this, any potential contribution resulting from increased margins of major grocery retailers and wholesalers is small relative to the overall increases in food prices.

### 2.1 Introduction

A major public concern underlying this inquiry is the significant recent increases in food prices in Australia (section 2.2). According to the Australian Bureau of Statistics (ABS), food prices in Australia have increased by an average of 5.2 per cent per annum since March 2006. This compares to food price inflation of around 3.7 per cent per annum over the previous decade. In particular, there have been substantial increases in the prices of fruit, vegetables, eggs, bread and cheese, with prices of these products increasing by between 17 and 28 per cent over the past two years.

While a number of parties have expressed concerns about whether the ABS Consumer Price Index (CPI) accurately measures food price inflation (section 2.3), there is little doubt that food prices have increased considerably in recent times.

Food price inflation in Australia has exceeded food price inflation in many OECD countries (section 2.4). This has occurred since the mid-1990s but has become more prevalent since 2006. Relevant to this inquiry, some parties have submitted that this suggests there has been a 'total collapse' of competition in grocery retailing in Australia. However, a number of factors could potentially explain differences in food price inflation between Australia and comparable OECD countries. Indeed, it is important to

recognise that food prices can increase for reasons other than the level of competition in the grocery sector.

Evidence suggests a range of factors have contributed to the recent increases in food prices in Australia, including the current drought, natural disasters in combination with quarantine restrictions and the world commodities boom (section 2.5). However, it is difficult to be certain whether these factors account wholly for the increases.

Competition issues in grocery retailing, wholesaling and supply are explored in the following chapters of this report.

## 2.2 Recent trends in food prices in Australia

The rate of food price inflation in Australia, as measured by changes in the ABS CPI, has increased significantly in recent times.<sup>1</sup> As shown in table 2.1, retail food prices have increased by around 5.2 per cent *per annum* (10.7 per cent in total) since March 2006. This compares to an economy-wide rate of price inflation of 3.1 per cent *per annum* (6.3 per cent in total) over the same period.

**Table 2.1 ABS CPI by group item—average annual percentage changes in price indexes**

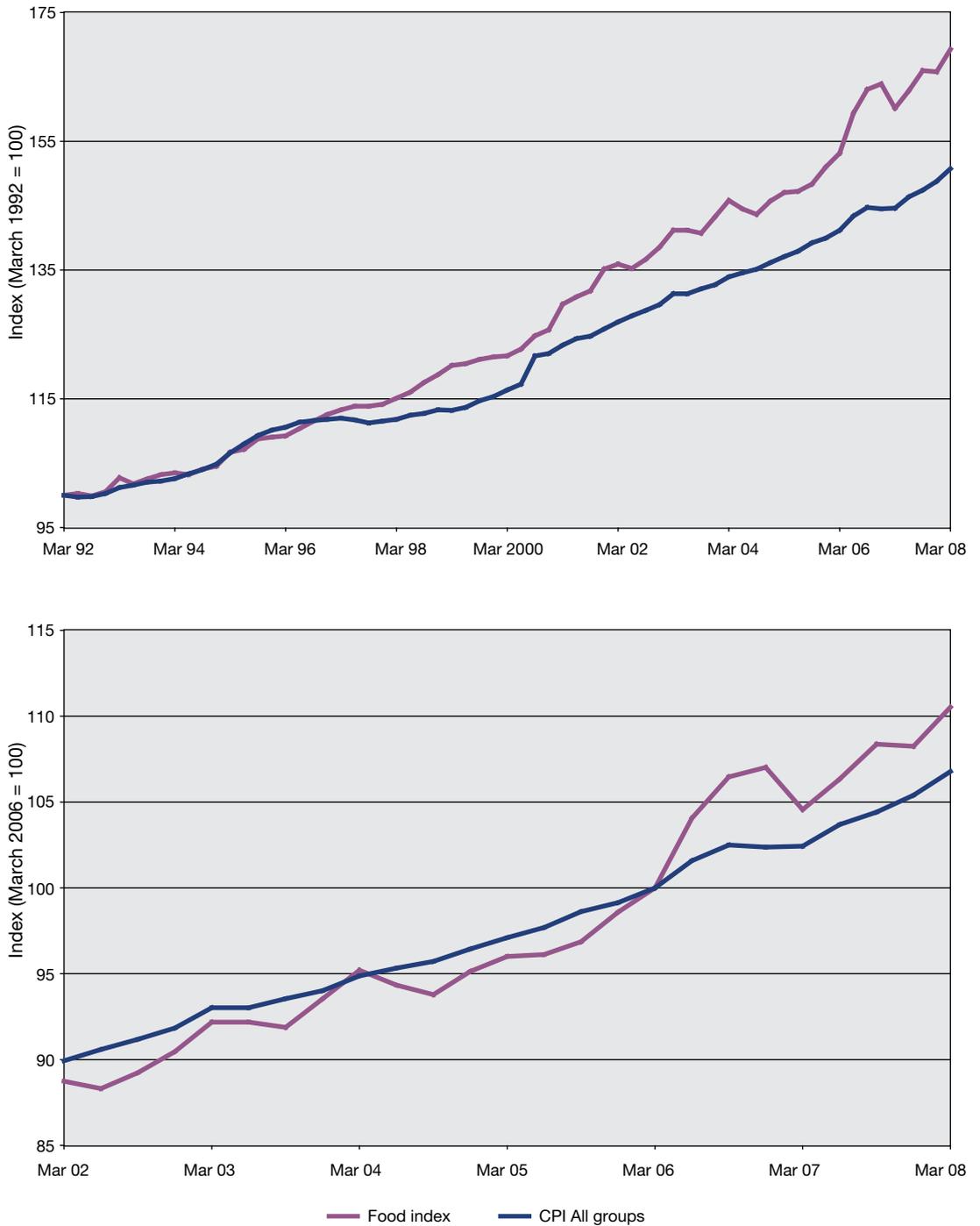
	1992–97	1997–2002	2002–07	Mar 2006– Mar 2008
Food	2.6	3.7	3.7	5.2
Alcohol and tobacco	6.5	4.8	3.5	3.4
Clothing and footwear	0.1	1.1	-0.7	-0.3
Housing	0.2	3.1	3.9	4.0
Household contents and services	1.1	1.2	0.5	0.7
Health	5.0	1.5	5.4	4.5
Transportation	2.5	2.2	2.9	3.2
Communication	-0.1	0.1	0.8	0.7
Recreation	1.9	2.5	0.5	1.4
Education	4.9	5.0	5.7	4.5
<b>All groups</b>	<b>2.2</b>	<b>2.8</b>	<b>2.7</b>	<b>3.1</b>

Source: ABS (cat. no. 6401.0)

While food price inflation in Australia has exceeded the overall rate of inflation since 1997, the difference has increased significantly over the past two years (chart 2.1).

<sup>1</sup> The CPI is compiled quarterly by the ABS for quarters ending in March, June, September and December each year. The quarterly index numbers are usually published between three and four weeks after the end of the quarter in ABS, Consumer Price Index, Australia (cat. no. 6401.0). This data can be used to calculate food price movements over time. The CPI is not designed to measure price levels; nor is it a precise measure of individual household price experiences. (ABS concepts, sources and methods are discussed in more detail in section 2.3.)

**Chart 2.1 ABS CPI comparisons—food products and all product groups, 1992 to 2008 and 2002 to 2008**



Source: ABS (cat. no. 6401.0)

Of the various food subgroups, the products that have increased the most over the last 15 years include fruit, vegetables, eggs, bread, milk, and lamb and mutton (table 2.2). In the last two years, the prices of fruit and vegetables have been extremely volatile and have increased the greatest, rising by 13.0 per cent and 9.6 per cent *per annum* respectively. This was significantly higher than overall food price increases (excluding meals and takeaway foods) over the same period.

**Table 2.2 ABS CPI by selected food items—average annual percentage changes in price indexes**

	1992–97	1997–2002	2002–07	Mar 2006– Mar 2008
Fruit	3.8	4.7	5.6	13.0
Vegetables	4.1	4.4	6.8	9.6
Eggs	7.4	2.6	4.3	8.5
Bread	5.5	4.2	3.7	8.1
Cheese	0.5	2.9	5.1	8.1
Fats and oils	2.0	3.4	5.2	7.6
Soft drinks, waters and juices	1.9	0.7	4.1	5.8
Milk	4.8	2.7	4.1	5.7
Fish and other seafood	1.6	3.5	2.5	5.0
Cakes and biscuits	2.2	3.2	3.0	4.6
Tea, coffee and food drinks	5.2	2.2	0.6	4.5
Snacks and confectionery	3.9	3.4	4.1	4.1
Food additives and condiments	1.4	2.6	1.6	4.1
Jams, honey and sandwich spreads	2.9	2.9	4.1	3.7
Other fresh and processed meat	1.5	5.2	2.0	3.4
Ice-cream and other dairy	3.3	4.8	1.7	3.3
Food n.e.c. <sup>a</sup>	1.5	3.0	2.1	3.2
Breakfast cereals	2.8	0.3	2.5	2.4
Bacon and ham	2.1	3.4	1.0	2.2
Poultry	1.6	0.4	0.1	1.8
Pork	2.7	5.1	3.1	1.7
Lamb and mutton	5.0	6.9	4.3	1.3
Beef and veal	0.3	6.2	3.0	0.7
<b>Food (excluding meals and takeaway foods)</b>	<b>3.1</b>	<b>3.4</b>	<b>3.8</b>	<b>5.8</b>

<sup>a</sup> n.e.c. (food not elsewhere classified) includes canned and packet soups, baby foods and prepared meals.

Source: ABS (cat. no. 6401.0)

## 2.3 Does the ABS Consumer Price Index accurately capture movements in food prices?

The CPI is designed to provide a general measure of price inflation for the household sector as a whole.<sup>2</sup> The ABS, in calculating the CPI, measures quarterly changes in the price of a ‘basket’ of goods and services covering a wide range of products, including food.<sup>3</sup> Importantly, the ABS does not endeavour to measure the minimum expenditure required to purchase a basket of goods and services capable of providing the same level of satisfaction to consumers over time.

Prices of some products change on a regular basis. For these items, frequent price observations are necessary to obtain reliable estimates of average prices over a quarter. For example, the prices of products such as milk, bread, fresh meat and seafood, and fresh fruit and vegetables are collected regularly.<sup>4</sup>

In constructing the CPI, the ABS’s objective is to ensure that the index reflects only ‘pure price changes’. This is achieved by making comparisons of prices on a ‘like-with-like’ basis. Price index theory provides statisticians with guidance as to the best practices and formulae to use in compiling price indexes to produce reliable measures of price movements. However, the accuracy of the data is limited by practical considerations, such as the cost of more frequent price comparisons.

In submissions to the inquiry, a number of participants have commented that the CPI has not accurately reflected food price increases in Australia. Issues raised by parties relate to concerns about changes in what consumers buy over time, and bias from changes in product quality over time and the introduction of new products. Also, while the rate of food price inflation in Australia has been significant (as shown in section 2.2), it appears that ABS data have been misinterpreted in the media during the course of this inquiry, which has had the effect of exaggerating the size of the problem.

### 2.3.1 Changes in what consumers buy

The ABS applies a ‘fixed basket’ approach to constructing the CPI which does not allow the quantities of the individual products to change when measuring period-to-period price changes.<sup>5</sup> Consequently, this approach does not take into account any adjustments or substitutions made by consumers in the quantities of various products they purchase. In particular, it does not allow for any consumer response to changes in relative prices between periods. Nor does it allow for any changes in what consumers buy as their tastes or incomes change.

The weights used in the CPI are primarily based on data obtained from the Household Expenditure Survey (HES) (box 2.1). The HES is conducted every five to six years. Accordingly, the ABS has changed the CPI weights to take account of changes in household spending patterns reflected in the HES. As noted by the ABS, the introduction of new weights is done in such a way that the index reflects only pure price change and not differences in the composition of the old and new baskets.<sup>6</sup>

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2 ABS, cat. no. 6461.0, *Australian Consumer Price Index: concepts, sources and methods*, Canberra, 2005.

3 The basket covers 11 groups, including food, alcohol and tobacco, clothing and footwear, housing, household contents and services, health, transportation, communication, recreation, education, and financial and insurance services.

4 ABS, cat. no. 6401.0, March quarter 2008, Canberra.

5 In constructing the CPI, the ABS uses around 90 expenditure classes—that is, groupings of like items. Each expenditure class has its own weight (or measure of relative importance). These (fixed) weights are applied to the price changes for each of the expenditure classes to calculate the CPI.

6 ABS, submission no. 245.

### **Box 2.1 The Household Expenditure Survey**

The Household Expenditure Survey (HES) is now conducted at six-year intervals (previously five) with the most recent being in 2003–04. The HES surveys expenditures on an item-by-item basis for around 7000 households for a two-week period.

Due to the time required to process and validate the data from the HES, new baskets (or weights) are introduced into the CPI a year or so after each HES is completed. For example, the weights based on the 2003–04 HES were introduced into the CPI in the September quarter 2005 (to measure price change from June quarter 2005).

Although the HES provides a comprehensive range of household expenditures, various adjustments are made to the HES data for use in the CPI, and for some products the HES is supplemented or replaced by data from other sources.

There are weaknesses in the HES data for CPI purposes:

- The HES is a survey and is thus subject to sampling error. It is possible for the inclusion of a set of households with exceptionally high expenditures on a certain product to significantly affect the expenditure estimate for that product at a regional level, especially in the smaller capital cities.
- Some expenditure recorded in the HES is not fully contemporaneous. Estimates for some products which are more expensive or purchased infrequently are obtained or supplemented by consumer recollection, rather than relying on expenditures actually recorded in the 'diary' during the two-week period. Periods over which households are asked to recall expenditure vary by product.
- The HES records all data as reported by households, with no adjustment for known cases of under-reporting, especially expenditure on alcohol and tobacco.<sup>7</sup>

The longer the period for which the same fixed weights are used, the less representative those weights become of current consumption patterns. This may undermine the credibility of an index that purports to measure the rate of change in the total cost of a basket of goods and services typically consumed by households. As noted by the International Labour Organization, the basket needs to be representative of not only the households covered by the index but also of expenditure patterns at the time the price changes occur.<sup>8</sup>

Woolworths has criticised the fixed basket approach adopted by the ABS. For example, Woolworths contended that 'the [ABS] Australian food price index greatly overstates the price increases experienced by Woolworths' customers for the basket of food that they buy.'<sup>9</sup>

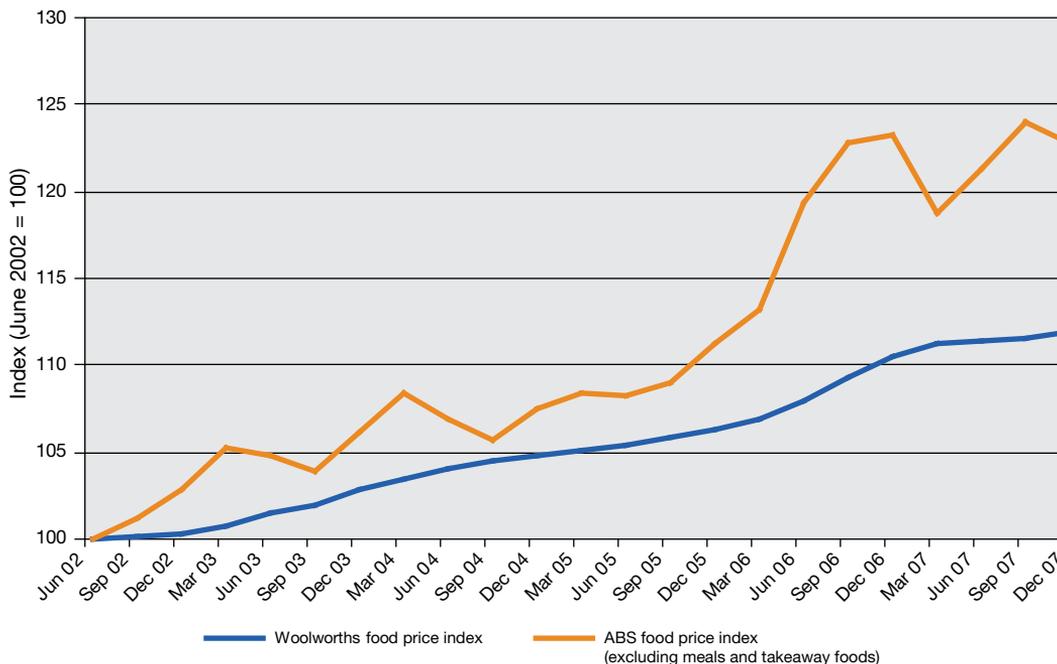
To show this, CRA International (CRA) (a consultant for Woolworths) constructed a 'Woolworths food price index' on a variable (current), revenue weighted basis. The Woolworths index is based on Woolworths' grocery prices and takes account of changes in consumer purchasing patterns as relative prices change and products become in short supply. Constructing a 'price' index in this fashion significantly reduces the measure of food price inflation in Australia (chart 2.2).

7 ABS, cat. no. 6461.0, *Australian Consumer Price Index: concepts, sources and methods*, Canberra, 2005.

8 International Labour Organization, *IWGIPS: consumer price index manual: theory and practice*, 2004.

9 Woolworths, submission no. 134, p. 13.

**Chart 2.2 Woolworths food price index compared to the ABS food price index (excluding meals and takeaway foods)**



Note: As explained in the Woolworths submission to the inquiry, the Woolworths food price index is calculated on a current revenue weighted basis and compared to the ABS food price index (excluding meals and takeaway foods), which is calculated on a 'fixed weights' basis. The majority of ABS food categories were matched against Woolworths' categories. The Woolworths' general merchandise and service delicatessen categories, and tobacco products and liquor were excluded.

Source: Woolworths, submission no.134

CRA commented that the ABS food price index appears to be sensitive to large price changes of products when they are in short supply because it does not account for the fact that consumers can change the composition of their basket.<sup>10</sup> The Woolworths food price index, on the other hand, is based on current expenditures made by consumers. As noted by Woolworths:

The Woolworths food price index is based on actual selling volumes, and is an expenditure index. If a product's price spikes, the data and index will reflect that (ie high prices multiplied by small volumes), giving a truer picture of the impact of those prices upon the outlays made by Woolworths' customers.

For example, the ABS index assumes consumers continued weighting their basket with the same volume of bananas, notwithstanding the prevailing high nominal selling prices following Cyclone Larry when there was almost complete unavailability of the single largest selling product in a supermarket (bananas) for an extended period. Given that the volume of bananas sold during the period shrank considerably as consumers replaced most or all of the bananas in their shopping basket, the ABS index does not give a true reflection of the impact of prices upon the cost of consumers' outlays. For example, to the extent to which consumers regard other fruits as a good substitute for bananas, consumer welfare will have been far less adversely affected by the increase in banana prices than the ABS index would suggest.<sup>11</sup>

<sup>10</sup> *ibid.*

<sup>11</sup> *ibid.*, p. 16.

The ACCC notes indexes that measure price changes between different baskets of goods and services over time—such as the Woolworths food price index—are subject to error from compositional shifts. For example, household expenditures change from one period to the next for a number of reasons, including changes in economic conditions, changes in tax rates and population growth. Moreover, as commented by the ABS:

... the reality is that the actual expenditures of individual households do change over time in response to many factors including changes in prices (particularly relative prices); changes in incomes; changes in family composition (including ages of family members); changes in tastes and preferences and the availability of products (including the emergence of new items). Further, within a calendar year, expenditures can change from month to month due to seasonality of either supply (seasonal availability of produce) or demand (e.g. chocolate at Easter). Changes over time in the expenditures of households in aggregate are additionally affected by changes in the demographic profile of the population at large (e.g. increases in the proportion of older Australians).<sup>12</sup>

Changes in household expenditure patterns resulting from many of the above factors would be picked up in the Woolworths food price index even though they have little to do with changes in the prices of food. Consequently, indexes based on variable weights are not directly comparable to the ABS food price index because they reflect different household expenditures over time. Notably, as demonstrated by CRA in Woolworths' submission to the inquiry, if fixed weights are applied to Woolworths food prices, trends in the ABS food price index and the Woolworths index are reasonably comparable.<sup>13</sup>

### ACCC's view

The 'fixed weights' approach, although providing a suitable measure of changes in prices of products over time, does not accurately reflect the effect of price changes on the standard of living of households. To the extent that households change their purchasing patterns in response to changes in prices, the fixed weights approach will *overstate* the effect of price increases on household welfare. As noted by the International Labour Organization, the longer the period for which the same basket is used, the greater the upward bias in the index is likely to become.<sup>14</sup>

The 'variable weights' approach adopted by Woolworths does not accurately measure price inflation. Moreover, to the extent that consumers substitute to less preferred products in response to price increases (say from steak to mincemeat), the Woolworths food price index will underestimate the effect of price changes on household welfare.

For the purposes of this inquiry, the ACCC considers that the ABS fixed weights approach provides a reasonable measure of food price inflation and, importantly, allows for 'like-with-like' comparisons of price changes of individual products. Further, as discussed by the ABS:

While the ABS appreciates that what the CPI measures is not always appropriate for the many uses made of it, a high priority is placed on ensuring we follow consistent, clearly described, internationally recognised standards and practice to the fullest extent possible. What is important in this regard, is that what the CPI does measure can be clearly articulated and users are provided with sufficient information to assist in modifying the index to better suit their purposes or, to at the very least, appreciate the extent to which the CPI measure might differ from what they are seeking.<sup>15</sup>

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12 ABS, cat. no. 6401.0, March quarter 2008, Canberra, 2008, p. 33.

13 Woolworths, submission no. 134.

14 International Labour Organization, IWGPS: *Consumer price index manual: theory and practice*, 2004.

15 ABS, submission no. 245, p. 11.

As noted by the ABS, another method that could potentially be employed is the ‘fixed utility’ approach (also known as a ‘cost of living’ index).<sup>16</sup> For this approach, the products for which prices are collected are treated as if they constituted a basket of goods and services from which the consumers derive ‘utility’ (or satisfaction).<sup>17</sup> A cost of living index measures the minimum amount by which consumers would have to change their expenditures to keep their utility level unchanged—allowing consumers to make substitutions between items in response to changes in relative prices.<sup>18</sup>

For many of the purposes for which the CPI is used, the fixed utility approach would be superior to the ABS approach. However, as stated by the ABS:

The items priced would be allowed to change from period to period but the level of utility would not. While this may represent a theoretically desirable approach to measuring price change, it is not one that is feasible to use in practice as it is not possible to measure the level of utility provided by any particular basket, or to identify different baskets that provide the same level of utility.<sup>19</sup>

## 2.3.2 Quality change and new product bias

As part of the Coles submission, freshlogic stated there are a number of problems with the CPI methods and calculations regarding, for example, the ABS approach to ‘weightings’ (discussed above).<sup>20</sup> In addition, freshlogic commented that:

CPI tracking and basket systems are not capturing the new product trends of retailers and manufacturers, such as:

- varietal and quality differentials
- pack size and portion diversity within categories in fresh and combined products
- the dynamic range of expansion which is mostly adding value to products—such as high-fibre and nutrient-enriched bread products, modified and enriched milks and salad mix products.<sup>21</sup>

As noted by the ABS, it is almost impossible to eliminate sources of bias such as ‘quality adjustment’ and ‘new goods’ bias.<sup>22</sup> Nevertheless, contrary to the claims made in the Coles–freshlogic report, the ABS has published numerous information papers that outline the steps the ABS takes to minimise bias in the CPI.<sup>23</sup>

### Quality comparisons

Product prices can and do change as product quality changes. To accurately measure price movements, changes in product prices resulting from changes in quality should be excluded from the CPI. Quality change bias can occur when a variety or model of a product is replaced by a new variety. For example, food products sold in packages (such as breakfast cereals) often undergo changes in packaging sizes and content mixtures.<sup>24</sup>

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16 *ibid.*

17 Utility is the pleasure or satisfaction derived by an individual from being in a particular situation or from consuming goods or services.

18 International Labour Organization, *IWGPS: Consumer Price Index Manual: Theory and Practice*, 2004.

19 ABS, submission no. 245, pp. 3–4.

20 Coles, submission no. 157.

21 *ibid.*, p. 12.

22 ABS, cat. no. 6461.0, *Australian Consumer Price Index: Concepts, Sources and Methods*, Canberra, 2005.

23 For example, the ABS has published ‘A guide to the Consumer Price Index: 15<sup>th</sup> Series—2005, which provides a detailed explanation of the CPI and addresses a range of issues related to the interpretation and use of the CPI. This information paper is attached to the ABS’s submission to the inquiry.

24 ABS, cat. no. 6461.0, *Australian Consumer Price Index: Concepts, Sources and Methods*, Canberra, 2005.

Attempts are made by the ABS to avoid or minimise this type of bias—to ensure that food products are priced on a ‘constant quality’ basis—by adjusting the prices of products for which quality changes have occurred. If no quality adjustments were undertaken, the price index would incorrectly regard price increases related to an improvement in quality as pure price change and would overstate the actual price movement.

## New products

When a new good is offered to consumers, ideally it should be introduced into the basket of goods and services—especially if the product is expected to be responsible for relatively high sales. New goods might have different price changes from existing ones, for example, at the start of their life cycle. In the initial period, producers can sometimes gain more from their ability to receive higher prices from their recently introduced product than might be attainable once the market settles. Conversely, they may offer a product at a discounted price initially.

The greatest sources of new goods bias are for items involving rapid technological advancement such as household appliances and electronic equipment.

### *Measures to minimise quality change and new product bias*

Over time new products appear in the market and replace older products, with the new products possessing different attributes (or quality). For the purposes of a price index, it is necessary to measure these changes in quality, and to remove any change in price attributable purely to the change in quality from the inflationary movement in the price.

As outlined by the ABS, the inclusion of new products in the CPI can be best illustrated by reference to a simplistic though contrived example of how the calculation of a price index for apples may have changed over time.<sup>25</sup> The example assumes that initially only prices of Red Delicious apples are available, then an expanded set, including Pink Lady and Gala, and finally back to only Red Delicious and Gala. It is assumed that in each period the quantities are equal.

Two possible methods for calculating price change are demonstrated in table 2.3. The first method simply makes use of the average of all prices available in each period while the second method measures period-to-period price change, based only on the prices of those specific products available in both periods.

The second method, which is generally referred to as a ‘matched sample’ approach, is used by the ABS to calculate the CPI. The first method, sometimes referred to as the ‘unit value’ method, represents an approach better suited to tracking changes in expenditure, particularly if the quantities purchased in each period are known.

As shown in table 2.3, there is no unambiguous single average price associated with a price index for any period. For any product, there is always the potential for there to be two average prices for each period: the average price for the sample that matches the previous period, and the average price for the sample that matches the following period.

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<sup>25</sup> ABS, submission no. 245, pp. 5–6.

**Table 2.3 ABS example calculation of a price index for apples**

	Period				
	0	1	2	3	4
	<b>Prices (\$)</b>				
Red Delicious	1.56	2.04	2.21	2.36	2.65
Pink Lady		3.80	4.09	4.93	
Gala		2.60	2.80	2.85	3.10
Simple average	1.56	2.81	3.03	3.38	2.88
Matched averages					
Periods 0 and 1	1.56	2.04			
Periods 1 and 2		2.81	3.03		
Periods 2 and 3			3.03	3.38	
Periods 3 and 4				2.61	2.88
	<b>Period-to-period percentage changes, using</b>				
Simple averages		80.3	7.8	11.4	-14.9
Matched averages		30.8	7.8	11.4	10.4
	<b>Price index, using</b>				
Simple averages	100.0	180.3	194.4	216.6	184.2
<b>Matched averages</b>	<b>100.0</b>	<b>130.8</b>	<b>141.0</b>	<b>157.1</b>	<b>173.4</b>

Source: ABS, submission no. 245

In addition to the matched sample approach, the ABS employs a range of techniques to reduce or mitigate bias in ABS price indexes. Quality is an important issue in the pricing of fresh meat, seafood and vegetable products for the ABS. For example, mincemeat can come in normal or premium ‘grade’ and, according to the ABS, considerable care is taken by its field officers to ensure that comparable grades are priced in each period. Regular assessments of the consumption of each grade type are also conducted by the ABS to ascertain which grade should be priced.<sup>26</sup>

### 2.3.3 Misinterpretation of ABS price data

Media commentary in recent months has suggested that the average family is now paying an extra \$139 a month in grocery bills compared to last year.<sup>27</sup> These claims have generally been made on the basis of information published in the ABS *Average retail prices of selected items* series.<sup>28</sup> This publication details average retail prices for a small sample of food and non-food items.

The ABS collects average retail prices and presents them in this publication for the purpose of making price comparisons between capital cities for individual items at a particular time. The data are presented in the form of ‘raw’ average prices. Prices are the averages across a range of grades, qualities and brands offered by a number of retailers in each city. Using the prices reported in this publication to measure price changes over time can provide a misleading picture. As noted by the ABS:

Unfortunately, despite the strong warnings against this practice, some users continue to use average price data to construct measures of price change over time. The average price data is simply not fit for this purpose. The only fit for purpose measures of price change over time are the published price indexes.<sup>29</sup>

26 ABS, cat. no. 6461.0, *Australian Consumer Price Index: concepts, sources and methods*, Canberra, 2005, p. 82.

27 For example: ‘Your food bill is up \$139 a month’, *Herald Sun*, 3 May 2008; ‘Hobart Family’s monthly food bill rockets \$139 in year’, *The Mercury*, 1 May 2008.

28 ABS cat. no. 6403.0.55.001, *Average retail prices of selected items: eight capital cities, March quarter 2008*, Canberra, 2008.

29 ABS, submission no. 245, p. 7.

The most significant source of error in comparing these prices over time is likely to result from changes in the products used to create the average retail prices from one period to the next. This is best shown by example—consider retail prices of eggs. As shown in table 2.4, according to the ABS *Retail prices* series, the average prices of eggs in Melbourne increased by 51 per cent between March 2005 and March 2008. The ABS CPI series indicates that the prices of eggs increased by 16.5 per cent over the same period.

The difference is that the types and brands of eggs in the ABS retail prices series changed over the period with consumers buying more free range eggs, which are more expensive than, for example, ‘generic’ type eggs. This change in the types of eggs purchased by consumers has increased the average retail prices of eggs. In contrast, the ABS CPI series compares the prices of eggs over time strictly on a ‘like-with-like’ basis.

**Table 2.4 Average retail prices and CPI for eggs in Melbourne**

	March 2005	March 2008	Percentage change
Eggs—average retail prices	\$3.06	\$4.62	51.0
Eggs—CPI <sup>a</sup>	172.0	200.4	16.5

<sup>a</sup> 1989–90=100.

Sources: ABS (cat. no. 6403.0.55.001); ABS (cat. no. 6401.0)

This example demonstrates that public perception of food price inflation might be influenced by media commentary that appears to have exaggerated the size of the problem.

## 2.4 International trends in food price inflation

In analysing food price movements in Australia, an important consideration is Australia’s ‘performance’ relative to other countries. Indeed, this has been raised as a significant public concern and features in a number of submissions to the inquiry. In addition, the validity of food price comparisons across countries has been a topic of contention in submissions and at the public hearings.

### 2.4.1 Comparing food price inflation for selected OECD countries

Data for comparisons of food price inflation across countries are based on OECD statistics. OECD data on food price inflation are prepared by national statistical agencies primarily to meet the requirements of users within their own country. In most instances, the indicators are compiled in accordance with international statistical guidelines and recommendations.<sup>30</sup>

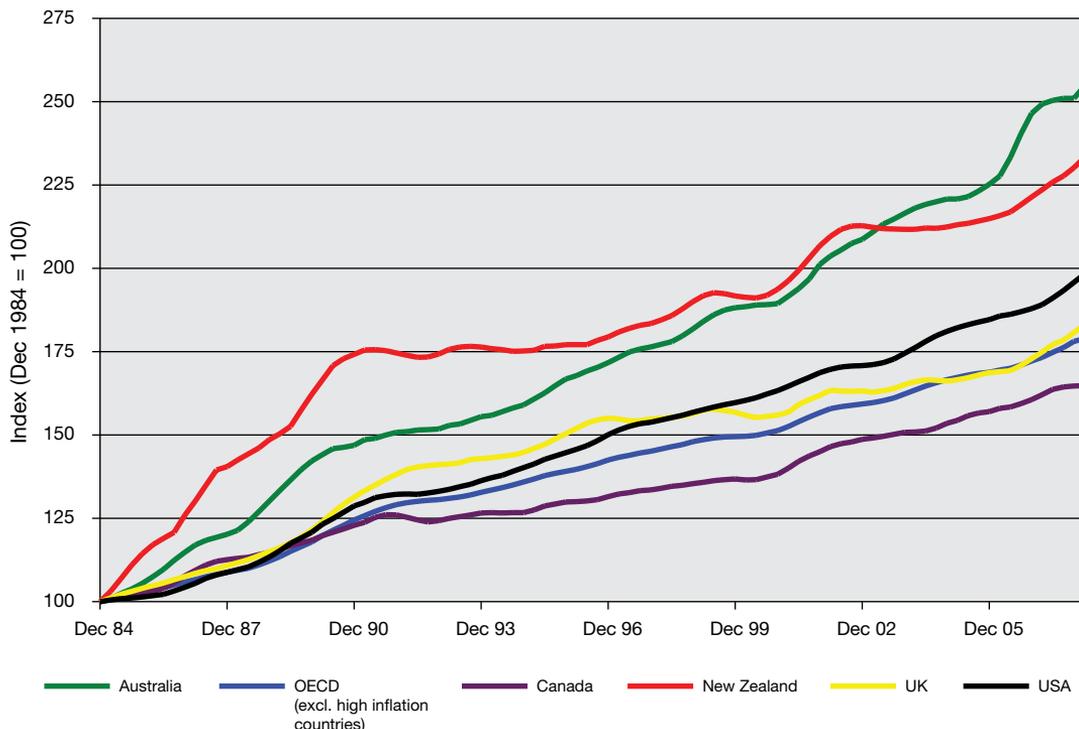
Cross-country comparisons of rates of price change can be affected by the choice of base period, as discussed by the ABS.<sup>31</sup> To minimise the potential for seasonal influences, a four-quarter moving average of each index is used.

OECD data suggest that food price inflation has been higher in Australia than in many industrialised countries since around 1984. For example, from 2005 to 2007, prices for food in Australia increased by around 11.4 per cent compared to 5.5 per cent for the OECD (excluding high inflation countries) (chart 2.3). Interestingly, trends in food prices for the United Kingdom, the United States and Canada appear to have followed a similar path.

<sup>30</sup> OECD, *Main economic indicators*, 2008.

<sup>31</sup> ABS, submission no. 245.

**Chart 2.3 Moving averages of food price indexes for selected OECD countries**



Source: OECD, Main economic indicators, 2008

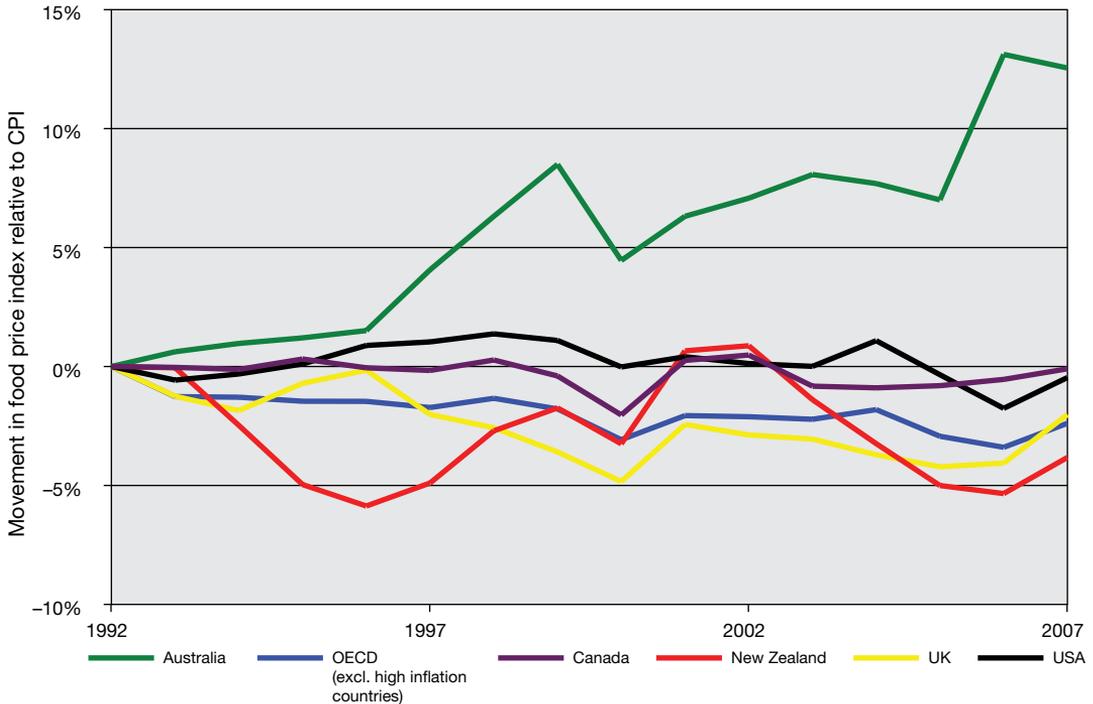
Australia appears to be unique among many OECD countries in having a rate of food price inflation which has been consistently above overall inflation over the last ten years or so (chart 2.4). This does not necessarily mean that *absolute* food prices are higher in Australia than in other OECD countries. As noted by Woolworths, international comparisons are 'highly susceptible to price level variations at the commencement of the period under study, since it is easier to make percentage gains off a low base than a high one.'<sup>32</sup>

Although international comparisons of food price levels—such as purchasing power parity (PPP) indexes and 'basket affordability' studies—can help to determine if Australian food prices are merely 'catching up' with the rest of the world, there are significant limitations associated with these types of measures. For example, criticisms of PPP indexes include that PPP can vary with the specific basket of products used, and differences in quality of goods are not sufficiently reflected across countries.<sup>33</sup>

<sup>32</sup> Woolworths, submission no. 134, p. 17.

<sup>33</sup> Leaving aside the problem of simply being able to obtain price data for a sufficient number of identical (or comparable) products in the various countries, the fact that there can be significant differences in the expenditure patterns across countries (and hence in the relative significance of products) means that it is not sensible to use the expenditures of any one country to weight together the individual PPPs.

**Chart 2.4 Food price index relative to CPI for selected OECD countries**



Source: OECD, Main economic indicators, 2008

## 2.4.2 Limitations of making international comparisons

Considerable effort has been made by the OECD to ensure that the data are comparable across all countries presented and that all the countries have good historical time-series data.<sup>34</sup> However, national practices may differ from OECD guidelines and, consequently, might impact on comparability between countries. Inconsistencies could arise from, for example, differences in methodology, assumptions and definitions.

In the Coles submission to the inquiry, a number of issues relating to intercountry comparisons were raised.<sup>35</sup> In particular, it was stated in the freshlogic report submitted by Coles that there is potential for limited consistency of food products that are included in the CPI. Further, different weightings are given to food categories within the food CPI basket and there are different weighting revision systems as consumption patterns change across any given year.

<sup>34</sup> OECD, *Main economic indicators*, 2008.

<sup>35</sup> Coles, submission no. 157.

In addition to concerns that international comparisons are exposed to methodological issues, a number of submissions have highlighted causes of divergence in food price trends between Australia and OECD countries that would make comparisons somewhat meaningless. For example, Metcash contended that different countries have a plethora of factors which lead to substantial differences in the structure of grocery retailing. More specifically, Metcash stated:

The value of any extensive cross-country comparison of grocery prices would be limited due to differences in:

- consumer tastes and shopping behaviour
- population size/density
- the regulatory environment, including import restrictions for agricultural produce
- exchange rates
- different products and pack sizes
- the role of tax in food prices
- different property markets and planning regimes.<sup>36</sup>

While there are substantial differences in the rate of food price inflation between Australia and other OECD countries, reasons for the disparity are wide ranging and it is difficult to identify the more significant underlying causes (as highlighted in a number of submissions to the inquiry). These difficulties can be overcome to some degree, however, by evaluating changes in food prices between Australia and New Zealand, given:

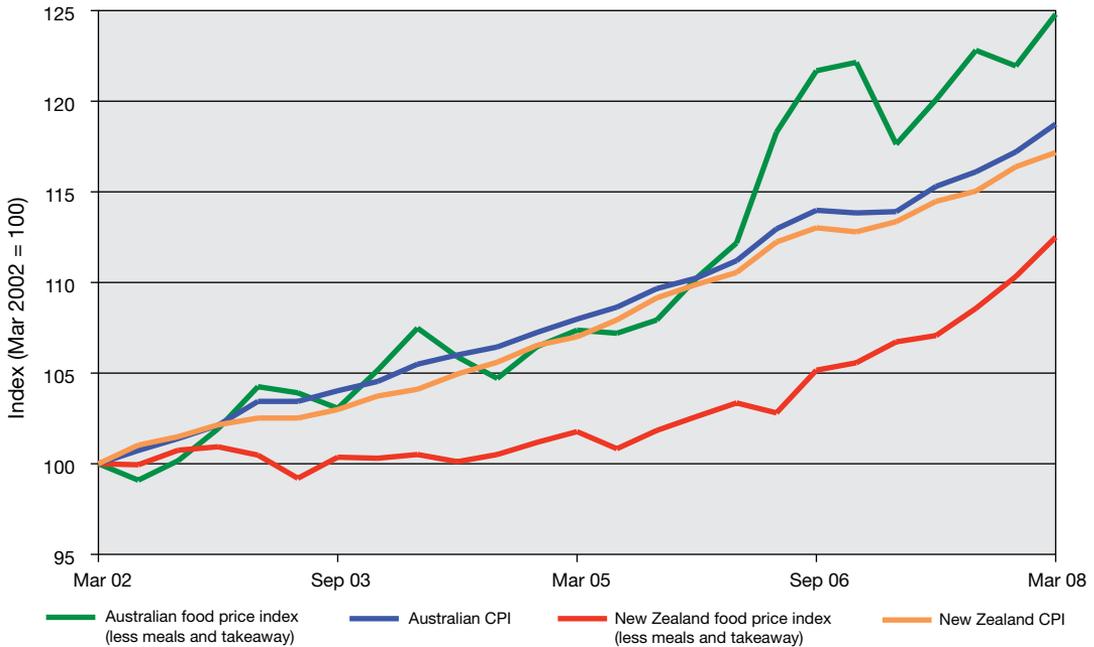
- industry concentration, macroeconomic performance and regulatory environments are comparable
- both countries are small open economies in a relatively isolated part of the world
- import and quarantine restrictions on food are similar
- the national statistical agencies use similar methodologies for calculating changes in food prices— including similar CPI weightings for food products.

Since 2002, food prices (excluding meals and takeaway foods) in Australia have increased at a greater rate than food prices in New Zealand (chart 2.5). Significantly, from 2002 to 2007, food prices increased in Australia by around 20.3 per cent compared to 7.7 per cent in New Zealand. Despite this, overall consumer price inflation has been remarkably similar for Australia and New Zealand over the same period.

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<sup>36</sup> Metcash, submission no. 181, p. 70.

**Chart 2.5 Food price index comparisons—Australia and New Zealand**

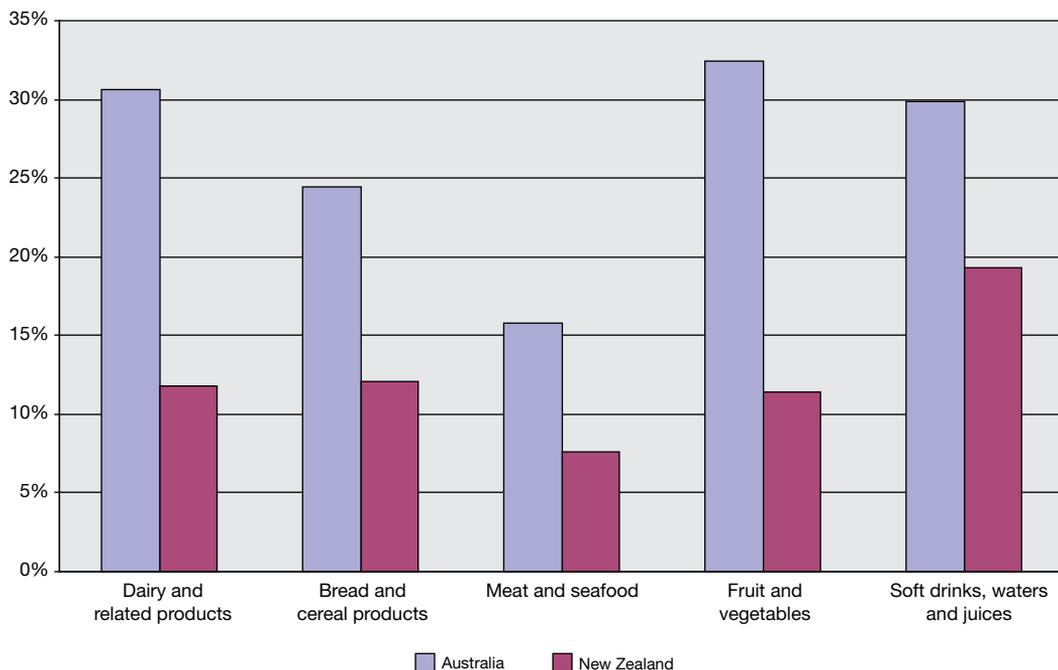


Sources: ABS (cat. no. 6401.0); Statistics New Zealand, Consumer Price Index: March 2008 quarter, 2008.

Differences in fruit and vegetables, and dairy price indexes explain a large part of the divergence between the Australian and New Zealand food price indexes (chart 2.6).<sup>37</sup> Further, New Zealand food price inflation has been lower across a range of food products.

<sup>37</sup> For example, fruit prices increased in Australia by around 55 per cent in 2006 compared to 9.3 per cent in New Zealand. Notably, increased prices for fruit and vegetables were also identified in section 2.2 as being the main driver of changes in overall food prices in Australia in recent years—and the cause of considerable volatility of food price inflation over this period.

**Chart 2.6 CPI comparisons for Australia and New Zealand—percentage changes from March 2002 to March 2008**



Note: The New Zealand price index for dairy and related products includes eggs, though the Australian dairy price index excludes eggs.

Sources: ABS (cat. no. 6401.0); Statistics New Zealand, Consumer price index, March 2008 quarter, 2008.

### ACCC’s view

In comparing food price inflation in Australia relative to New Zealand, and the rate of food price inflation to overall inflation (as discussed in section 2.2), there is little doubt that food prices have increased significantly in recent times in Australia. Also, comparisons of Australian and New Zealand price indexes indicate that domestic factors are likely to be playing a role in Australian food price inflation.

## 2.5 What has caused increased food prices in Australia?

In Australia, domestic and foreign shocks can have significant impacts on food prices. As discussed by the Reserve Bank of Australia (RBA), food prices have been an important contributor to overall consumer price inflation in recent years because of two main factors.<sup>38</sup> Namely, for some tradable items (such as wheat), it partly reflects a sharp increase in global food prices, while for others (such as fruit and vegetables), it reflects the effect of the drought which has reduced local supply.

Due to difficulties in quantifying the effect of domestic and international shocks on the food price index, it is hard to be certain whether these factors account wholly for the increases.

<sup>38</sup> RBA, ‘Developments in the farm sector’, *Reserve Bank Bulletin*, February 2008.

While domestic and foreign shocks directly affect the prices farmers and food producers receive, it appears that the effects flow through to retail prices. As discussed in chapter 13, the ACCC considers that there is no broad observable trend relating to an increasing gap between farm gate or wholesale prices, and retail prices. In particular, the difference between wholesale and retail prices for fruit and vegetables over the last five years has not varied significantly.

### 2.5.1 Domestic factors

The impact of domestic shocks such as natural and weather disasters in Australia, in combination with quarantine restrictions, could help explain differences in food price inflation between Australia and other countries such as New Zealand.

Other domestic factors—including shocks to productivity, wages and exchange rates—could also be significant. For example, Metcash asserted that higher labour costs have put upward pressure on grocery prices, as labour is an essential input into many supply chain functions. On the other hand, cost increases have been somewhat offset by rising levels of productivity resulting from supply chain improvements.<sup>39</sup>

#### Implications of the drought in Australia

The agricultural regions of Australia have experienced dry conditions since 2000. Water flows into, for example, the Murray-Darling Basin have been historically low. Despite continued improvements in farm management, real farm output in Australia remains below levels experienced at the start of the decade.

The RBA has commented that the current drought has had a noticeable effect on food prices, although this is not typically the case. The RBA noted that food prices have outpaced overall inflation in Australia in recent years, which is in contrast to other periods of drought where food prices increased at around the same rate as the overall CPI.<sup>40</sup>

There are several reasons listed by the RBA for why droughts have historically had relatively small effects on the CPI:

First, the contribution of commodity prices to final retail food prices is generally small. Second, the contribution of drought-affected food prices to the overall CPI is relatively minor. Third, while cereal prices generally rise during a drought, meat prices tend to fall as livestock slaughter rates rise in response to the dry conditions. Finally, many food items can be imported in the event of shortfalls in production, and there is also some scope for food manufacturers to engage in ingredient substitution limiting the effect on domestic prices.<sup>41</sup>

Significantly, the RBA stated that the sustained rise in the relative price of food in the current drought can largely be explained by the broader range of agricultural products that have been affected by this drought compared to previous episodes. For example, the duration of the drought, and the extent of the decline in stored water levels have contributed to sharp falls in vegetable and dairy production.<sup>42</sup> This in turn has caused the prices of these items to rise more markedly than in previous droughts.<sup>43</sup>

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39 Metcash, submission no.181.

40 RBA, 'Developments in the farm sector', *Reserve Bank Bulletin*, February 2008.

41 *ibid*, p. 11.

42 Fonterra noted the severe drought in Australia has affected the Australian dairy industry, contributing to increased retail prices for milk, cheese and other foods which have a significant dairy component. Moreover, 'drought conditions in Australia, in particular in some of the key dairy producing areas in Victoria have had a significant effect in the reduction of milk produced by dairy farmers. (Fonterra, submission no. 85, p. 5.)

43 RBA, 'Developments in the farm sector', *Reserve Bank Bulletin*, February 2008.

## Supply disruptions caused by natural disasters

Natural disasters have affected food prices and caused considerable price volatility, particularly for fruit and vegetables. As noted by the ABS, the prices of fruit and vegetables have behaved quite differently from prices of the other components of the CPI—being significantly affected by domestic climatic conditions (table 2.5).<sup>44</sup> (More detailed explanations of reasons for changes in the price indexes for fruit and vegetables are provided in the ABS’s submission to the inquiry.)

For example, tropical cyclone Larry in March 2006 resulted in significant supply disruptions of fruit and vegetables, which subsequently affected the ABS food price index. More specifically, fruit prices increased by around 52 per cent during the June 2006 quarter, which was largely attributed to increased prices of bananas by around 250 per cent due to shortages (with bananas accounting for around 18 per cent of household expenditure on fruit according to the HES). Prices also rose for citrus fruit, apples, melons and strawberries, in part reflecting increased demand for alternative fruit as consumers looked for a substitute to bananas.

**Table 2.5 Reasons for change in the price indexes for fruit and vegetables**

<b>Quarter</b>	<b>Explanation of price change</b>
<b>December 2005</b>	Fruit and vegetable prices are affected by storms, hail and floods in major growing areas
<b>March 2006</b>	Supply of vegetable products affected by adverse weather in major growing areas in eastern Australia
<b>June 2006</b>	Substantial disruption to banana supply resulting from cyclone Larry
<b>September 2006</b>	Increased fruit prices (mainly bananas) partially offset by price falls for vegetables
<b>December 2006</b>	Fall in fruit prices (mainly bananas), accompanied by an increase in vegetable prices following hailstorms in southern Queensland and a cold snap in eastern Australia
<b>March 2007</b>	Fall in fruit prices almost entirely due to bananas—vegetable prices increased due to a combination of drought, hailstorms and frosts in November 2006
<b>June 2007</b>	Fruit price increases due mainly to bananas from cooler than normal weather in growing regions; berries and melons were also affected; vegetable prices increased—particularly tomatoes and lettuce—due to drought in the early part of the quarter followed by heavy rains in the later part
<b>September 2007</b>	Fruit prices increased mainly from bananas. Vegetable prices increased—particularly salad vegetables—due to unseasonal weather and disease
<b>December 2007</b>	Both fruit and vegetable prices fell due to good conditions in most growing areas
<b>March 2008</b>	Increased vegetable prices partly offset by a small fall in fruit price due to plentiful supplies of grapes, peaches and bananas

Source: ABS, submission no. 245.

## Quarantine restrictions in Australia

The objective of Australia’s quarantine and biosecurity policies and risk management measures is to enhance the national interest through a science-based process that manages the risk of the entry, establishment or spread of pests and diseases not present in Australia that could cause significant harm to people, animals, plants and other aspects of the environment.<sup>45</sup>

Imported food is only allowed into Australia if it meets strict quarantine laws and food safety standards.

<sup>44</sup> ABS, submission no. 245.

<sup>45</sup> Quarantine and Biosecurity Review Panel, *Quarantine and biosecurity review issues paper*, 2008.

Australian regulations governing imports of animals, plants and their products are contained in the *Quarantine Act 1908*, the Quarantine Proclamation 1998 and the Quarantine Regulations 2000. Imports are assessed for pest and diseases by Biosecurity Australia, tested for food safety by the Australian Quarantine and Inspection Service, and then must conform to Food Standards Australia New Zealand requirements.

While quarantine laws are important for protecting Australia's economic wellbeing, there are a number of tradeoffs for both producers and consumers. For example, an obvious trade-off with an import ban is between the benefits of reducing a particular pest or disease risk and the benefits from obtaining cheaper or different products.<sup>46</sup> As noted by freshlogic as part of the Coles submission to the inquiry:

Australia remains insulated from competitive dynamics in fresh fruit and vegetables, poultry, [and] pork due to stringent local quarantine regimes, and strong ethical credentials in other livestock industries where a significant export role exists.

In certain sectors we have not seen the advantages from globalisation being reflected in the cost of food to the consumer. Some of our disease risk management approaches have not enabled global least-cost producers to supply this market—for example in fresh fruit categories such as bananas, apples and pineapples.

It is likely that there would have been more stable pricing of fruit and vegetables over time—which earlier analysis shows as the most volatile components that influence CPI under current methods—if fewer import restrictions had applied, and imported product had filled domestic shortages.<sup>47</sup>

Fruit and vegetables that have strict quarantine restrictions cannot be readily supplemented by imports in the event of supply disruptions. For example, in the case of cyclone Larry (discussed above), quarantine laws made it difficult to source bananas from other countries (such as the Philippines) to meet local demand for biosecurity reasons.<sup>48</sup> Indeed, bananas were being sold for up to \$13 per kg in the aftermath of the cyclone, which was reflected in the ABS food price index.

In addition to restrictions on fruit and vegetables, there are significant quarantine restrictions on the importation of feed grain into Australia. As noted by the Productivity Commission, recent rises in feed grain prices are in part attributable to drought, economic growth and changing tastes, but they also reflect the impact of quarantine restrictions on grain imports, especially during drought.<sup>49</sup> Moreover, the Productivity Commission stated:

Given Australia's status as a grain exporter, quarantine restrictions on grain imports mainly impact during periods of drought (unless particular types of grain are not produced in Australia or are only produced in very small quantities), as producers are likely to pay the prevailing 'world price' for grain at other times. During drought, local supplies are limited and prices typically approach, and sometimes exceed, world parity prices.<sup>50</sup>

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46 M Binder, 'The role of risk and cost-benefit analysis in determining quarantine measures', *Productivity Commission staff research paper*, AusInfo, Canberra, 2002.

47 Coles, submission no. 157, pp. 13–14.

48 Other fruits that are subject to strict quarantine restrictions in Australia include apples (excluding Fuji apples from Japan), pineapples, pears and oranges.

49 Productivity Commission, *Safeguards inquiry into the import of pigmeat*, report no. 44, Canberra, March, 2008.

50 *ibid.*, p. 99.

As part of the Safeguards Inquiry into the Import of Piguemeat, the Productivity Commission recommended that:

Quarantine arrangements should impose only the minimum requirements needed to satisfy objectives. As new options emerge for dealing with quarantine risks, arrangements should be reviewed to take them into account. The current Quarantine and Biosecurity Review is well placed to further explore these issues.<sup>51</sup>

### ACCC's view

Australian quarantine and biosecurity policies and risk management measures are important in safeguarding the community from significant losses associated with the spread of pests and diseases.

However, where the supply of fruit and vegetables or other food products cannot be readily supplemented by food imports as a result of quarantine restrictions, prices are more susceptible to sharp price increases when local supply disruptions occur.

The ACCC supports the Productivity Commission's recommendation that quarantine arrangements should impose the minimum requirements needed to satisfy their objectives. These issues can be expected to be further explained in the current quarantine and biosecurity review, with the report and recommendations due to the minister by 30 September 2008.

## 2.5.2 International factors

Historically, world commodity price shocks have played a role in food price inflation outcomes around the world, particularly in small open economies such as Australia and New Zealand.

In more recent years, the rapid pace of global growth has seen the RBA's monthly index of rural commodity prices (including beef, wheat, wool, cotton, sugar, barley, canola and rice) increase by around 30 per cent from March 2006 to March 2008.<sup>52</sup> In addition, global dairy prices have risen by 56 per cent over the same period (chart 2.7).<sup>53</sup>

Further, it is likely that relatively strong global food prices will be sustained in the near term as indicated by the high level of prices for many agricultural goods in futures markets.<sup>54</sup> As noted in the freshlogic report submitted by Coles, 'food prices are currently rising and are under pressure to continue to follow that trend as a consequence of major changes in global forces affecting supply and demand of a number of commodities.'<sup>55</sup>

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51 Productivity Commission, *Safeguards inquiry into the import of pigmeat*, report no. 44, Canberra, March, 2008, p. 100.

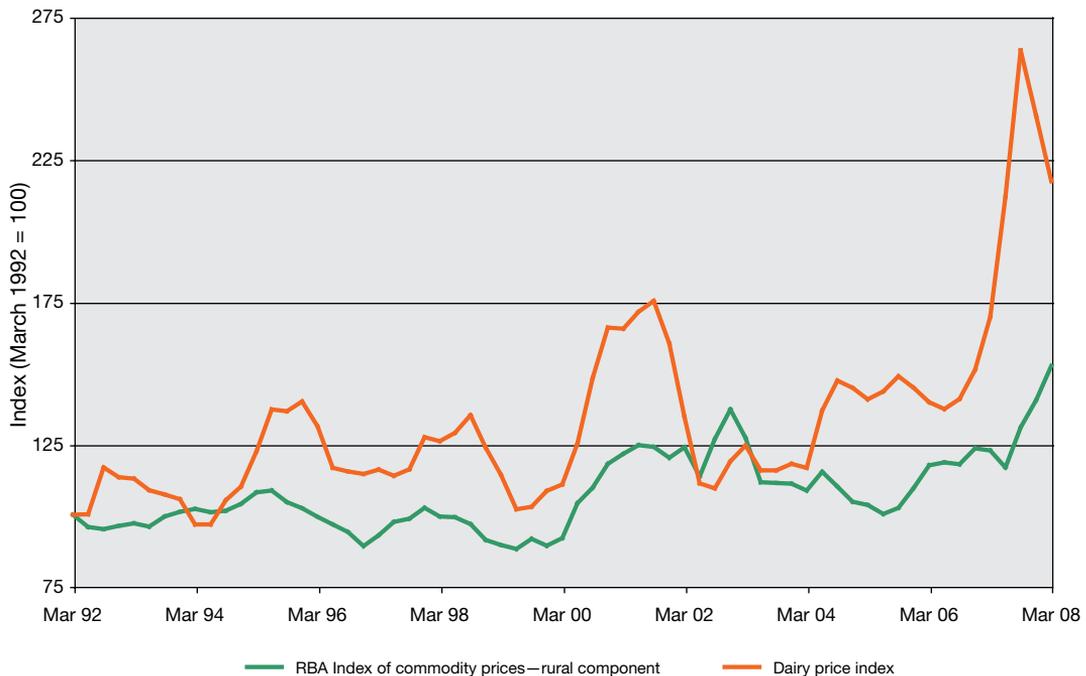
52 As noted by the OECD and Food and Agriculture Organization of the United Nations (FAO), 'policy makers have become extremely concerned by recent price developments because of the implications for consumers' ability to meet their most basic of needs, food. This is a critical issue for developing countries where large portions of the population have income levels that are low or at subsistence levels. But increasing prices reduces the purchasing power of incomes also in relatively high-income countries [such as Australia], where it will be the low-income groups that are particularly affected. In general, households with low incomes are more heavily penalized when the price of necessities rise because these absorb a larger share of their income.' (OECD-FAO, *Agricultural Outlook 2008-2017*, 2008, p. 33)

53 Westpac-National Farmers Federation, Westpac-NFF rural commodity price indices, 2008.

54 RBA, 'Developments in the farm sector', *Reserve Bank Bulletin*, February 2008.

55 Coles, submission no. 157, p. 16.

**Chart 2.7 RBA commodity price index (rural component) and Westpac–NFF dairy price index, Australian dollars**



Note: The rural component of the RBA commodity price index includes wheat, beef and veal, wool, cotton, sugar, barley, canola and rice.

Sources: RBA, Bulletin statistical tables: RBA, Index of commodity prices, 2008; Westpac–National Farmers Federation, Westpac–NFF rural commodity price indexes, 2008

The predominant reason for world commodity price rises is widely considered to be increases in demand—not just in developed countries but also in the developing world. For example, strong income growth and improving living standards in emerging economies, such as China and India, have led to significant growth in demand for protein in recent years.<sup>56</sup> As noted by the Reserve Bank of New Zealand, demand for protein is income sensitive and rising income levels in emerging markets have led to improvements in diet, incorporating more meat, eggs and milk.<sup>57</sup>

In addition, higher energy prices have prompted some substitution away from crop production for food consumption towards biofuels (such as ethanol).<sup>58</sup> This competition from crops used in biofuel production may be reducing the area available for the planting of wheat and, thus, indirectly affecting food prices.<sup>59</sup> As noted by the OECD:

<sup>56</sup> RBA, 'Developments in the farm Sector', *Reserve Bank Bulletin*, February 2008.

<sup>57</sup> Reserve Bank of New Zealand, 'Commodities, dairy prices and the New Zealand economy', speech by Alan Bollard, 2007.

<sup>58</sup> Ethanol is produced from the fermentation of feedstock such as sugar or grain materials and is blended into petrol for use as a fuel or in industrial applications.

<sup>59</sup> As noted by the RBA, biofuel demand has had an indirect effect on wheat prices through strong corn and oilseed prices (such as canola and soybeans). This reflects that these crops are in direct competition with wheat for acreage in some regions, so that the commodity with the strongest relative price could lead to reduced supply of other crops. However, to date the contribution of biofuel demand to higher wheat prices seems less than the contribution of droughts and frosts, which have reduced global production of wheat in recent years. (RBA, unpublished)

While smaller than the increase in food and feed use, biofuel demand is the largest source of new demand in decades and a strong factor underpinning the upward shift in agricultural commodity prices.<sup>60</sup>

This concern has been highlighted in submissions to the inquiry. For example, the Victorian Eco Innovation Lab stated ‘increasing biofuel production can directly affect food production (and prices) through competition for land, water and agricultural inputs.’<sup>61</sup> In addition, the Sydney Food Fairness Alliance commented:

... allocation of agricultural land and crops for biofuel production in the US and Europe has pushed up the global price of grains and products that rely on grain such as meat, cereal and bread.<sup>62</sup>

While the use of grains for food and feedstock remains greater than its use for biofuels, demand for biofuel has been growing rapidly. This is partly because of government policy changes, with a number of countries (including the United States and most European Union countries) implementing policies to encourage the use of biofuel in recent years (box 2.2).

### **Box 2.2 Effect of biofuels programs on world food markets**

Biofuels offer a potential source of renewable energy and possible large new markets for agricultural producers. Governments provide substantial support to biofuels so that they can compete with petroleum and conventional diesel. These supports include consumption incentives (fuel tax reductions), production incentives (tax incentives, loan guarantees, direct subsidy payments) and mandatory consumption requirements. Though, as stated by the World Bank, current biofuels programs have numerous social and environmental costs—such as upward pressure on food prices, intensified competition for land and water, and possibly, deforestation.<sup>63</sup>

The OECD has commented on some of the perverse outcomes from the implementation of policy changes by governments that encourage the use of biofuel, stating:

Crop farmers will certainly benefit from the higher prices coming from increased demand for biofuels. But with contemporary technologies and current public support policies these are mostly cereal and oilseed producers in OECD countries. Livestock producers, whether inside or outside the OECD area, who use the same cereals and oilseeds as animal feed do not benefit from this support. Hence, they will face higher costs and reduced incomes despite lower protein feed prices due to the additional supply of feed by-products from biofuel production. Also, the industrial demand for biofuels crops may be less price sensitive than traditional food and feed demand, which would add to price instability in world cereal markets.<sup>64</sup>

The Productivity Commission has also noted that support for the ethanol industry has the potential to harm farmers involved in livestock production, where ‘policies supporting biofuels pursued by other nations (particularly the United States and the European Union) have ... increased world grain prices and therefore it is foreign support for the ethanol industry that is likely to have adversely affected the pigmeat industry, both in Australia and globally.’<sup>65</sup>

60 OECD-FAO, *Agricultural Outlook 2008–2017*, 2008, p. 11.

61 Victorian Eco Innovation Lab, submission no. 190, p. 17.

62 Sydney Food Fairness Alliance, submission no. 52, p. 2.

63 The World Bank, *World development report 2008: agriculture for development*, 2008, p. 70.

64 OECD, *Biofuels for transport: policies and possibilities*, policy brief, November, 2007, p. 6.

65 Productivity Commission, *Safeguards inquiry into the import of pigmeat*, report no. 44, Canberra, March, 2008, p. 96.

Strong global demand for food has occurred against the backdrop of supply disruptions around the world—including in several major agricultural exporting countries. For example, weather related supply disruptions have occurred in large grain-exporting regions such as the United States and the European Union, while in China drought and the re-zoning of rural land have affected rice production.<sup>66</sup> This has seen global stocks of wheat, other coarse grains and rice fall to historically low levels, placing further pressure on global food prices to rise. Indeed, data on global supply and use of wheat, for example, suggest that much of the boost to prices has come from reduced supply.<sup>67</sup>

While higher world prices for agricultural products are spurring greater optimism across the farm sector in Australia, the cost of doing business has also risen substantially. Raw materials and other inputs into farm production have risen at an increasing rate since the early 1990s (table 2.6). For example, from 2001–02 to 2006–07, annual prices increased the most for fuel (10.1 per cent), seed, fodder and livestock (5.7 per cent), and interest paid (6.8 per cent). This can be compared to increased total farm costs of 4.1 per cent per annum over the same period.

**Table 2.6 Average annual percentage changes in farm costs in Australia**

	<b>1991–92 to 1996–97</b>	<b>1996–97 to 2001–02</b>	<b>2001–02 to 2006–07</b>	<b>1992–93 to 2006–07</b>
Fuel	1.0	4.1	10.1	5.0
Fertiliser	1.9	1.0	1.9	1.6
Chemicals	0.3	1.3	2.1	1.2
Seed, fodder and livestock	3.7	3.8	5.7	4.4
Marketing	1.6	3.2	2.8	2.5
Maintenance	2.7	3.4	2.9	3.0
Labour	2.3	3.1	3.3	2.9
Interest paid	–3.5	–2.3	6.8	0.2
<b>Total price paid</b>	<b>1.8</b>	<b>2.6</b>	<b>4.1</b>	<b>2.8</b>

Source: ABARE, Australian commodity statistics, 2007

Such rises in prices have significantly increased Australian farm production costs given, for example, fuel, and seed and fodder accounted for around 6.2 per cent and 14.4 per cent respectively of total farm costs over the period 2001–02 to 2006–07 (table 2.7). This places further pressures on food prices where costs are passed through the supply chain to the retail level.

<sup>66</sup> RBA, 'Developments in the farm sector', *Reserve Bank Bulletin*, February 2008.

<sup>67</sup> RBA, unpublished.

**Table 2.7 Major components of Australian farm costs—average annual percentage contribution over period**

	1991–92 to 1996–97	1996–97 to 2001–02	2001–02 to 2006–07	1992–93 to 2006–07
Fuel	5.3	5.6	6.2	5.8
Fertiliser	6.4	7.4	6.1	6.5
Chemicals	5.4	6.3	5.6	5.7
Seed and fodder	12.8	11.8	14.4	13.3
Marketing	11.0	12.1	10.7	11.1
Repairs and maintenance	8.2	8.5	8.4	8.4
Wages	12.0	12.6	11.8	12.1
Interest paid	9.6	8.2	9.6	9.2
Other costs	29.2	27.4	27.1	27.8

Source: ABARE, Australian commodity statistics, 2007

However, according to the RBA, global factors are likely to have accounted for only a portion of the increase in overall domestic food prices.<sup>68</sup>

First, the increase in global food prices has been concentrated in three categories (grains, soybeans and dairy products) with the prices of other foodstuffs broadly unchanged over recent years. These items are intensively used in the bread and cereals, and dairy categories, which together account for less than 20 per cent of the food component of the Australian CPI.

Second, retail prices of these foods include a number of other inputs and profit margins, such that the direct influence of raw commodity prices on the final consumer price is relative low. As noted by the OECD:

... food consumers will face higher prices resulting from increased raw commodity prices. In most OECD countries where costs of agricultural raw materials are only a small part in the final costs of food in the shops and where food represents only a small share of total expenditures, this issue should not be over-emphasised.<sup>69</sup>

For example, in the case of milk, the cost of unprocessed milk accounts for only around one third of the final retail price in Australia on average, with other costs (such as transport, distribution and retailing) comprising a larger portion of final prices.<sup>70</sup> Similarly, global wheat prices have a relatively modest effect on breads and cereals—with the price of wheat estimated to contribute around 5 to 10 per cent to the retail price of bread (chapter 12).

Interestingly, there appears to be a close link between global prices and domestic farm gate prices for fresh milk. Such a close link may initially appear surprising given milk is a non-traded item due to its high water content. However, a linkage exists between global and domestic prices due to the ability of producers to export milk in powdered or processed form—hence creating arbitrage pricing (box 2.3).<sup>71</sup>

68 RBA, unpublished.

69 OECD, *Biofuels for transport: policies and possibilities*, policy brief, November 2007, p. 6.

70 RBA, unpublished.

71 *ibid.*

### **Box 2.3 International trade and food prices**

In an open economy, such as Australia's, farm gate prices for tradable food products are generally heavily influenced by world market conditions. For example, in the absence of forms of protection (such as tariffs and subsidies), and transport and transaction costs, if the prices of 'standardised' internationally traded products were lower in one country than in another, traders could gain by buying products in the country where they are cheaper and selling them in the country where they are more expensive. In other words, if traded products exhibit different prices across countries, then there is a potential arbitrage opportunity—effectively creating a 'price ceiling' and 'price floor' for tradeable food products. As noted by the Department of Agriculture, Fisheries and Forestry:

Agricultural goods which are non-perishable, undifferentiated and internationally traded have their prices effectively determined by international markets irrespective of domestic post-farmgate production and competition factors. In such cases, the return to the farmer is essentially governed by the price point at which a domestic manufacturer or processor could attract product away from the export market or compete with an imported item. What happens beyond the farmgate is essentially irrelevant to a farmer's ability to extract price gains.<sup>72</sup>

Although such assumptions are far from realistic and internationally traded food products are differentiated, world market conditions do affect farm gate prices. For example, if the export price rises significantly, more suppliers would sell into the export market to obtain the higher price. Domestic customers would need to match the higher price to compete for product with international buyers. While there could be lags due to existing contracted prices (although this depends on whether international price changes are a factor in setting current contract prices), the effect will nonetheless be significant.

Also, as noted by Fonterra, increased international dairy commodity prices affect the domestic market for manufacturing milk as processors consider the returns which can be achieved from the export of dairy products—such as cheese, butter, whole and skim milk powder—against returns that can be achieved from the domestic market.<sup>73</sup>

Beef and lamb prices are also influenced by export markets. Freshlogic noted in the Coles submission regarding lamb, 'despite a higher proportion of meat going into the domestic market, returns to the lamb production and processing sector are strongly influenced by world trade, through prices demanded by overseas customers.'<sup>74</sup> Freshlogic further noted:

The beef industry in Australia is strongly geared for export production, whilst there is static overall domestic consumption. ... The forces of supply and demand in international beef markets drive the level of returns to the Australian industry.<sup>75</sup>

<sup>72</sup> S Spencer, *Price determination in the Australian food industry, a report*, Department of Agriculture, Fisheries and Forestry, Canberra, p. 2.

<sup>73</sup> Fonterra, submission no. 85, p. 7.

<sup>74</sup> Coles, submission no. 157, p. 51.

<sup>75</sup> *ibid*, p. 47.

### 2.5.3 Potential contribution of changes in the margins of grocery retailers and wholesalers to food price inflation

Central to this inquiry is the relationship between the state of competition in grocery retailing and wholesaling, and food price inflation in Australia. The potential contribution of any weakening of price competition in grocery retailing and wholesaling to food price inflation can be estimated based on changes in the margins of major grocery retailers and wholesalers. To the extent that there has been a weakening of price competition, it can be assumed that this weakening would be reflected in higher margins which, in turn, would lead to increased food price inflation.

As detailed in chapter 6, the gross margins Coles, Woolworths and Metcash achieved in their grocery businesses increased over the last five years by between 0.2 and 1.6 percentage points. Coles, Woolworths and Metcash account for roughly 70 per cent of grocery products sold throughout Australia (chapter 3). The ACCC estimates that if these increased margins were solely derived from increased prices paid by customers, then they would account for an increase in retail grocery prices of around 0.8 to 1.0 per cent over the last five years. This compares to the actual total increase in food prices of 21 per cent (2001–02 to 2006–07) in Australia.

This is not to imply that the margin increases have in fact been the result of a weakening of price competition; there are other possible reasons for improved margins beyond increased prices, such as improvements in the efficiency of operations. It is simply saying that there is little evidence that any weakening of price competition in grocery retailing and wholesaling has played a significant role in explaining recent increases in food price inflation.

### 2.5.4 ACCC's view on the causes of increased food prices in Australia

Based on evidence available to the ACCC, it appears that a range of domestic and international factors have substantially contributed to the recent increases in food prices in Australia, including:

- the current drought, which has reduced the supply of many agricultural products and increased the costs of farming
- natural disasters such as cyclones and floods, which in combination with quarantine restrictions have caused considerable supply disruptions for some fruit and vegetable products
- the international commodities boom, which has:
  - increased the cost of commodities (such as fertiliser and petrol) used to produce and transport many Australian food products
  - increased the prices some Australian farmers and food producers can sell their products in export markets, leading to higher domestic prices.

These factors have significantly contributed to food price inflation in Australia and can explain much of the recent increases in retail food prices. In particular, domestic shocks have substantially influenced the prices of fruit and vegetables, which have been the main driver of changes in overall food prices in Australia, and a large part of the divergence in food price inflation between Australia and New Zealand.

It is difficult to be certain about the extent to which the above domestic and international factors account for the observed increases in food prices. Despite this, any potential contribution resulting from increased margins of major grocery retailers and wholesalers is small relative to the overall increase in food prices.



## 3 Retail industry structure, retail concentration and growth

### Key points

- There are many different grocery retailing models in Australia, ranging from full vertical integration to a complete split of ownership and control between retailing and wholesaling.
- There have been trends towards vertical integration for grocery retailers and consolidation in the wholesale sector.
- Significant changes in the retail grocery market over the last 10 years include the exit of the Dairy Farm International operated Franklins business and the entry of ALDI.
- Coles and Woolworths have maintained a fairly consistent proportion of supermarkets above 1000 m<sup>2</sup> over the last 10 years, with each having just over 30 per cent nationally. The major supermarket chains (MSCs) account for around 87 per cent of stores above 2000 m<sup>2</sup> and around 96 per cent of stores above 3000 m<sup>2</sup>.
- The Nielsen Company's ScanTrack data, which suggests that the MSCs account for around 78 per cent of national sales in packaged groceries, is not a valid measure of the MSC's share of all grocery sales. Data from Coles and Woolworths suggests that sales through their supermarkets account for around 60 per cent of packaged grocery sales. However, external data suggests the MSCs' share of sales of packaged groceries is greater than 60 per cent.
- MSCs account for a smaller proportion of sales in the fresh product categories. Data from Coles and Woolworths suggests that sales through their supermarkets account for between 40 per cent and 50 per cent of fresh grocery categories. External data is generally supportive of the stated share of fresh grocery sales.
- International comparisons show that market structures vary widely between countries. In some OECD member nations, including New Zealand and Austria, the grocery industry is dominated by two participants. The United Kingdom and Canada have a larger number of retailers, although there is one clear leader in each country.
- The level of concentration in the grocery sector, particularly in packaged groceries and for large format supermarkets, warrants closer consideration of the competitive dynamics within the sector.

### 3.1 Introduction

This chapter provides an overview of the grocery industry structure at the retail level. In analysing the retail level it is necessary to also discuss the wholesale grocery sector as the MSCs, namely Coles and Woolworths, are vertically integrated in wholesaling and retailing, as are a number of smaller retailers. This chapter then investigates various measures of the size of industry participants, which is described as a concentration analysis. The chapter also discusses the growth of the MSCs, and conducts some basic concentration comparisons with other countries.

## 3.2 Major supermarket chains

Australia has two MSCs, Coles and Woolworths. The MSCs are vertically integrated, meaning that they undertake both wholesale and retail level functions. A typical MSC store is above 2000 m<sup>2</sup> in net trading area and stocks in excess of 25 000 product lines.

### 3.2.1 Coles

Coles supermarkets were the largest business unit within the former Coles Group Limited (Coles Group). Wesfarmers Ltd purchased the Coles Group in November 2007 and restructured the business into four divisions—Coles, Kmart, Target and home improvement and office supplies. The Coles division includes all supermarkets, fuel and convenience stores, liquor stores and Pharmacy Direct.

Coles operates around 750 supermarkets (branded as either Coles or BI-LO) and is represented in every Australian state and territory. In 1987, Coles purchased the BI-LO discount supermarket chain to operate in parallel with Coles supermarkets. However, in 2007, Coles commenced re-branding its BI-LO stores as Coles stores—a process that did not prove successful. Many BI-LO stores have now been re-branded as Coles or have closed, but around 70 stores remain in New South Wales and Queensland. Coles also operates 600 smaller format Coles Express stores in Australia which offer fuel and convenience store items.

Coles' total food and liquor sales in Australia for 2006–07 were \$20.4 billion. Earnings before interest and tax (EBIT) were \$700 million. More details on Coles' financials are provided in chapter 6.

### 3.2.2 Woolworths

Woolworths Ltd is an Australian Stock Exchange listed company with over 2000 stores across Australia including around 780 supermarkets operating under the Woolworths and Safeway brands. Other Woolworths outlets include a discount department store chain (Big W), electronic stores (Dick Smith and Tandy) and liquor brands (Woolworths Liquor, BWS and Dan Murphy's). It also operates petrol station/convenience stores in conjunction with Caltex.

In Tasmania, Woolworths owns a 60 per cent share in Statewide Independent Wholesalers (SIW), which distributes groceries and fresh produce to the 28 Tasmanian Woolworths stores and also the 111 independent supermarkets in that state. Woolworths' sources supply for its Tasmania stores from SIW, its Hobart distribution centre and through its mainland distribution network.

Woolworths' total food, liquor and petrol sales in Australia for 2006–07 were \$32.6 billion, with EBIT of \$1.7 billion. More details on Woolworths' financials are provided in chapter 6.

## 3.3 Other industry participants

The following provides a brief overview of grocery retailers competing with the MSCs in Australia. Further details are in chapters 7 and 8 of the report.

### 3.3.1 Vertically integrated supermarkets

In addition to the MSCs, there are two smaller vertically integrated supermarket chains in Australia, ALDI and Franklins.

## ALDI

ALDI operates stores in New South Wales, Victoria, Queensland and the Australian Capital Territory. It commenced operations in Australia in 2001 and currently has approximately 170 stores with combined estimated annual sales of \$1.5 billion. All ALDI stores are owned and operated by ALDI Australia, which is a subsidiary of German company ALDI Sud.

ALDI stores stock around 900 products including dry groceries, fresh items and general merchandise. Ninety per cent of products are ALDI's own exclusive brands manufactured by Australian and foreign producers. ALDI supermarkets have an average trading area of around 850m<sup>2</sup>.

## Franklins

Franklins operates in New South Wales with 74 corporately owned stores and six franchised stores. It is a wholly owned subsidiary of Pick 'n Pay Stores Limited, a large grocery retailer based in South Africa.

Pick 'n Pay Stores Limited acquired the Franklins brand name and 50 stores in 2001, following the divestment of Franklins Limited by Dairy Farm International. Before 2001 Franklins was a vertically integrated supermarket chain owned by Dairy Farm International that operated 287 stores in Queensland, Victoria and New South Wales. Franklins stores not acquired by Pick 'n Pay Stores Limited were either sold to competing retailers and re-branded, or closed.

Franklins operates stores in a range of sizes, from less than 1000 m<sup>2</sup> to above 3000 m<sup>2</sup>. The majority of stores however are between 1000 m<sup>2</sup> and 2000 m<sup>2</sup>.

In 2005 Franklins established its own distribution and logistics capabilities and buying team after terminating its supply arrangements with Metcash. Franklins is now vertically integrated, and all Franklins stores are supplied via its two distribution centres. These distribution centres are only used to service stores which operate under the Franklins banner.

### 3.3.2 Independents supplied by Metcash

Metcash provides marketing and wholesale services to the majority of independent and franchise grocery retailers in Australia. Supermarkets serviced through Metcash include the IGA network, Foodland IGA and FoodWorks as well as some independents not affiliated with any chain or banner group. Although not a retailer itself, Metcash does from time to time purchase retail stores and maintains an ownership share in a number of grocery retail businesses.

In comparison with the MSCs, a large proportion of the independent grocery retailers serviced by Metcash operate in rural and regional areas. Metcash does not operate in Tasmania, with the wholesaling function for independent retailers being undertaken there by SIW.

Metcash distributes through four channels:

- IGA Distribution (IGA>D) comprises 12 distribution centres, which serve approximately 2500 independent retail grocery stores across Australia.
- IGA Fresh supplies fresh fruit, vegetables, meat, deli and bakery products to approximately 240 independent retail stores.
- Campbells Wholesale supplies small business customers and convenience stores.
- Australian Liquor Marketers (ALM) supplies liquor to hotels, liquor stores, restaurants and other licensed premises.

Grocery retailers can purchase products from Metcash through the above channels or directly from suppliers with the purchase cost settled with Metcash. Metcash also undertakes marketing activities for some of the independent retailers it supplies.

Independent retailers do not source all products through Metcash. For example, an IGA store might typically obtain up to 70 per cent of its groceries through Metcash, with other groceries (particularly fresh items, but it may be much broader than just fresh) obtained directly from the manufacturer or producer, other (smaller) wholesalers or from wholesale markets.

### 3.3.3 Other independent grocery retailers

#### SPAR

SPAR Australia Limited is a grocery wholesaler based in Brisbane. It supplies groceries to approximately 300 retailers located in Queensland, New South Wales, the Australian Capital Territory, the Northern Territory and overseas.

SPAR Australia Limited maintains two distribution warehouses in Brisbane—a refrigerated goods warehouse and a dry goods warehouse—which were formerly operated by the Woolworths-owned Australian Independent Wholesalers (AIW). SPAR stocks approximately 14 000 product lines.

SPAR also provides marketing and retail services to approximately 140 affiliated grocery retailers (both supermarkets and convenience stores) under the SPAR and 5 Star banner groups. The ACCC understands that none of the affiliated retail stores are corporately owned. All SPAR and 5 Star retailers own their stores plus a share in SPAR Australia Limited, which negotiates, procures, warehouses and distributes most of each store's range of products. It also provides retail support through systems, promotions and marketing.

#### Specialty retailers

In addition to rival supermarkets and convenience stores, supermarkets face competition from an array of speciality stores. These include butchers, fishmongers, bakeries, greengrocers, produce markets, pharmacies and Asian grocers. There are approximately 22 000 speciality retail grocery stores operating in Australia.<sup>1</sup>

Specialty stores range from large chains to independently owned and operated stores. Supply methods range from producing products themselves (e.g. bakeries), purchasing direct from suppliers or through wholesalers or markets.

Specialty retailers are discussed in more detail in chapter 8 of the report.

## 3.4 Different models of supermarket retailing in Australia

As seen in these descriptions of the major players, there are many different retailing models in Australia, ranging from full vertical integration to a complete split of ownership and control between retailing and wholesaling. There are also a variety of models that fit somewhere between these extremes. Table 3.1 summarises the more prevalent retailing models.

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<sup>1</sup> ABS, Counts of Australian businesses, including entries and exits, June 2003 to June 2007, catalogue no. 8165.0.

**Table 3.1 Retailing models in Australia**

<b>Approximate description of level of vertical integration</b>	<b>Stores which fit the description</b>
Full vertical integration between retailing and wholesaling	ALDI, Coles, Woolworths (other than Tasmania) and some Franklins stores
The wholesaler owns a 'banner-group' agreement with the retailer, which gives the wholesaler some limited control of the retailer's operations (i.e. promotions)	Most of the IGA branded stores in Australia (the wholesaler is Metcash)
The wholesaler owns a minority interest in the retailer in addition to a 'banner-group' agreement, which gives the wholesaler some limited control of the retailer's operations (i.e. promotions)	Some of the major IGA stores and chains (the wholesaler is Metcash)
The wholesaler has a franchising agreement with the retailer	SPAR, some Franklins stores and some IGA stores
The wholesaler is run as a cooperative with each retailer having a stake in the wholesaler	Tasmanian Woolworths, IGA and independent stores each have an interest in Tasmanian wholesaler Statewide Independent Wholesalers
A collection of retailers have a 'banner group' agreement, which gives the collective a degree of control over each retailer's operations. The collective negotiates with wholesalers on behalf of all the stores	FoodWorks (which acquires dry groceries as a collective from Metcash)
Independent retailers who have no banner group agreement or shareholding links with wholesalers	Non-IGA independents supplied by Metcash

### 3.5 Trends in the structure of the industry

Historically, there has been a move towards vertical integration in the grocery sector. Vertical integration in itself is unlikely to raise competition concerns unless an organisation has market power at the wholesale or retail level. In the Australian grocery sector, vertical integration (in all its various forms) is likely to enhance efficiencies in the supply chain.

Another significant trend over the last two decades has been consolidation in the wholesale sector, particularly the wholesale sector that supplies independents. With the exception of SIW in Tasmania and SPAR in Queensland, Metcash is now the only wholesale supplier in Australia able to supply a supermarket with a full range of dry groceries. The mergers that gave rise to this situation and the question of whether this situation raises competition concerns are discussed in chapter 7 and appendix E. A key issue discussed in that chapter is whether Metcash supplies the independents with dry groceries at a price that enables them to compete effectively with the MSCs.

### 3.6 Concentration analysis

This concentration analysis provides information on the relative size and reach of the major industry participants. An assessment of industry concentration is an important element in competition assessment and can provide an indication of whether there may be competition concerns. However, a finding that an industry is concentrated is not itself determinative of competition issues. Other factors, particularly barriers to entry, must also be assessed.

One of the criticisms of Australia's grocery retail market is that it is too concentrated, with regular statements being made by industry commentators that the two largest retailers, Coles and Woolworths, account for 80 per cent of retail sales. This section looks at the basis of these claims and sets out a range of indicators of industry concentration.

A number of measures can be used to assess the competitive presence of different participants in the retail grocery sector.<sup>2</sup> Some of these measures, presented below, include retail turnover, the number of stores operated and retail custom (number of store visits).

### 3.6.1 Turnover

Turnover, or volume of sales, provides an indication of the scale of a company's operations. The following analysis looks at turnover for all retail grocery items and also for individual product categories.

#### All grocery sales

There is no single measure for determining the share of retail grocery turnover held by various businesses. All measures referred to below have limitations in respect of the businesses or products covered, or in the data collection methodology. These limitations are outlined as appropriate.

#### *The Nielsen Company's ScanTrack data*

The Nielsen Company's (Nielsen) ScanTrack data is commonly referred to in analysis of grocery retail sales. ScanTrack uses point-of-sale data to monitor the sales of over 90 fast-moving consumer good categories sold through Coles, Woolworths, Franklins and Metcash supplied supermarkets (sales through Campbells Wholesale are excluded). ALDI sales are not tracked, but are estimated through Nielsen's Homescan service.<sup>3</sup>

These tracked product categories are estimated to account for approximately half of all grocery sales by value. It includes a selection of dry groceries, dairy and frozen foods as well as a number of non-food items, but does not cover fresh products (e.g. meat, fruit and vegetables) which are a significant part of the retail offer.

The exclusion of a number of product ranges—particularly from fresh departments where supermarkets generally have a lower share of overall sales—and exclusion of sales from businesses not registered with the service (other than ALDI) will tend to overstate the relative expenditure at each of the businesses covered.

The Nielsen submission to the Joint Select Committee on the Retailing Sector in 1999 stated that the market share figures derived from ScanTrack data only relate to the packaged grocery market. According to Nielsen, this definition is restrictive and an assessment of the grocery market turnover should include fresh meat, fresh fruit and vegetables, delicatessens, bread and liquor.<sup>4</sup> For these reasons, the ACCC does not believe that Nielsen ScanTrack data is an appropriate measure of the share of total grocery retail turnover achieved by the businesses covered. It can, however, be used as an indication of share of sales achieved by the various businesses for packaged groceries (discussed below).

#### *Woolworths data*

Woolworths data on retailer shares of national grocery expenditure is contained in table 3.2. This data is based on sales of 'take-home food and grocery items' as defined by Woolworths and excludes liquor and general merchandise sales.

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2 The ACCC will generally avoid using the phrase 'market shares' in this assessment of market concentration as the word 'market' has a specific meaning in the *Trade Practices Act 1974*. The concentration figures presented in this chapter are not necessarily representative of market shares in the context in which the word 'market' is used in the Act.

3 Homescan is a consumer panel of 10 000 households. Participants record details of all purchases, including grocery products.

4 ACNielsen, Submission to the 1999 Joint Select Committee on the Retailing Sector, submission 165, pp. 3–5.

Grocery sale shares of Coles and Woolworths do not include expenditure at convenience stores, petrol outlets or department stores operated by these businesses. The overall sales figures for these businesses are therefore likely to be understated by this measure.

According to Woolworths, the MSCs maintained a combined share of 53 per cent to 54 per cent of take-home food and grocery item sales for the period 2002–03 to 2006–07. The largest gains were made by ALDI and the non-supermarket sales channels at the expense of Metcash supplied stores. Other than ALDI, Woolworths is the only supermarket chain to maintain its share of sales over this period.

**Table 3.2 Woolworths’ estimates of grocery retail sales shares**

Business	Share of national take-home food and grocery sales (per cent)	
	2002–03	2006–07
Woolworths supermarkets	30.6	30.8
Coles supermarkets	23.1	22.8
ALDI	1	2.8
Franklins	1.6	1.1
Metcash supplied stores	19.7	16.6
Mass merchants	1.6	1.6
All other retailers selling food	22.5	24.3

Note: ‘mass merchants’ includes department stores and discount department stores. ‘All other retailers selling food’ includes non-Metcash supplied independent retailers, as well as specialty retailers (e.g. bakeries) and food markets but excludes take-away outlets, cafes and restaurants.

Source: ACCC, public hearing transcript, Melbourne, 19 May 2008; Woolworths, submission no. 233

### *Coles data*

Coles estimated, using ABS measure 2<sup>5</sup>, that its supermarkets account for between 24 per cent and 25 per cent of retail grocery sales.<sup>6</sup> This is down from the estimate of 27.5 per cent made by the ABS for the Joint Select Committee on the Retailing Sector in 1999.<sup>7</sup>

### *ACCC survey*

An ACCC survey of grocery consumer habits found that 81 per cent of grocery shopping (by dollars spent) is done at supermarkets, 16 per cent at specialty stores, and 3 per cent at convenience stores or other retail outlets.<sup>8</sup> This includes both dry and fresh groceries.

### *Roy Morgan survey*

The ACCC obtained consumer survey data from Roy Morgan. This survey data shows the proportion of retail grocery expenditure at all supermarkets, grocery stores and convenience stores (including petrol outlets) achieved by each business (see chart 3.1). Respondents to the survey were asked about the amount spent at each supermarket or convenience store visited over the past week. Yearly figures were obtained through an aggregation of the results of surveys conducted throughout the year.

5 ABS measure 2 includes supermarket, grocery and convenience stores, liquor retailers and specialty food retailers (e.g. bakeries, butchers, and fruit and vegetable retailers).

6 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 38.

7 Joint Select Committee on the Retailing Sector, *Fair market or market failure? A review of Australia’s retailing sector*, August 1999, chapter 4.

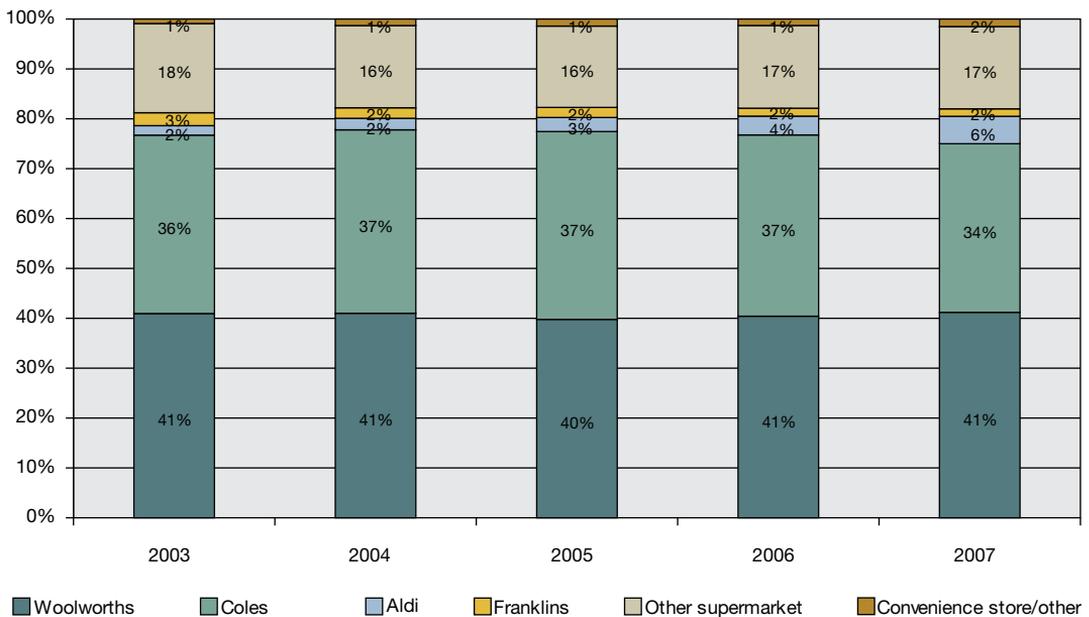
8 Respondents answer to the question ‘And overall about what percentage of your shopping is made at the supermarket, what percentage at specialty stores and what percentage at convenience stores such as service stations and milk bars?’, ACCC consumer survey, April 2008. The survey had 1500 respondents.

For Coles and Woolworths, this data includes grocery expenditure at all relevant supermarkets, convenience stores, petrol outlets and internet sales. Grocery sales at Coles and Woolworths operated department stores are not included.

Not included in this data is expenditure at specialist retailers such as butchers and bakeries. Accordingly, this measure overstates the relative expenditure at each of the businesses covered.

The survey results indicate that the proportion of retail grocery sales achieved by Coles (34 per cent), Woolworths (41 per cent) and independent supermarkets (17 per cent) has either remained constant or fallen slightly over the last five years. Significant gains have been made by ALDI over this same period, although it still only accounts for around 6 per cent of sales. Smaller grocery or convenience stores (2 per cent) have also made some gains over this period.

**Chart 3.1 Retailers' shares of grocery sales**



Source: Roy Morgan consumer survey

### ACCC's view

Based on the information available to it, the ACCC's view is that the MSCs account for between 55 per cent and 60 per cent of consumer expenditure on grocery items. Woolworths accounts for at least 30 per cent and Coles around 25 per cent. Although each of these shares of retail grocery sales are large for a single company, to say that the MSCs enjoy an 80 per cent share of grocery sales exaggerates the position of the retailers.

### *Is this level of concentration likely to reduce competitive pressure in the sector?*

To assist in an assessment of the level of concentration in the retail grocery sector, measures commonly employed by the ACCC in merger reviews under s. 50 of the Act can be used. Measures including the CR4 ratio<sup>9</sup> and the Herfindahl-Hirschman Index (HHI)<sup>10</sup> provide a summary of the level of concentration which can be useful in determining whether a particular market structure is likely to raise competition concerns.

These concentration measures, combined with the sales shares of individual businesses, may be indicative, but not determinative, of the ability of a business to exert market power. Accordingly, they are only used as an indicator of the potential for competition issues in a sector. Generally, a market would be considered concentrated for the purposes of a merger assessment if the CR4 ratio was greater than 75 per cent or the HHI was greater than 2000.

For the grocery retail sector, the CR4 ratio is at least 70 per cent, and the HHI is between 1800 and 2200. Both these measures indicate that the sector is concentrated. However, the level of concentration in the sector, and in particular the positions of Coles and Woolworths, does not represent a level which, of itself, requires market reform.

### **Individual product categories**

It is also clear on closer analysis that the MSCs share of the grocery dollar varies dramatically depending on the food category being examined. Specialty stores sales are substantial in the fresh product categories and therefore need to be considered in any analysis of whether there are competition problems at the retail level.

### *Packaged groceries*

Packaged groceries, which constitute dry, frozen and chilled groceries, are the single largest product category within supermarkets. The majority of packaged groceries are sourced on a national level, reflecting the long shelf life of these products relative to fresh produce.

The ACCC obtained ScanTrack data from Nielsen. As discussed above, ScanTrack collects point-of-sale data from registered grocery operators for a range of packaged grocery categories. This data does not cover all packaged grocery products and it excludes businesses not registered with the service (except ALDI)—meaning that it is likely to overstate the proportion of total expenditure on packaged groceries for each of the businesses covered.

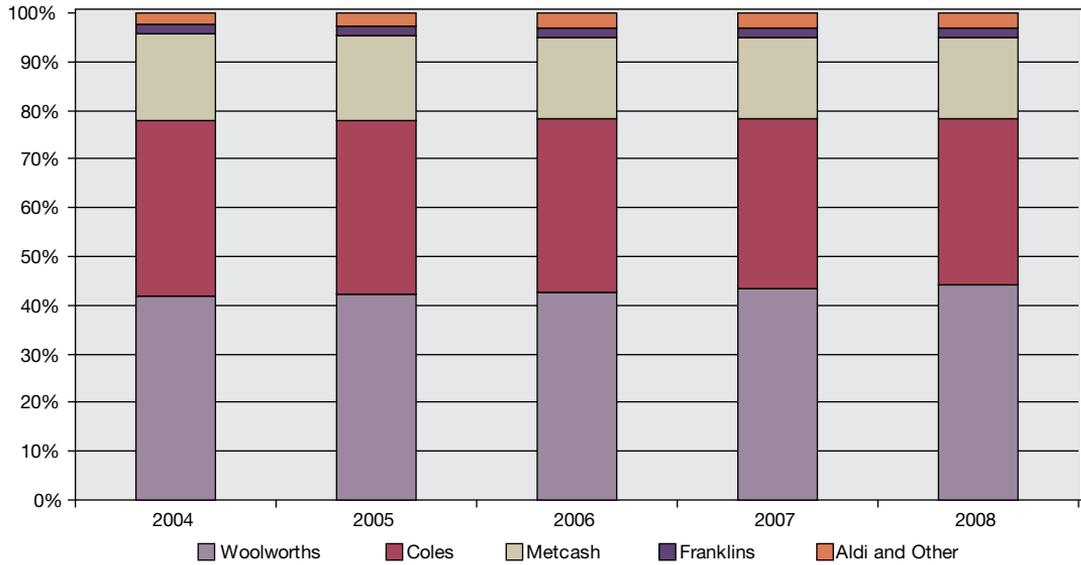
Charts 3.2 and 3.3 represent Nielsen data on retailers' share of sales, both nationally and at a state level, for packaged groceries between 2004 and 2008. According to this data, Coles and Woolworths account for around 78 per cent of national supermarket packaged grocery sales. Woolworths has increased its share of packaged grocery sales from 42 per cent in 2004 to 44 per cent in 2008. Coles' share of sales has fallen from 36 per cent in 2004 to 34 per cent in 2008. The share of sales varies significantly between states, with Coles and Woolworths accounting for 79 per cent of packaged grocery sales in New South Wales but only 67 per cent in Western Australia.

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9 The CR4 ratio is given by the sum of the market shares of the four largest firms in the relevant market.

10 The HHI is calculated by adding the sum of the squares of the market share of each firm in the relevant market.

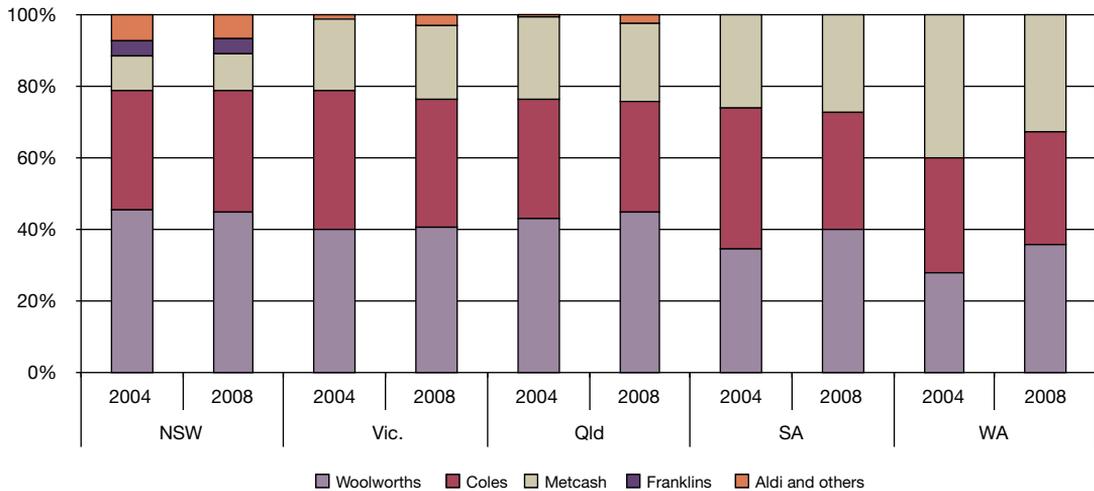
**Chart 3.2 Nielsen: retailers' shares of packaged grocery sales (national)**



Note: 'ALDI and other' is a projection (i.e. it is not based on point-of-sale scanning data).

Source: the Nielsen Company

**Chart 3.3 Nielsen: retailers' shares of packaged grocery sales (by state)**



Note: 'ALDI and other' is a projection (i.e. it is not based on point-of-sale scanning data).

Source: the Nielsen Company

The share of sales through Metcash supplied supermarkets has fallen from 18 per cent in 2004 to 17 per cent in 2008. This drop in sales share has been most pronounced in Western Australia, with the share of sales through Metcash supplied supermarkets falling from 40 per cent in 2004 to 33 per cent in 2008. ALDI has increased its share of sales in Victoria and Queensland but still only accounts for 2 to 3 per cent of sales in those states. Franklins has maintained its share of sales in New South Wales.

A CHOICE survey on the main location for purchasing grocery products such as packaged goods found that the MSCs were the main location for 79 per cent of respondents. Woolworths was the main supermarket for 42 per cent of respondents, Coles 37 per cent, ALDI 6 per cent and other supermarkets 15 per cent.<sup>11</sup>

Woolworths submitted that it accounts for around 33 per cent of grocery sales (including packaged groceries, dairy and frozen goods).<sup>12</sup> Coles submitted that it accounts for around 27 per cent to 28 per cent of packaged grocery sales.<sup>13</sup>

### ACCC's view

The ACCC considers, based on the information available to it, that all the data indicates that packaged groceries is the category most heavily dominated by the MSCs. While 78 per cent represents the highest the share is likely to be, the ACCC considers that it is not likely to be much less. A figure of approximately 70 per cent seems a reasonable assessment.

The HHI for the retailing of packaged groceries based on this assessment of sales shares is between 2750 and 3000. Although these figures show a high level of concentration in this segment of the retail grocery industry, other factors including barriers to entry and expansion must be considered before any conclusions are drawn on the effectiveness of competition.

### *Fresh groceries*

The proportion of retail sales of fresh groceries through the MSCs is generally lower than for packaged groceries. The arrangements for sourcing fresh groceries also differ. For example, most produce is sourced on a state or local level.

### *Fruit and vegetables*

A range of estimates have been provided on the volume of fresh fruit and vegetable sales through different retail outlets. The share of national fresh fruit and vegetable sales through Woolworths and Coles has been estimated between 40 and 65 per cent.

Roy Morgan survey results indicate that the MSCs account for 42 per cent of fresh fruit sales and 44 per cent of fresh vegetable sales (charts 3.4 and 3.5). This represents a significant fall from 2003 where the MSCs accounted for 49 per cent of fruit sales and 51 per cent of vegetable sales. Over this period, other supermarkets and specialty retailers for fresh fruit and vegetables have had gains in their share of sales of 4 per cent. Again, these sale share figures are likely to vary between regions and product categories.

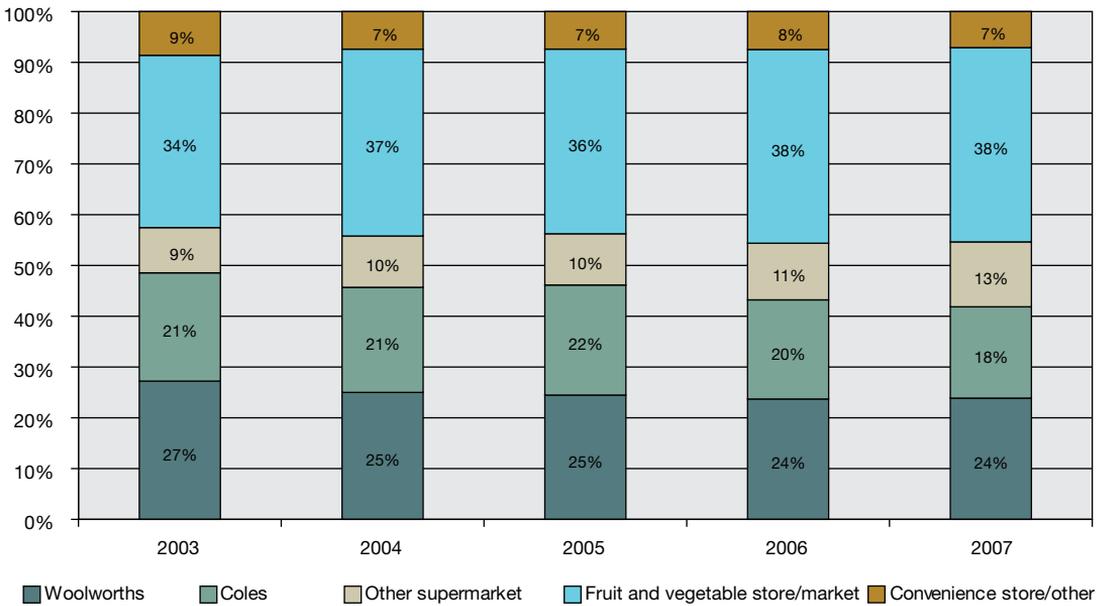
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11 CHOICE, submission no. 143, p. 10.

12 Woolworths, submission no 232, p. 3.

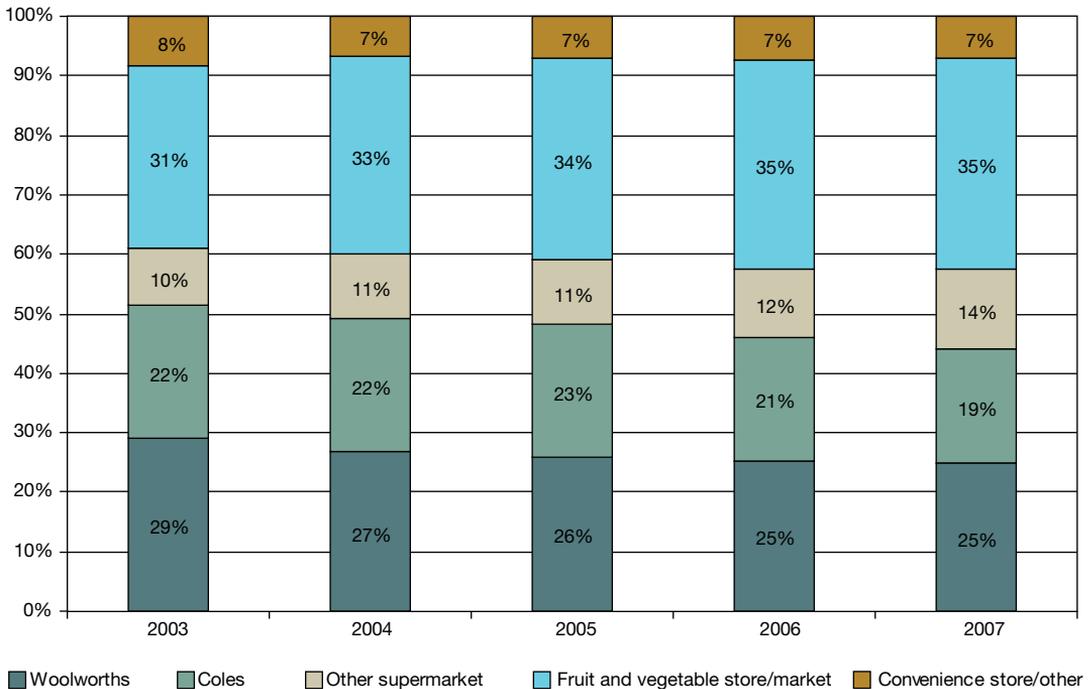
13 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 38.

**Chart 3.4 Retailers' shares of fresh fruit sales**



Source: Roy Morgan consumer survey

**Chart 3.5 Retailers' shares of fresh vegetable sales**



Source: Roy Morgan consumer survey

The Roy Morgan data is supported by Horticulture Australia Ltd (HAL), which stated that around 25 per cent of fruit and vegetables are sold through Woolworths and 20 per cent through Coles, these figures having fallen slightly over the past five years.<sup>14</sup>

Woolworths submitted that it accounts for around 26 per cent of fruit and vegetable retail sales.<sup>15</sup> Coles submitted that it accounts for around 19 per cent to 20 per cent of fresh products, but did not provide any further details on specific fresh categories.<sup>16</sup>

A CHOICE survey on the main location for purchasing fruit and vegetables found a significantly lower level of custom at the MSCs, with Woolworths the main location for 19 per cent of respondents and Coles 13 per cent. Fruit and vegetable stores and markets were the main source of fruit and vegetables for 50 per cent of respondents.<sup>17</sup>

The Australian Chamber of Fruit and Vegetable Industries<sup>18</sup>, and Brismark and Brisbane Markets Ltd<sup>19</sup> estimated that 60 to 65 per cent of fresh produce sold in Australia is handled by Coles and Woolworths. These estimates correspond to individual product share estimates provided for apples, pears and avocados.<sup>20</sup>

### ACCC's view

Based on the information available to it, the ACCC considers that it is likely that no more than 50 per cent of fresh fruit and vegetables are sold through the MSCs, and that the Roy Morgan figures for Woolworths (25 per cent) and Coles (20 per cent) are realistic and supported by other available data.

### Meat

Of domestic meat production in 2007, 44 per cent of red meat, and nearly all poultry meat, was consumed domestically.<sup>21</sup>

Roy Morgan survey results indicate that Woolworths and Coles combined account for 48 per cent of fresh meat sales, down from 53 per cent in 2003 (chart 3.6). Sales through butchers have remained fairly constant between 30 and 31 per cent.

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14 ACCC, public hearing transcript, Cairns, 4 April 2008, pp. 4–5.

15 Woolworths, submission no. 232, p. 3.

16 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 38.

17 CHOICE, submission no. 143, p. 10.

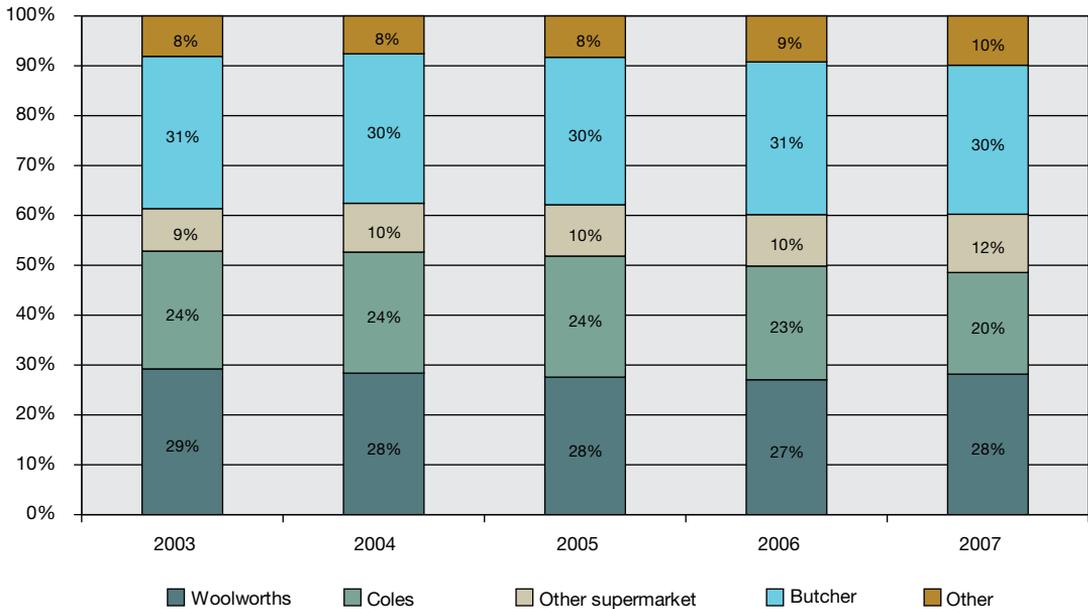
18 Australian Chamber of Fruit and Vegetable Industries, submission no. 135, p. 4.

19 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 107.

20 Apple and Pear Australia, submission no. 80, p. 3; ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 118.

21 ABS, *Livestock Products*, Australia, cat. no. 7215.0, Canberra; Department of Agriculture, Fisheries and Forestry, *Export Statistics*, Canberra; ABARE.

**Chart 3.6 Retailers' shares of fresh meat sales**



Note: 'other' includes markets, delicatessens and other retail outlets.

Source: Roy Morgan consumer survey

Other industry data on red meat market shares is broadly supportive of the Roy Morgan findings. This includes the Meat and Livestock Association (MLA) estimate that Coles and Woolworths have approximately a 50 per cent share of red meat retail sales.<sup>22</sup>

Industry estimates of shares of poultry sales by large format supermarkets are similar to those for red meat. However, butchers are estimated to account for only 18 per cent of poultry sales.<sup>23</sup> The difference is attributed to a larger share of poultry meat going through the food service industry.

Woolworths submitted that it accounts for around 30 per cent of fresh meat retail sales.<sup>24</sup> Coles submitted that it accounts for about 19 per cent to 20 per cent of fresh products generally.<sup>25</sup>

A CHOICE survey on the main location for purchasing fresh meat found a lower level of custom at the MSCs, with Woolworths the main location for 23 per cent of respondents and Coles 16 per cent. Butchers were the main source of fresh meat for 43 per cent of respondents.<sup>26</sup>

### ACCC's view

The ACCC considers that, based on the information available to it, it appears that approximately 50 per cent of fresh meat is sold through the MSCs.

### Bakery products

Bakery products include those produced on site by the retailer and those provided for sale by external suppliers.

22 MLA, information provided to the ACCC, 16 July 2008, relying on data provided by BIS Shrapnel/Roy Morgan.

23 S Spencer and M Kneebone, *FoodMap: a comparative analysis of Australian food distribution channels*, DAFF, 2007, p. 44.

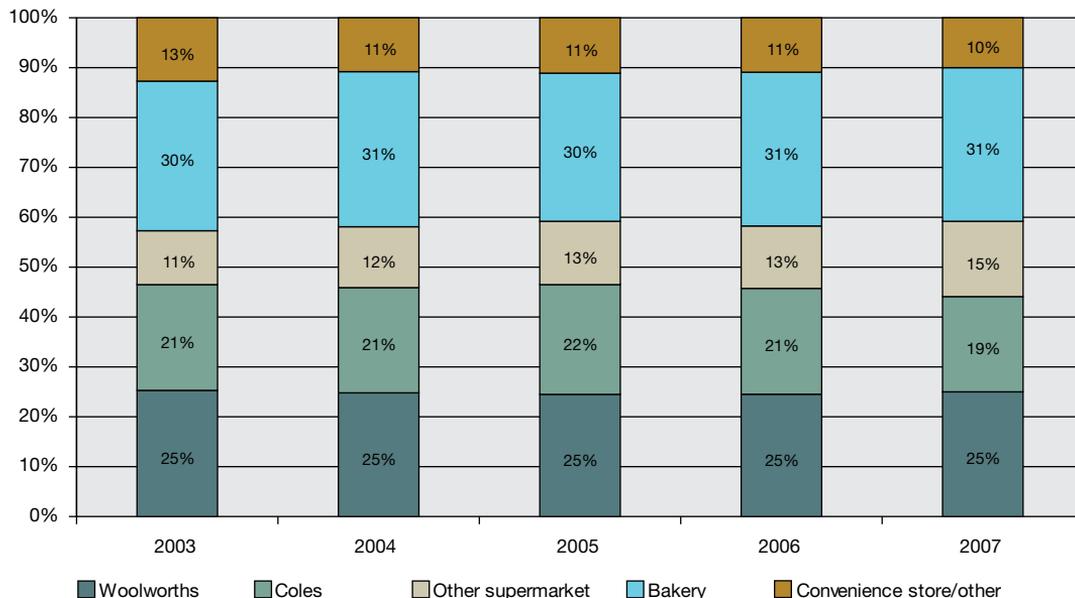
24 Woolworths, submission no. 232, p. 3.

25 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 38.

26 CHOICE, submission no. 143, p. 11.

Roy Morgan survey results indicate that Woolworths and Coles account for 44 per cent of bakery sales, with independent bakeries making up 31 per cent of total sales (chart 3.7). These sale shares have been relatively stable over the last five years. Overall, sales through supermarkets (59 per cent) have been increasing at the expense of sales through convenience stores.

**Chart 3.7 Retailers' shares of bakery sales**



Source: Roy Morgan consumer survey

This data is generally supported by estimates from the Australian Government Department of Agriculture, Fisheries and Forestry (DAFF)<sup>27</sup> and IBISWorld.<sup>28</sup>

Woolworths submitted that it accounts for around 23 per cent of bakery sales.<sup>29</sup> Coles submitted that it accounts for about 19 per cent to 20 per cent of fresh products generally.<sup>30</sup>

### ACCC's view

The ACCC considers that all the data available indicates that it is unlikely that any more than 50 per cent of bakery products are sold through the MSCs. Further, the ACCC considers that the Roy Morgan figures for Woolworths (25 per cent) and Coles (19 per cent) are realistic and supported by other available data.

### Dairy

Although falling under the category of 'packaged groceries', dairy products including fresh milk, have a relatively short shelf life. Accordingly, supply channels for these products more closely resemble those for fresh grocery items.

27 S Spencer and M Kneebone, *FoodMap: a comparative analysis of Australian food distribution channels*, DAFF, 2007, p. 37.

28 IBISWorld Industry report G5124, *Bread and cake retailing in Australia*, November 2007, p. 6.

29 Woolworths, submission no. 232, p. 3.

30 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 38.

Share of dairy product sales for the MSCs is estimated at between 50 per cent and 60 per cent for categories including fresh milk, cheese and dairy spreads, but is thought to be larger in some categories such as yoghurt.<sup>31</sup>

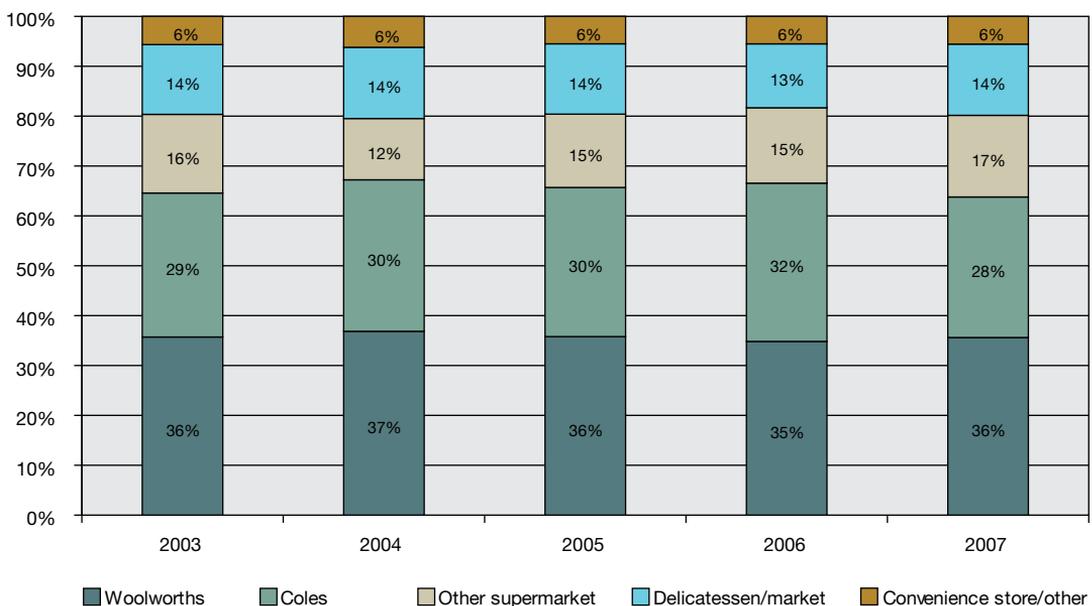
### ACCC's view

The ACCC considers, based on the information available to it, that it appears that between 50 per cent and 60 per cent of dairy products, including fresh milk, cheese and dairy spreads, are sold through the MSCs.

### Deli products

Roy Morgan survey results indicate that Woolworths and Coles account for 64 per cent of deli sales, down from an average for the previous four years of 66 per cent. Combined sales through delicatessens and markets have remained stable at 14 per cent over this period, with the remaining sales being made through other supermarkets and convenience stores (chart 3.8).

**Chart 3.8 Retailers' shares of deli sales**



Source: Roy Morgan consumer survey

Woolworths submitted that it accounts for around 31 per cent of deli sales.<sup>32</sup> Coles submitted that it accounts for about 19 to 20 per cent of fresh products generally.<sup>33</sup>

### ACCC's view

Based on the information available to it, the ACCC considers that it appears that 50 per cent to 60 per cent of deli sales are through the MSCs.

31 S Spencer and M Kneebone, *FoodMap: a comparative analysis of Australian food distribution channels*, DAFF, 2007, p. 35; ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 4; Dairy Australia, *Australian dairy industry in focus 2008*, July 2008.

32 Woolworths, submission no. 232, p. 3.

33 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 38.

## Eggs

The retail market for eggs is estimated to account for about 45 to 50 per cent of domestic egg production, with the remainder going to the food service and manufacturing industries.<sup>34</sup> DAFF estimated that the MSCs sell approximately half of all eggs available to the retail market.<sup>35</sup>

### ACCC's view

Based on the information available to it, the ACCC considers that it appears that up to 50 per cent of fresh egg retail sales are through the MSCs.

### Summary

Table 3.3 sets out the ACCC's estimates of the share of sales enjoyed by the MSCs for a range of product categories. It can be seen that the MSCs' share of the grocery dollar varies dramatically depending on the food category being examined. In particular, the proportion of retail sales of fresh groceries through the MSCs is generally lower than for packaged groceries, with specialty stores such as fruit and vegetable retailers, bakeries and butchers competing with supermarkets in the fresh product categories.

Woolworths and Coles are clearly the largest players in each of the product categories. However, with the exception of packaged groceries, the share of sales attributable to each of Coles and Woolworths are not at a level that raises significant concerns about the current market structure.

**Table 3.3 ACCC estimates of MSC product category shares of sales**

Category	MSC share of sales
Packaged groceries	Approximately 70 per cent
Fruit and vegetables	Up to 50 per cent
Fresh meat	Approximately 50 per cent
Bakery products	Up to 50 per cent
Dairy products	50–60 per cent
Deli products	50–60 per cent
Eggs	Approximately 50 per cent

## 3.6.2 Store numbers

Store numbers can provide a useful indicator of market structure. With a focus on competition within local markets, the operation of a greater number of stores means that a business is likely to influence the overall competitive strategy of competing businesses.

However, it must be recognised that, because of differences in size and turnover of individual grocery stores, store numbers may not be an accurate gauge of the relative scale of competing businesses.

Woolworths referred to ABS data to submit that the MSCs only contributed to 7 per cent of the growth in food retail outlets between 2003 and 2007.<sup>36</sup> If the analysis is confined to supermarket growth, however, the MSCs can be seen to have contributed significantly more to growth in the sector.

Coles and Woolworths have both increased the number of stores operated by over 40 per cent in the last 10 years. This growth has enabled the MSCs to maintain a fairly consistent proportion of all

<sup>34</sup> Australian Egg Corporation, submission no. 113, p. 4; ACCC, public hearing transcript, Canberra, 8 April 2008, p. 61.

<sup>35</sup> S Spencer and M Kneebone, *FoodMap: a comparative analysis of Australian food distribution channels*, DAFF, 2007, p. 48.

<sup>36</sup> Woolworths, submission no. 134, p. 26.

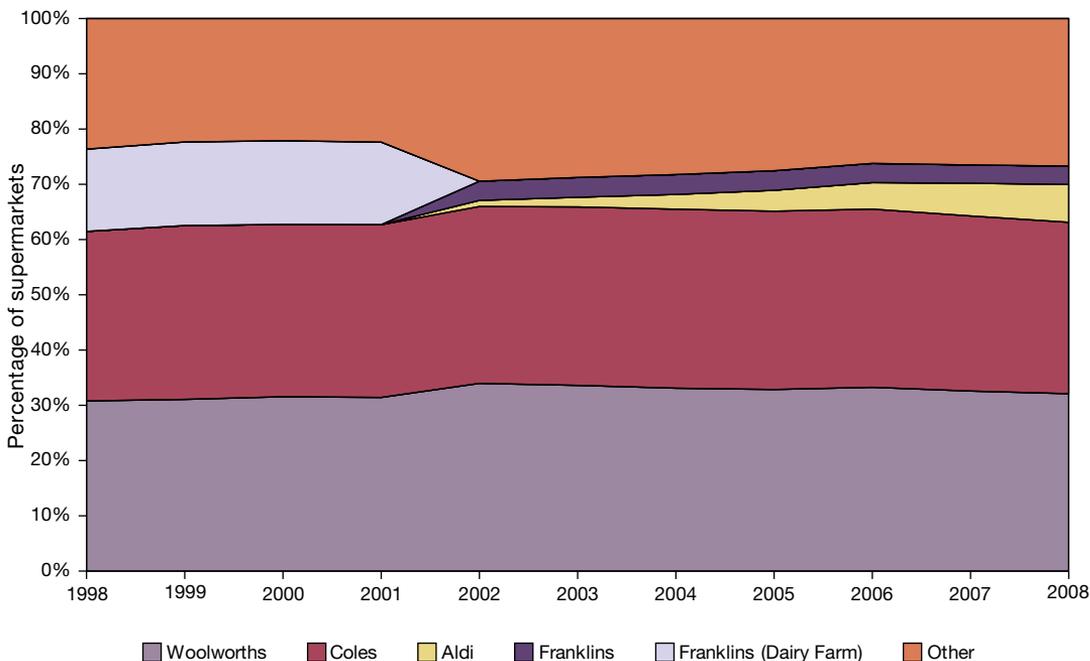
supermarkets of about 1000 m<sup>2</sup> or greater, with just over 30 per cent each nationally (chart 3.9). There are approximately 2400 supermarkets of about 1000 m<sup>2</sup> or greater currently operating in Australia.

Over this period, there have been substantial changes to the competitive landscape, both in relation to the players in the sector and the overall retail offer provided. The most significant change over this period involved the exit of the Dairy Farm International operated Franklins business in 2001.

Purchases of the majority of the Franklins stores by independent grocery retail businesses resulted in an increased holding by independent retailers of supermarkets above 1000 m<sup>2</sup> from 22 per cent to 29 per cent. Woolworths also increased its presence through the acquisition of around 70 Franklins stores, moving from 31 per cent to 34 per cent of total store holdings.

ALDI entered Australia in 2001 and have expanded to currently account for approximately 7 per cent of all grocery stores of around 1000 m<sup>2</sup> or greater (by number).

**Chart 3.9 Proportion of supermarkets, with a sales area of about 1000 m<sup>2</sup> or greater, operated nationally by different businesses**



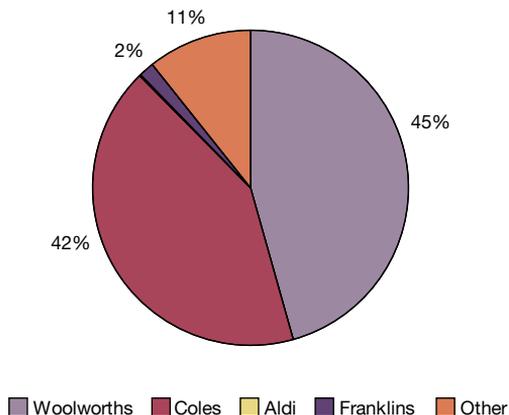
Source: data aggregated from various public and confidential sources.

Although there are a substantial number of stores above 1000 m<sup>2</sup> competing with the MSCs, most of these are mid-sized rather than large format supermarkets with the majority between 1000 m<sup>2</sup> and 2000 m<sup>2</sup>. In comparison, around 60 per cent of MSC stores are above 3000 m<sup>2</sup> in sales area.

Looking only at supermarkets above 2000 m<sup>2</sup>, the MSCs account for around 87 per cent of stores (chart 3.10). For supermarkets above 3000 m<sup>2</sup>, the MSCs account for around 96 per cent of stores (chart 3.11). Of the larger format supermarkets that compete against the MSCs, the majority are operated by independent retailers.

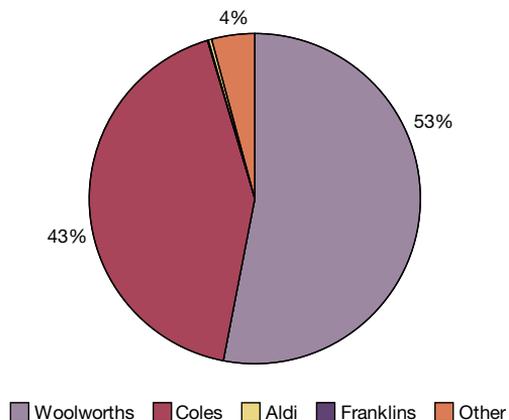
Analysis of consumer demand in the recent UK investigation into the supply of groceries<sup>37</sup> found that consumers do not view all store sizes as perfectly substitutable for one other. In particular, stores larger than 1000 m<sup>2</sup> to 2000 m<sup>2</sup> were greatly preferred for large weekly shopping trips. An ACCC survey found that approximately three-quarters of all grocery shoppers conduct a large weekly shop.<sup>38</sup> As a result, the dominance of Coles and Woolworths in large format supermarkets may raise market structure concerns.

**Chart 3.10 Proportion of supermarkets, with a sales area greater than 2000 m<sup>2</sup>, operated nationally by different businesses**



Source: Mapinfo

**Chart 3.11 Proportion of supermarkets, with a sales area greater than 3000 m<sup>2</sup>, operated nationally by different businesses**



Source: Mapinfo

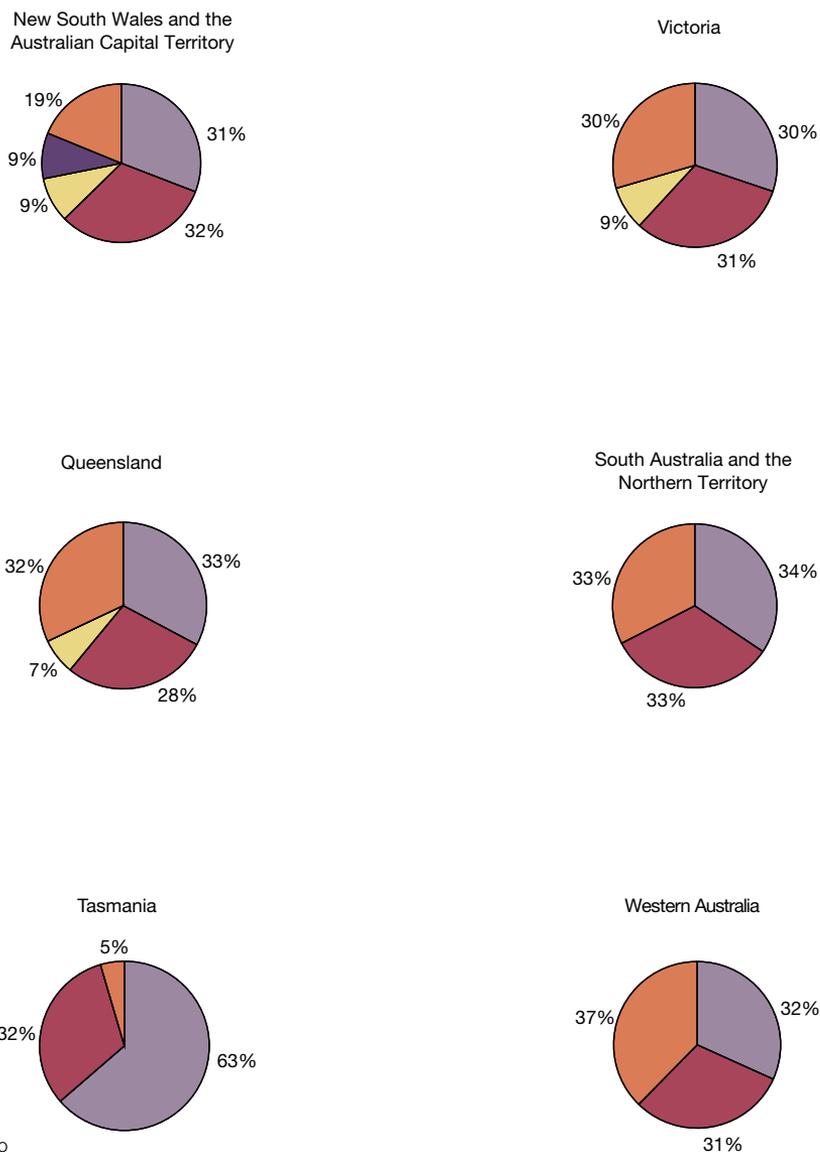
37 Competition Commission, *The supply of groceries in the UK market investigation*, April 2008, pp. 62–67.

38 Respondents answer to the question 'Which of the following best characterises the way you typically do your grocery shopping?', ACCC consumer survey, April 2008.

At the state level, New South Wales has the least concentration of operators of supermarkets above 1000 m<sup>2</sup> (see chart 3.12). Coles and Woolworths each account for just over 30 per cent of stores, ALDI and Franklins each hold around 10 per cent of stores and the remainder (19 per cent) are held by independents. ALDI is also present in Victoria and Queensland, with between 7 per cent and 9 per cent of stores in those states.

Independent retailers have a relatively larger presence in those states where ALDI is not present, accounting for 33 per cent and 37 per cent in South Australian and Western Australia respectively. Tasmania is the exception, with independent retailers accounting for only 5 per cent of supermarkets above 1000 m<sup>2</sup>. However, it should be noted that, as with other states, there are a significant number of smaller format independent supermarkets in Tasmania.

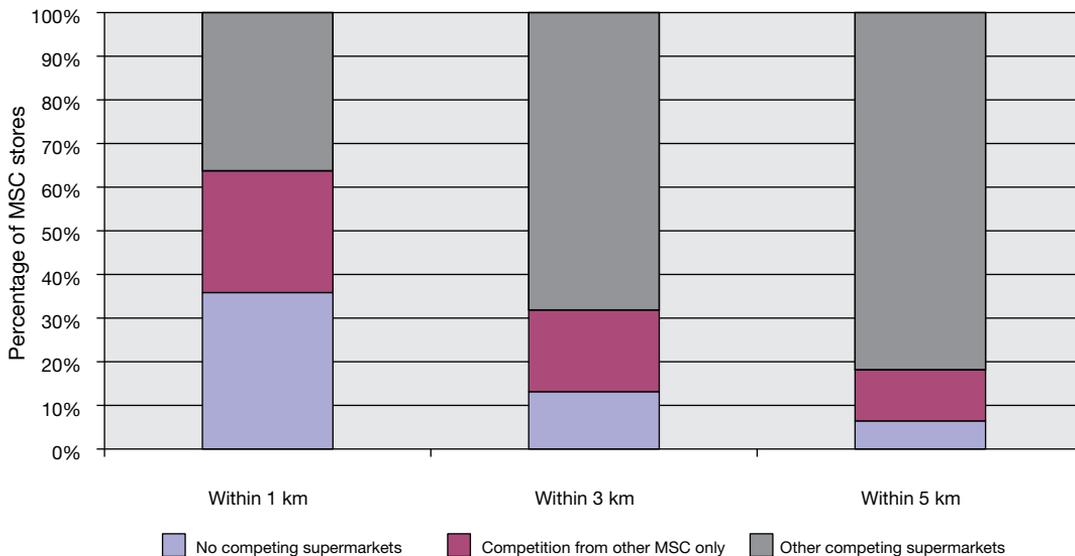
**Chart 3.12 Proportion of supermarkets, with a sales area greater than 1000 m<sup>2</sup>, operated in each state or territory by different businesses**



Source: Mapinfo

The majority of MSC stores face competition from both the other MSC and other supermarkets above 1000 m<sup>2</sup> (chart 3.13). Within 3 km, almost 70 per cent of MSC stores face competition from a non-MSC supermarket. A further 19 per cent face competition from the other MSC only. Within 5 km, only 6 per cent of MSC stores do not have a competing supermarket above 1000 m<sup>2</sup>, with most of these stores located in rural areas.

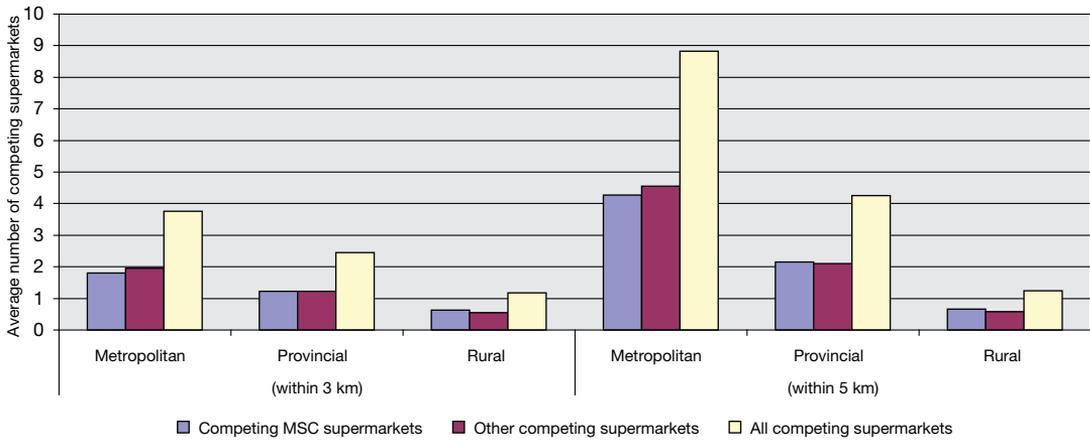
**Chart 3.13 Percentage of MSC stores facing competition from other supermarkets above 1000 m<sup>2</sup> within defined distances**



Source: Mapinfo

Within 3 km of an MSC store there are, on average, three competing supermarkets above 1000 m<sup>2</sup> (chart 3.14). Within 5 km this increases to six competing supermarkets. Metropolitan MSC stores face the greatest competition, with an average of four competing supermarkets within 3 km (compared to around two for provincial stores and one for rural stores) and nine within 5 km (compared to four for provincial stores and one for rural stores). The competing supermarkets are split relatively evenly between MSC and other supermarkets.

**Chart 3.14 Average number of supermarkets (above 1000 m<sup>2</sup>) competing against an MSC store within defined distances**

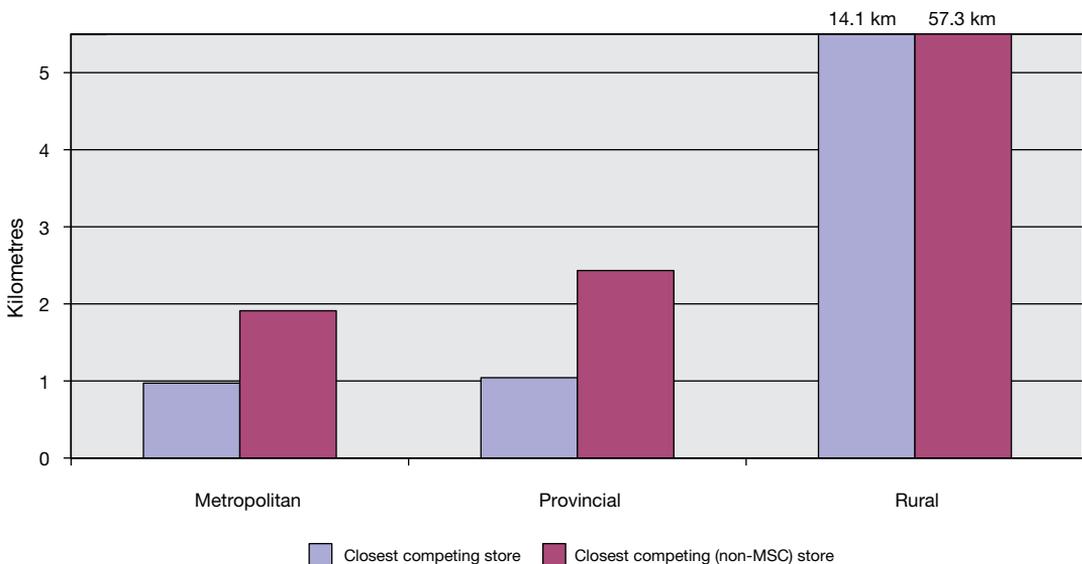


Note: 'provincial' is defined as an urban area with a population greater than 20 000.

Source: Mapinfo

The average distance between an MSC store and its nearest competing supermarket above 1000 m<sup>2</sup> in metropolitan areas is less than 1 km (chart 3.15). This increases to just over 1 km for provincial stores and 14 km for rural stores. However, it is important to note that the average distance to a competing store in rural areas is affected by a small number of very remote stores. Metropolitan MSC stores, on average, face competition from a non-MSC supermarket above 1000 m<sup>2</sup> within 2 km. This increases to around 2.5 km for provincial stores and 57 km for rural stores.

**Chart 3.15 Average distance between an MSC store and its nearest competing supermarket above 1000 m<sup>2</sup>**



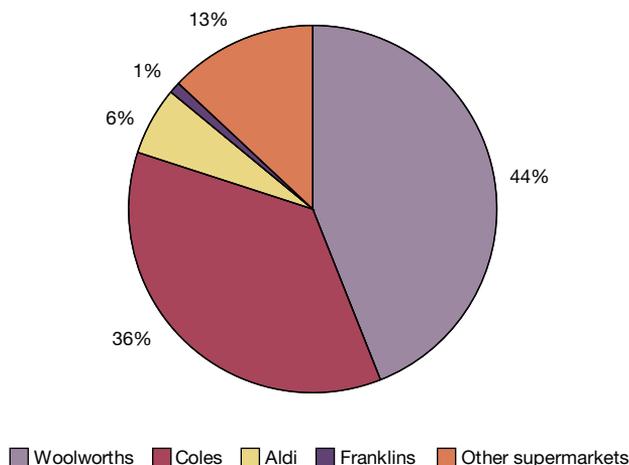
Note: Tasmanian and Northern Territory stores have been excluded from the 'closest competing (non-MSC) store' data set because of the small number of independent stores above 1000 m<sup>2</sup> in these locations.

Source: Mapinfo

### 3.6.3 Store visits

The primary supermarket frequented by grocery consumers, as found in an ACCC survey of grocery consumer habits, is set out in chart 3.16. This data is based on the number of store visits rather than expenditure. As the average level of expenditure varies significantly between supermarkets, this should not be taken as an indication of the proportion of grocery retail sales achieved by different businesses. Additionally, this data only looks at supermarkets and therefore will tend to overstate the relative level of custom at each business included.

**Chart 3.16 Primary supermarket frequented by grocery consumers**



Source: respondents answer to the question 'Which one of the following (supermarkets) do you shop at most often?' ACCC consumer survey, April 2008.

A CHOICE survey on the main location for grocery shopping found similar results. Woolworths was the main supermarket for 42 per cent of respondents, Coles 36 per cent, ALDI 6 per cent and other supermarkets 16 per cent.<sup>39</sup>

### 3.6.4 Conclusion

There are a wide range of methods by which concentration analysis can be conducted. The most appropriate measure will depend upon the question being asked. However, whichever approach is taken, Australia's grocery retail sector can be seen as relatively concentrated.

Woolworths and Coles are clearly the largest supermarket retail operations in Australia by a significant margin. Collectively, the independent sector supplied by Metcash is significant, but still appears to be well behind the size of Coles, the smaller of the MSCs. ALDI is a quickly growing organisation along the eastern seaboard, but still relatively small. Franklins is only in New South Wales and other independent operators, such as SPAR, are limited in size and geographical reach.

Share of sale figures vary significantly between product categories, with MSCs accounting for 78 per cent of packaged grocery sales, when using Nielsen ScanTrack data, but as low as 42 per cent for some fresh goods when using Roy Morgan survey data.

<sup>39</sup> CHOICE, submission no. 143, p. 6.

Coles and Woolworths have, over the past 10 years, maintained operation of a consistent proportion of all supermarkets with sales area above 1000 m<sup>2</sup>. This indicates that the ability of smaller chains and the independent sector to take advantage of suitable development opportunities for stores of this size has not changed over time. However, Coles and Woolworths clearly dominate large format supermarket sites, with around 87 per cent of supermarkets of sales area above 2000 m<sup>2</sup>, and around 96 per cent of supermarkets of sales area above 3000 m<sup>2</sup>. Although the dominant position of Coles and Woolworths in this segment of the grocery sector may indicate that other operators face difficulties in establishing large, full-line supermarkets, it does not seem to have prevented specialty stores and smaller supermarket operators from competing in most product categories.

## 3.7 Retail grocery market structures in foreign economies

To provide some context for the Australian concentration analysis, the ACCC has briefly reviewed available recent information from a number of comparable countries.

It is important to note that in making comparisons between countries, consideration must be taken of factors such as population size, market structure and regulatory framework. Importantly, the approach to measuring concentration is critical. As was shown above, depending on what measure is used may give rise to quite different results.

### 3.7.1 New Zealand

A 2007 New Zealand High Court decision stated the following in relation to concentration of the supermarket industry in New Zealand:

The national market shares of Progressive and Foodstuffs are reasonably even. Progressive has a 44% share of national supermarket sales and Foodstuffs has 56%.<sup>40</sup>

With nearly all national supermarket sales attributable to Progressive and Foodstuffs, the impact of independent supermarkets in New Zealand is negligible.

Foodstuffs, New Zealand's largest grocery distributor, is a cooperative owned by its retailers. At the wholesale level, Foodstuffs distributes groceries throughout New Zealand through its franchised supermarket chains New World, Pak'n Save and Four Square.

Since 2005 Progressive has been a subsidiary of Woolworths Ltd. It directly operates approximately 150 vertically integrated supermarkets under the Woolworths, Countdown and Foodtown banners. It also has approximately 50 franchised supermarket stores under the Fresh Choice and Super Value banners, which it services through its subsidiary Wholesale Distributors Ltd.

### 3.7.2 United Kingdom

In 2008 the UK Competition Commission grocery investigation reported on market structure.<sup>41</sup> Table 3.4 sets share of sales of retail grocery items by retailer.

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<sup>40</sup> *Woolworths Limited and ors v The Commerce Commission*, HC WN CIV 2007-485-1255 [2007] NZHC 902 (12 September 2007).

<sup>41</sup> Competition Commission, *The supply of groceries in the UK market investigation*, April 2008, appendix 3.1.

**Table 3.4 UK—retailers' shares of grocery sales**

Retailer	Share of grocery sales (%)					
	2002	2003	2004	2005	2006	2007
Tesco (S,C)	20.2	22.4	23.8	25.4	26.8	27.6
Asda (S)	12.3	12.9	13.3	13.4	13.7	14.1
Sainsbury's (S,C)	12.8	12.5	12.6	12.8	13.4	13.8
Morrisons (S)	3.8	4.2	10.3	9.6	9.7	9.9
Safeway (S,C)	8.2	7.8	2.4	0.0	0.0	0.0
Somerfield Chain (S)	2.9	2.8	3.0	3.7	4.1	3.9
M&S (D)	3.3	3.4	3.4	3.5	3.6	3.8
CGL (C)	2.8	3.2	3.0	2.9	2.8	3.8
Waitrose (S)	2.5	2.6	2.8	3.0	3.2	3.3
Iceland (S)	1.7	1.6	1.5	1.4	1.4	1.5
ALDI (S)	0.9	1.0	1.1	1.3	1.4	1.5
Lidl (S)	1.1	1.1	1.0	1.1	1.2	1.3
Netto (S)	0.5	0.6	0.6	0.6	0.6	0.6
Kwik Save (S)	2.0	1.8	1.6	1.3	0.7	0.0
Others	24.9	22.1	19.6	20.0	17.4	14.9

Note: 'S' = supermarkets, 'C' = convenience stores, 'D' = department stores

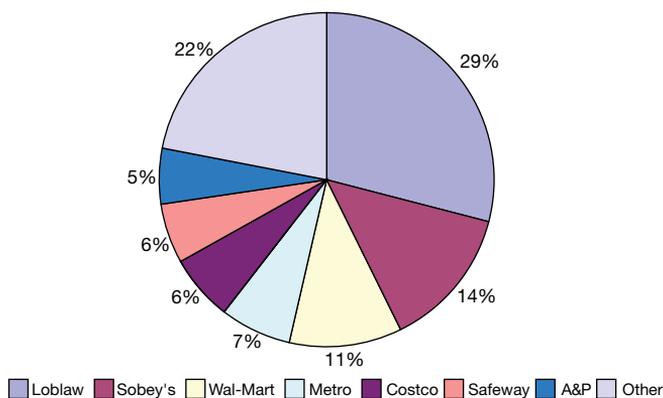
Tesco is the leading grocery retailer with almost 30 per cent of the market, twice as much as its closest competitor Asda. There are four operators in the market with 10 per cent or more of total grocery sales.

The larger grocery retailers are all vertically integrated. Smaller retailers are serviced by more than 400 grocery wholesalers throughout the UK, although the two largest wholesalers account for approximately 50 per cent of grocery wholesaling revenue.

### 3.7.3 Canada

A 2005 report on the grocery industry in Canada<sup>42</sup> found that there was one clearly leading grocer retailer—Loblaw—with almost 30 per cent of national grocery sales. Two other retailers had over 10 per cent of national sales (chart 3.17). All retail chains in Canada are vertically integrated.

**Chart 3.17 Canada—retailers' shares of grocery sales**



Source: Elsevier Food International

42 L Lewis, 'Canada—outsiders outnumbered', *Elsevier Food International* vol. 8, no. 2, May 2005.

Supermarket chains accounted for almost 60 per cent of retail grocery sales in Canada, with independent supermarkets around one third. This situation was projected to remain through to 2008.

### 3.7.4 Ireland

Share of retail grocery turnover by business in 2006 was set out by Ireland's Competition Authority (table 3.5).<sup>43</sup>

**Table 3.5 Ireland—retailers' shares of grocery sales**

Retailer	Share of sales (%)	
Vertically integrated retailers		46
ALDI	0–5	
Dunnes Stores	10–15	
Lidl	5–10	
Marks & Spencer	0–5	
Superquinn	5–10	
Tesco	15–20	
Wholesaler-franchisor		40
ADM Londis	0–5	
Barry Group	n/a	
BWG Foods	5–10	
Gala Wholesalers	0–5	
Mangan Wholesale	n/a	
Musgrave	20–25	
Independent retailers		14

The wholesaler–franchisors each have their own retail brand that they licence to affiliated retailers, similar to the IGA brand operated by Metcash. These businesses also supply to independent retailers.

### 3.7.5 Austria

In June 2007 the Austrian Federal Competition Authority (AFCA) concluded its sector inquiry on buyer power of supermarkets with the subsequent main finding:

The grocery sector in Austria is—also compared to other European markets—highly concentrated. The main competitive constraint ensues primarily from discount shops. The entry barriers are high, as reflected in the low number and limited expansion of new market entrants in recent years.<sup>44</sup>

The AFCA also stated the following on the concentration of the grocery retailing market in Austria:

According to several studies by AC Nielsen and other market specialists, REWE Austria (with its supermarket chains, discounters and small local corner shops) and SPAR share between 65 per cent and 70 per cent of the grocery retailing market in Austria. Although discounters such as the 'hard discounters' Hofer, Lidl, etc. and the 'soft discounters' Zielpunkt as well as REWE's own discounter, Mondo, etc. prove to be in fierce competition with the big two retailers, REWE and SPAR have been rapidly expanding nationally as well as internationally (particularly in the neighbouring Eastern European countries).

Moreover, there seems to be a higher supermarket density in Austria—REWE and SPAR each have over 1000 branches, mainly between 400 m<sup>2</sup> and 1000 m<sup>2</sup>—in comparison to Germany.<sup>45</sup>

43 The Competition Authority, *A description of the structure and operation of grocery retailing and wholesaling in Ireland: 2001 to 2006*, March 2008, p. 66.

44 Bundeswettbewerbsbehörde, *FCA accomplished sector inquiry on buyer power of supermarkets*, 30 August 2007, viewed at [www.bwb.gv.at/BWB/English/groceries\\_sector\\_inquiry.htm](http://www.bwb.gv.at/BWB/English/groceries_sector_inquiry.htm).

45 Austrian Federal Competition Authority, *2003–2004 Annual Report on Competition Policy Developments in Austria*, p. 9.

### 3.7.6 Summary

It can be seen from the data that retail market concentrations vary significantly in different countries. In New Zealand, although there are many different retail banner groups operating at the retail level they are all supplied by only two wholesalers. Austria is similarly concentrated, with two dominant operators. The UK and Canada have a larger number of vertically integrated operators in the grocery sector with one clearly dominant business in each country.

Although an important aspect of assessing the level of competition in a sector, the number of players is only one of a number of issues to which regard must be paid. The existence of a highly concentrated market is not, in and of itself, inimical to competition.

## 3.8 ACCC assessment of structure

Broadly speaking, public debate overstates the structural problems within grocery retailing. The MSCs maintain a large share of sales for packaged groceries and this may raise concerns, but this position needs to be assessed in conjunction with other factors such as barriers to entry and expansion before any conclusions are drawn.

Another potential area of concern is the apparent inability of smaller chains and the independent sector to compete with Coles and Woolworths in the operation of supermarkets greater than 2000 m<sup>2</sup>. Control over these larger sites may provide the MSCs with a significant advantage in attracting custom, particularly for large weekly shopping trips. It does not seem, however, to have prevented competition from specialty retailers and smaller supermarket operators in most product categories (see chapters 7 and 8).

The level of concentration in the Australian market, although not optimal, is not an uncompetitive level. For example, there is some evidence that the New Zealand grocery sector, which is more concentrated than Australia's, has seen more intense price competition in recent years relative to Australia (see chapter 6). Accordingly it is necessary to consider other aspects of the market to determine the strength of price competition.



# 4 Nature of competition in grocery retailing

## Key points

- Grocery retailers compete over a range of elements in the grocery retail offer, including price, quality, range and convenience. Competition on the non-price elements of the retail offer plays a key role.
- The competitive rivalry between grocery retailers occurs at the local level, with grocery retailers attempting to win local customers.
- Some responses to local rivalry can occur at the regional or national levels, such as state-based or national pricing, national promotions, and state and national supply and distribution arrangements.
- There are differences in grocery prices across regions and states, many of which are the result of cost differences in sourcing and retailing groceries, as well as local demand and competition conditions.

## 4.1 Introduction

This chapter explores the nature of competition in grocery retailing in Australia. The degree to which this has delivered competitively priced groceries is assessed in the following chapters. Conclusions about the current level of competition in grocery retailing are provided in chapter 10.

Consumers typically choose to buy their groceries from retail outlets located close to where they live or work. Grocery retailers compete for customers by attempting to make their retail offer more attractive to shoppers than the offers of other retailers in their locality. The origin of competition in grocery retailing is therefore rivalry between local retailers.

Grocery retailers compete on a range of dimensions, including convenience, product quality, availability, range and price (the total retail offer). The major supermarket chains (MSCs) and many other large grocery retailers offer a one-stop shop where consumers can buy a wide range of products. Specialty retailers offer a specialised product range.

Although consumers choose between retailers in their local area, some of the responses of the MSCs and other large grocery retailers to local competition are made at the state or national level. The MSCs compete for customers across a large number of local areas throughout Australia. Nationwide promotions such as Woolworths' 'Rollback' and Coles' 'Something Better Every Day' are generally an attempt to win customers within each of these local areas.

This does not mean that the MSCs have a single retail offer. The opposite is the case. The ACCC has found significant store-by-store differences in the prices the MSCs offer, based on local cost, demand and competition conditions.

For many consumers, price is a key component of where they choose to shop. Comparing prices across grocery retailers is difficult, especially comparing the prices of all the products in a typical weekly shop. As a shortcut, price sensitive consumers tend to compare the prices of products they spend a lot on and are easy to compare (such as a two-litre bottle of Coca Cola). Not surprisingly, price competition between major grocery retailers is primarily focused on these products (known as key or known value items, or KVIs).

## 4.2 The nature of competition between supermarkets

Substantial growth in supermarkets and supermarket shopping has occurred since supermarkets first appeared in Australian suburbs in the early 1960s. This growth was driven by the economies supermarkets were able to achieve over smaller format retailers of dry groceries operating at that time.

Supermarket chains have been able to achieve significant cost savings by retailing an array of grocery products under one roof and by spreading advertising and marketing costs over a large number of stores. Supermarkets also reduce the time consumers spend doing their grocery shopping. The product range offered by supermarkets provides consumers with an option of buying most or all of their groceries from one store.

Most consumers tend to make their major grocery purchases on a weekly basis, with smaller top-up purchases throughout the week. Supermarkets provide an array of complementary services, such as car parking, product range, product quality and payment facilities. Known as the grocery 'retail offer', the basket of products and services is combined in different ways to attract various types of shoppers.

Larger supermarkets primarily aim to attract consumers completing their weekly shopping, although in recent times some have also catered to consumers shopping for smaller quantities (by adding express lanes, for example). Supermarkets face competition from specialist retailers such as butchers and greengrocers in relation to meat and fresh fruit and vegetables; however, their closest competitors are usually other supermarkets with broadly similar retail offers.

Competition between supermarkets occurs in local markets due to the generally limited distances consumers are willing to travel to purchase grocery products. There are also regional dimensions to local competition, such as supply chain efficiencies and national pricing.

### 4.2.1 Consumer shopping behaviour

The retail offers of supermarkets are generally aligned with consumer shopping behaviour. A large proportion of consumers tend to make weekly or one-stop shopping trips, during which they purchase the majority of their grocery needs. Many consumers also make secondary or top-up shopping trips during the week in order to obtain perishable items such as bread or milk, or items not anticipated or available during their weekly shopping trip.

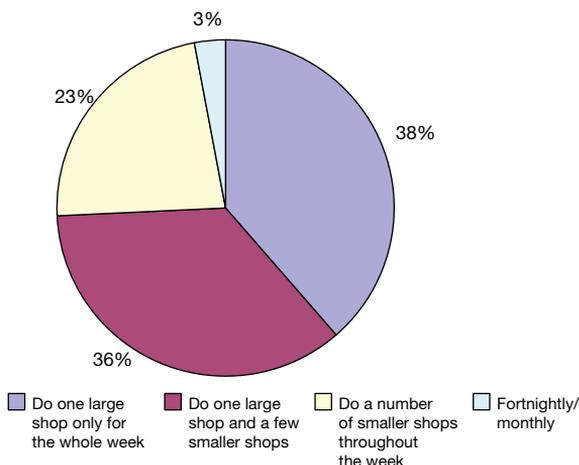
To better understand the shopping patterns of consumers, the ACCC commissioned Millward Brown to survey 1500 consumers across the country (ACCC consumer survey). Some of the results from the survey are detailed in this chapter.

As shown in chart 4.1, a large majority of respondents to the ACCC consumer survey<sup>1</sup> do all of their grocery shopping once a week (38 per cent), or do one large shop in addition to a few smaller shopping trips (36 per cent). A significant proportion reported doing their shopping over the course of the week with a number of smaller shopping trips (23 per cent).

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<sup>1</sup> ACCC, Survey of grocery consumers, April 2008.

**Chart 4.1 Consumer grocery shopping behaviour**



Source: ACCC, Survey of grocery consumers, April 2008. Proportion of respondents' answers to the question: 'Which of the following best characterises the way you typically do your grocery shopping?'

Consumer decisions about the number of shopping trips to make, when to make them and the amount spent each time, are partly dependent on the costs of making such trips. Grocery shopping requires time to visit a grocery retailer and to transport the items home. Although online grocery shopping has increased in popularity, the proportion of grocery shopping completed online remains very low in Australia.<sup>2</sup> Costs of visiting a grocery retailer often include the expense of running a car or using public transport, but also include the cost of the time spent, which could have been used in other ways. These costs all tend to be greater if the nearest grocery retailer is located further away.

It is likely that consumers purchasing the bulk of their weekly groceries at one time do so as a way to minimise such costs. There is usually one occasion or a small number of convenient occasions during the week to make a shopping trip. Purchasing the majority of grocery needs at one time enables consumers to save time.<sup>3</sup> This can involve a trip to a supermarket or a shopping mall, or to the local High Street or shopping strip.

For many people who complete a large weekly grocery shop, the need to make smaller, ad hoc or occasional purchases of groceries remains. Such smaller shopping trips might be needed because some items are perishable and are purchased more often or because some items were forgotten or needs have changed since the last grocery store visit. Of course, at the individual level, choices about the size and number of visits will vary according to individual circumstances.<sup>4</sup>

Although the distinctions are not clear-cut, it is useful to use the broad categories of weekly or one-stop shopping visits on one hand, and small or top-up shopping visits on the other.<sup>5</sup>

2 Less than 1 per cent of respondents in the ACCC consumer survey reported that they often purchased grocery items over the internet. Around 95 per cent of respondents said that they have never purchased grocery items over the internet, and 3 per cent reported they rarely bought groceries this way.

3 Some consumers visit more than one competing grocery retailer during any given shopping trip. However, there is a limit to the number of additional retailers visited on a single shopping trip due to additional time and costs.

4 For example, differences in the costs of transport, the amount of available time or the amount of perishable food a given household consumes and is able to store will affect these decisions.

5 The terms 'one-stop' and 'top-up' are commonly used to label these categories of shopping visits. Other terms used include 'major' shopping visits and 'secondary' or 'fill-in' shopping visits.

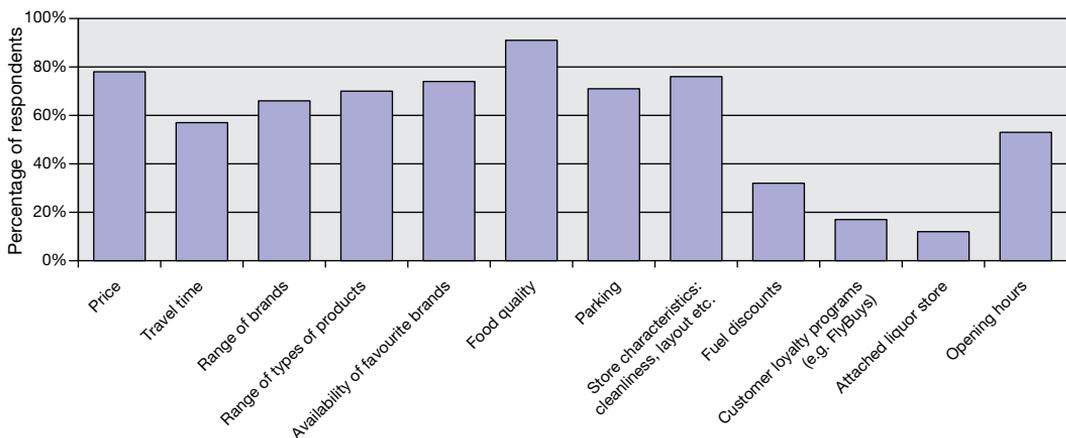
## 4.2.2 The supermarket retail offer

As noted above, supermarkets offer a joint product, which consists of retailing a broad range of products from the same location. Not all supermarkets are the same. Supermarkets can differentiate their offer to consumers in a number of ways, including:

- the prices of products
- the quality of products
- the range of products
- the convenience of shopping, which can reflect:
  - opening hours
  - location
  - length of queues (number of cash registers)
  - availability of car parking
- the shopping experience, which can reflect:
  - friendliness and knowledge of employees
  - the feel of the store (for example, lighting and spaciousness)
  - discounts on other products, such as vouchers for petrol
  - other factors, such as support for local communities.

The retail offers of supermarkets include many of these elements. Chart 4.2 below details the elements of the retail offer that consumers find important. It is important to note that consumers did not exclusively rate price as 'Very important' when choosing where to shop for groceries. In particular, food quality, availability of favourite brands and store characteristics were also rated 'Very important' to similar proportions of respondents.

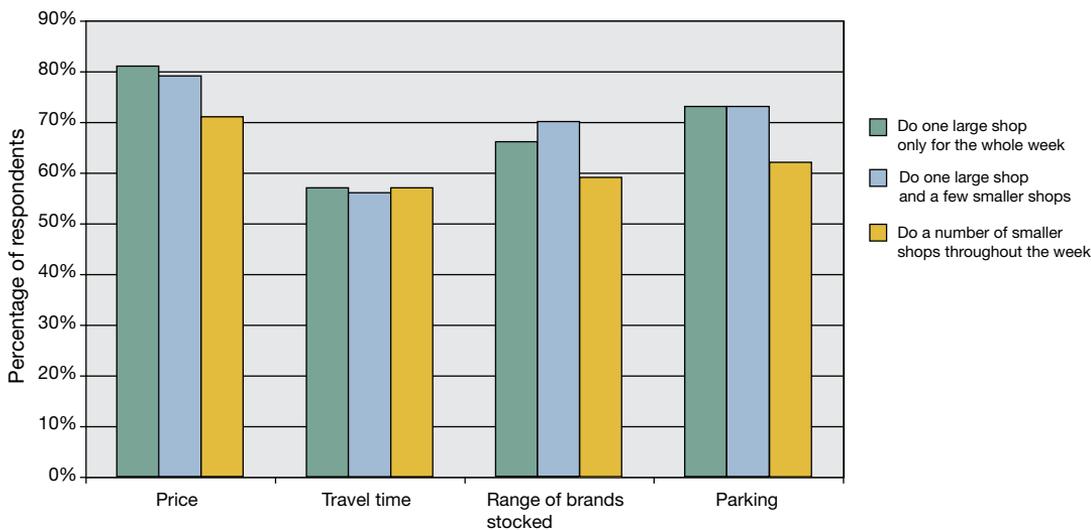
**Chart 4.2 Elements of the retail offer respondents rated as 'Very important'**



Source: ACCC, Survey of grocery consumers, April 2008. Proportions of respondents who rated each of the factors as 'Very important' when choosing where to shop for groceries.

Retailers' choice to emphasise different elements of the retail offer reflects the types of shoppers who can be profitably targeted. Consumers making weekly shopping visits are likely to have different priorities to consumers on smaller shopping visits. For larger shopping visits where consumers purchase a greater proportion of their grocery needs, factors such as the range of products available will generally have a higher priority. Prices are also usually a higher priority on these occasions given the generally larger purchases made.

**Chart 4.3 Elements of the retail offer that different shoppers rated as 'Very important'**



Source: ACCC, Survey of grocery consumers, April 2008. Proportions of respondents who rated each of the factors as 'Very Important' when choosing where to shop for groceries, split by the way they typically do their shopping.

Some of the differences in priorities were reflected in the ACCC consumer survey. Chart 4.3 indicates that more one-stop shoppers ranked price as very important when compared with shoppers who do a number of smaller shops throughout the week. A similar difference can be seen in relation to the range of brands stocked and parking; however, the importance of travel time to the different shoppers was about the same.

Overall, the ACCC consumer survey indicated that, with some variations according to the types of shoppers, consumers place a very high value on the wider elements of the supermarket retail offer. This includes non-price elements, such as parking, the standard of facilities and product range. The results indicate that the non-price elements of the retail offer play an important role in competition between supermarkets.

### 4.2.3 The nature of non-price competition among supermarkets

The importance placed by consumers on non-price elements provides supermarkets with important opportunities to compete. Indeed, the evidence could suggest that non-price competition is more effective for retailers. A large proportion of respondents to the ACCC consumer survey (detailed further below) indicated they never compare grocery prices across supermarkets before choosing where to shop.

On the other hand, non-price attributes offer supermarkets some scope to differentiate their offer and to influence consumers' decisions about where to shop. This often involves significant investments by supermarkets, which pay particular attention to non-price aspects such as convenience and the freshness of products. For example, Coles' submission to the inquiry noted:

Whether advantage is obtained by one [full service supermarket] over the other comes down to the following factors for a supermarket shopper:

- store locations (and proximity to rivals/direct alternatives)
- retailer brand perception
- the consumer's assessment of the price/value/quality equation
- the quality of the shopping experience – in terms of time, product availability and service.<sup>6</sup>

Smaller supermarkets in particular compete through improvements to other elements of the retail offer. For example, Metcash submitted to the inquiry:

Independent retailers compete effectively with the major chains through the following non-price elements of the retail offer:

- Convenient shopping (quick in, quick out)...
- Niche ranges...
- Community focus...
- Personal service...

In areas where an independent retailer has a significant presence, the competitive pressure it adds through these non-price elements poses a significant constraint on the major chain store's ability to raise prices.<sup>7</sup>

Consumer preferences and budgets ultimately dictate which non-price elements will grant supermarkets an advantage over rivals. Emphasis of some elements might have greater success than others. The ACCC consumer survey indicated that competitive advantages can arise from investments in food quality, store characteristics and range of brands. This indicates that non-price competition between supermarket retailers is a significant element of competition in this industry.

#### 4.2.4 Conveying price offers to consumers

Supermarkets' ability to compete on prices depends on the extent to which they can convey their price offers to consumers. Price competition between supermarkets is examined in greater detail in the following chapter, in the context of competition between the MSCs.

Comparing the prices of one grocery retailer with another can be difficult for consumers for a number of reasons. First, for larger shopping trips, consumers would require a substantial amount of time to make comparisons across the total shopping spend at different retailers. Second, consumers often make purchases which are unplanned or difficult to predict until arriving at the supermarket.

Third, grocery prices can be complex. Different sized grocery items can often be difficult to compare in terms of price. Unit pricing, which is pricing per 100 grams or similar, may assist customers in making comparisons between products of different sizing. Unit pricing is discussed in more detail in chapter 20 of this report.

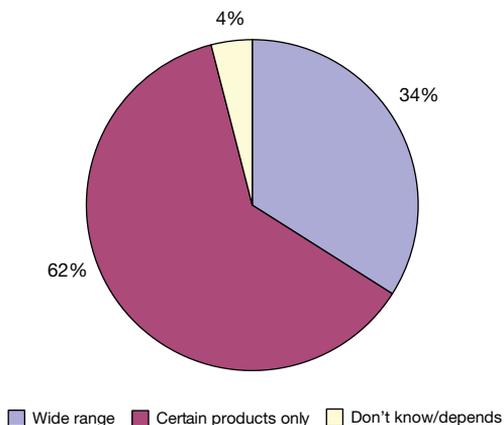
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<sup>6</sup> Coles, submission no. 157, p. 30.

<sup>7</sup> Metcash, submission no. 217, pp. 1–2.

As a result of these difficulties, price sensitive consumers often use shortcuts to compare prices, limiting the products they compare to a few. The results from the ACCC consumer survey indicate that a significant number of consumers do use the prices of specific items to choose the grocery store they will visit (see chart 4.4).

**Chart 4.4 Range of grocery products used by consumers to compare prices**



Source: ACCC, Survey of grocery consumers, April 2008. Proportion of respondents' answers to the question: 'Do you compare prices across a wide range of products or just on certain products?'

This can explain why most grocery retailers focus on certain key value items or known value items (KVIs). Retailers understand that the prices of KVIs are more closely compared by price sensitive consumers. A number of parties told the inquiry that price competition between supermarkets is concentrated on KVIs. For example, Woolworths' Chief Executive Officer, Mr Michael Luscombe, told the inquiry:

[Known Value Items] would be items that we would think a customer probably has a good awareness of what the price might be generally in the market place ... They may not know to the exact cent what the price of that is ... unless they buy a product regularly, [customers] wouldn't know the relative price of thousands of items ... There's a small list of items ... bananas would be another good example ...<sup>8</sup>

Coles' Chief Operating Officer, Mr Mick McMahon also told the inquiry:

We're trying to measure those things which are typically in the basket, which are high value items, which are critical lines for, you know, for a household out there struggling with higher prices at the moment. They're the ones we focus on ...<sup>9</sup>

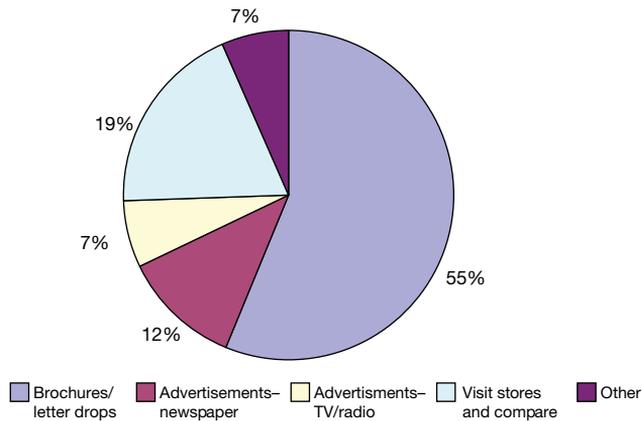
The other key element of price competition is promotions. At any one time the MSCs have between 2000 and 4000 products on special or promotion. Many of these items are also KVIs. Promotions enable supermarkets to differentiate their price offer through advertising campaigns.<sup>10</sup> Chart 4.5 indicates that a large proportion of consumers utilise brochures or letter drops to compare the prices of grocery items.

8 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 53.

9 ACCC, public hearings transcript, Melbourne, 26 May 2008, p. 46.

10 Promotions or price discounts can also make price comparisons difficult for consumers if supermarket chains change their prices often. The use of promotional pricing, versus more stable pricing, is discussed in greater detail in chapter 5.

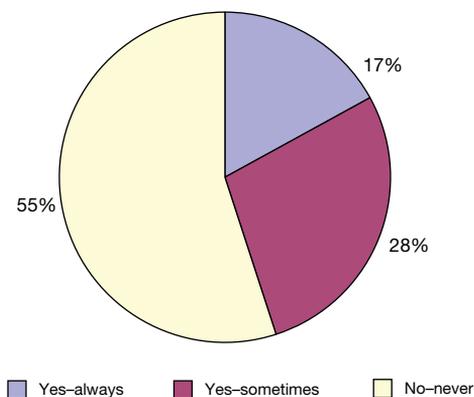
**Chart 4.5 Consumer sources of price information**



Source: ACCC, Survey of grocery consumers, April 2008. Proportion of respondents' answers to the question: 'And how do you compare prices before you do your usual grocery shopping?'

Other results from the ACCC consumer survey indicate that 55 per cent of consumers do not compare prices before buying groceries, with 28 per cent doing so sometimes (see chart 4.6). Despite this, a large proportion of the same respondents rated price as 'Very important'. It is likely that some consumers instead compare prices over time and build a mental picture of prices. Instead of comparing prices before every shopping trip, these consumers might re-evaluate their choices as their experiences change.

**Chart 4.6 Proportions of consumers who compare prices**



Source: ACCC, Survey of grocery consumers, April 2008. Proportion of respondents' answers to the question: 'Do you compare grocery prices from one supermarket to another before you buy your groceries?'

Another reason for fewer consumers comparing prices can be the perceived costs associated with changing from a preferred grocery retailer. The cost of breaking with habit or the changeover effort of shopping at an unfamiliar store with a different layout can limit consumers' willingness to compare the prices at their regular grocery retailer with another.

## 4.2.5 Nature of competition between supermarkets and specialty stores

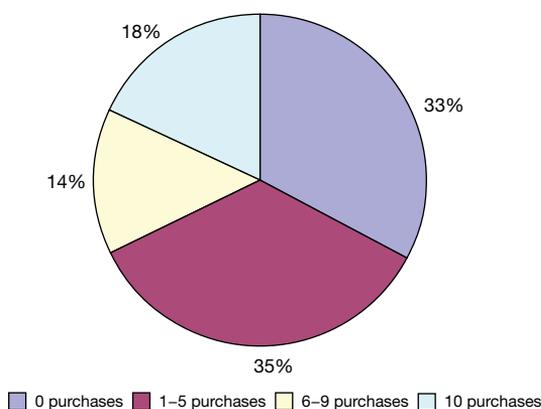
Competition exists between supermarkets and specialty stores, which include bakers, butchers, fishmongers and greengrocers. As indicated above, the supermarket retail offer includes the provision of a wide range of product categories. This range of product categories presents supermarkets with an advantage over specialty stores for some consumers who might be less inclined to split their weekly shopping and to visit successive retail stores. As noted earlier, such costs can push consumers towards making fewer larger volume shopping trips

However, specialised stores can exert competitive pressure on supermarkets, particularly where they are closely located. Specialised stores located outside the entry to supermarkets are likely to attract customers on one-stop shopping trips where the additional time involved to split some of their weekly purchases is low.<sup>11</sup>

Competitive pressure is also exerted by specialised retailers located at further distances, by attracting consumers with higher quality or service aspects of the grocery retail offer. These elements can be sufficiently compelling to grocery consumers to warrant the additional time and cost of making additional shopping visits.

Evidence suggests that large numbers of consumers shop at specialised retailers. For example, the ACCC consumer survey indicated that a majority of consumers split their grocery purchases, buying their meat and fish from fishmongers, butchers or markets (see chart 4.7).

**Chart 4.7 Number out of last 10 meat and fish purchases made at a specialty store**



Source: ACCC, Survey of grocery consumers, April 2008. Proportion of respondents' answer to the question: 'How many of the last 10 meat and fish purchases have you made at a specialty grocery store, such as a butcher, fishmonger or market?'

This indicates that specialised retailers provide consumers with an alternative to supermarkets, which they exercise often. This can apply competitive pressure to supermarkets in particular grocery categories. Some competitive advantage remains for supermarkets in being able to offering the full range of grocery categories because they offer dry groceries in addition to other grocery categories, particularly for consumers with less time. Nonetheless, a degree of competition in these categories is indicated by the significant proportion of consumers who visit speciality retailers.

<sup>11</sup> Such shoppers can be thought of as being encouraged to make an additional top-up shopping visit.

## 4.2.6 Nature of competition between supermarkets and convenience stores

In a similar way to specialty stores, convenience stores can play a role in constraining supermarkets in competition for items purchased mainly on top-up shopping visits. However, the proportion of such items stocked in supermarkets is lower and there tends to be fewer common elements in their retail offers.

Convenience stores tend to serve the needs of top-up shoppers, usually involving a greater emphasis on convenience through choices about location, store layout and opening hours. There is evidence to suggest supermarkets compete for these customers—for example, by offering greater convenience with express lanes and by placing the relevant items closer to the front of the store. Equally, convenience stores can, in principle, price low enough to induce customers to split their purchases and buy some items from convenience stores.

However, elements of the retail offer that are important to one-stop shoppers are usually not part of the convenience store offer. Greater convenience enables their customers to briefly enter and exit the store, with less importance given to the range of products available, which is more important to one-stop shoppers. In addition to other important elements such as car parking, there appears to be less scope for commonality in the retail offers of convenience stores and supermarkets.

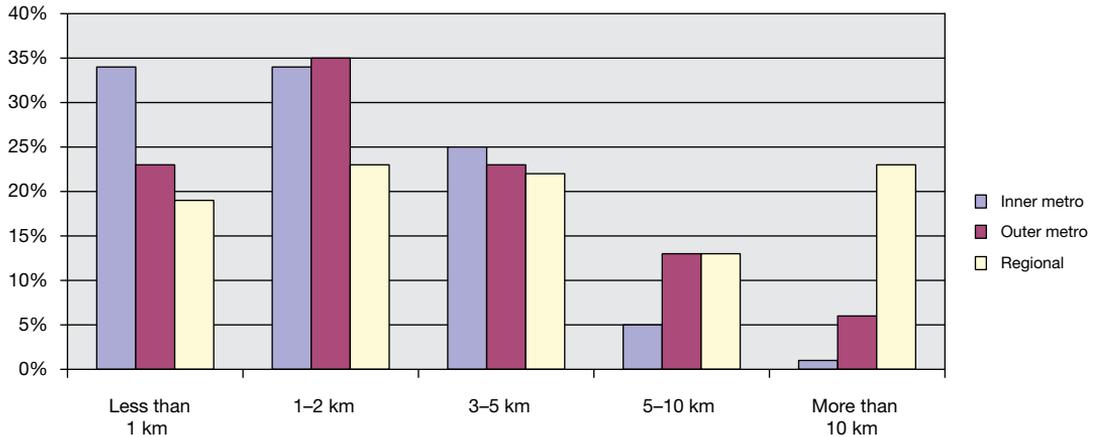
However, each circumstance must be considered on its merits because in practice there is no bright line distinction between a supermarket and a convenience store. Many smaller supermarkets can share characteristics with convenience stores, and larger convenience stores can appear to be like supermarkets. Notwithstanding this, it is more likely that in most circumstances the degree of overall competitive pressure convenience stores place on supermarkets is not strong.

## 4.3 The local nature of competition in grocery retailing

The origin of competition in grocery retailing is in the retailers' efforts to make their retail offer more attractive than those of the other retailers in the same local area. Supermarkets react to this competition at the local level, and at the broader regional and national levels with national price campaigns and supply chain improvements.

As shown in chart 4.8, almost 90 per cent of consumers living in metropolitan regions normally travel less than 5 km to shop at their regular supermarket. In regional areas, consumers tend to travel further to do their supermarket shopping, with 23 per cent travelling more than 10 km.

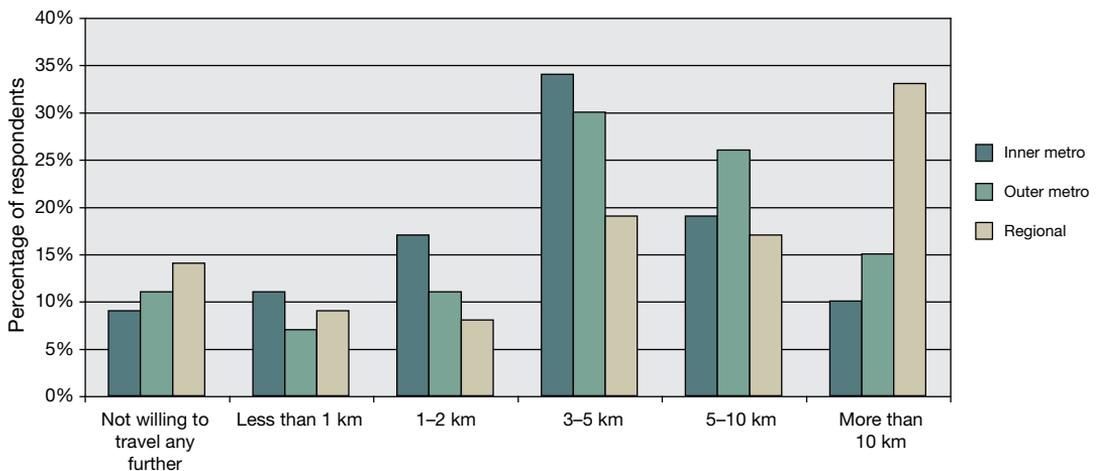
**Chart 4.8 Distances normally travelled for regular groceries**



Source: ACCC, survey of grocery consumers, April 2008. Proportion of respondents' answers to the question: 'How far do you normally travel to get to your regular supermarket?'

Chart 4.9 indicates that the distances consumers might be willing to travel to shop at an alternative supermarket differ between regional and metropolitan areas. More than 32 per cent of consumers in metropolitan areas would be willing to travel up to between 3 km and 5 km to another supermarket. More than 30 per cent of regional customers are prepared to travel more than 10 kilometres.

**Chart 4.9 Distances consumers willing to travel to an alternative supermarket**



Source: ACCC, Survey of grocery consumers, April 2008. Proportion of respondents' answers to the question: 'What is the furthest distance you would be willing to travel to another supermarket as an alternative to your regular supermarket?'

Before this inquiry, the ACCC has found that, in metropolitan areas, competition occurs between grocery retailers with similar characteristics in locations of between 3 and 5 kilometres apart. However, outside metropolitan areas, competition has been found to occur among grocery retailers located up to 60 km apart.<sup>12</sup>

### 4.3.1 State and national responses to local competition

Local competition between grocery retailers has regional and national effects, which include regional or national pricing policies and supply chain improvements.

National and regional pricing policies of larger supermarket chains encompass large numbers of stores. The larger grocery retailers set the same prices for certain grocery items across a number of stores, sometimes nationally but more often across stores in each state or territory. Prices set at this level take account of cost differences between states or regions as well as the prices of competitors who are present in many of the local markets.

The ACCC understands there are a number of factors that generally motivate a supermarket chain to set uniform pricing across its stores, which include:

- cost savings from standardising aspects of its operations across a large number of stores, including product labelling and pricing
- the greater returns from promotions and advertising expenditure when targeting large numbers of customers
- local competitive environments involving the same competing supermarket chains across local areas
- consumer dissatisfaction when observing different prices for the same product in different stores.

The ACCC understands that regional or national price-setting is motivated by cost savings through standardisation of prices across stores with similar costs and facing similar competitive conditions. The most significant influence on wider national or regional pricing tends to be the more common local competitive conditions faced by a retailer across the local markets in which they are operating.<sup>13</sup>

Other regional or national effects from local competition include supply chain initiatives. In order to be cost-effective competitors at the local level, a grocery retailer must be able to source a wide range of products at a competitive cost. This encourages vertically integrated grocery retailers to pursue more efficient wholesaling and buying operations. For stand-alone retailers, it encourages them to seek more competitive terms from their wholesalers.

## 4.4 Regional pricing differences

Grocery prices differ across regions or states for a range of reasons, including differences in the supply costs of grocery products, the cost of delivering them to regional stores, the regional differences in the size and characteristics of demand, and differences in local competition.

Regional price differences are more pronounced among independent retailers than the MSCs. The size of regional differences in grocery prices and the reasons for these differences are discussed below.

<sup>12</sup> See, for example: ACCC, Public Competition Assessment, *Woolworths Limited—proposed acquisition of Jindabyne IGA Supermarket, Festival IGA Liquor, and Porter's Liquor Licence*, 26 June 2007, available at [www.accc.gov.au/content/index.phtml/itemId/501191](http://www.accc.gov.au/content/index.phtml/itemId/501191).

<sup>13</sup> Competition between different local areas is unlikely in grocery retailing. Purchases of regular groceries in places where consumers do not mainly reside or work is uncommon. This implies, for example, that a Woolworths in Sydney would not compete for the customers of a Coles supermarket in Melbourne.

## 4.4.1 State and regional price differences among the MSCs

### ACCC price study

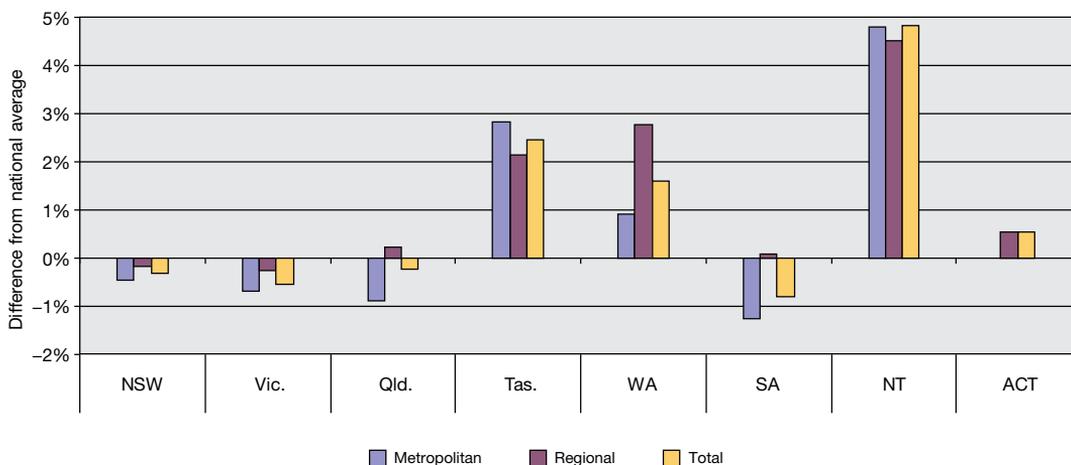
The ACCC conducted a quantitative analysis of Woolworths and Coles supermarket prices over 2007. Price data was obtained for the top 10 000 grocery items (in terms of 2007 sales revenue) for each Coles and Woolworths supermarket. The analysis was conducted on Coles and Woolworths supermarkets with a net trading area above 1000 m<sup>2</sup>.

The price data represents the prices paid by consumers at the register. As a result it includes promotional prices, temporary mark downs and standard shelf prices. The analysis compares the prices of products on a like-for-like basis. For full details of this data and the price comparisons, see appendix D.

The prices consumers paid for grocery products at Coles and Woolworths stores were the lowest in South Australia and the eastern mainland states and territories. Prices in each of these states and territories were within 1 per cent of the national average prices for both Coles and Woolworths (except Coles stores in South Australia, which were 1.5 per cent below the national average). The prices consumers paid for grocery products were the highest in the Northern Territory, followed by Tasmania and Western Australia (charts 4.10 and 4.11). Price variations between states and territories from each MSC's national average were extremely similar.

Price variations between states were different between product categories. In a comparison of metropolitan areas between states, grocery products which are generally sourced on a national level (e.g. dry groceries) were found to vary less than the prices consumers paid for products which are more likely to be sourced regionally (e.g. fresh produce) (charts 4.12 and 4.13).

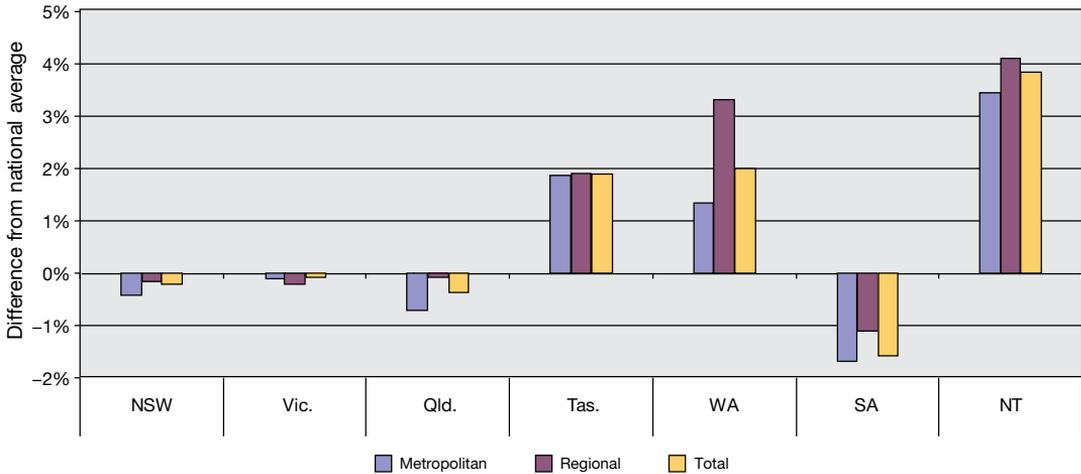
**Chart 4.10 Woolworths—state and regional price differences, 2007**



Note: state and regional price differences represent the differences between the average prices consumers paid for grocery products in Woolworths stores in each state/region and the average prices consumers paid for grocery products across all Woolworths stores. Woolworths data excludes Weipa, which is a particularly remotely located store.

Source: ACCC analysis based on confidential information provided by Woolworths and Coles

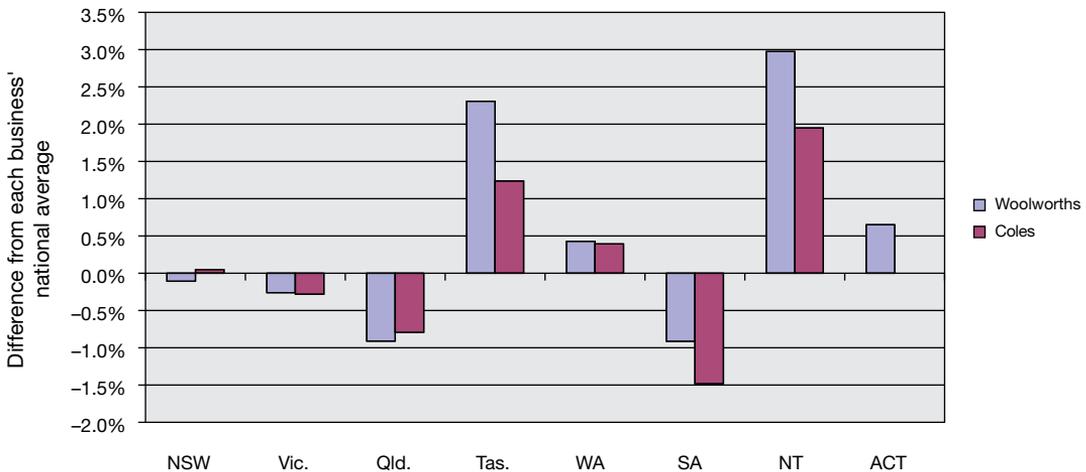
**Chart 4.11 Coles—state and regional price differences, 2007**



Note: state and regional price differences represent the differences between the average prices consumers paid for grocery products in Coles stores in each state/region and the average prices consumers paid for grocery products across all Coles stores.

Source: ACCC analysis based on confidential information provided by Woolworths and Coles.

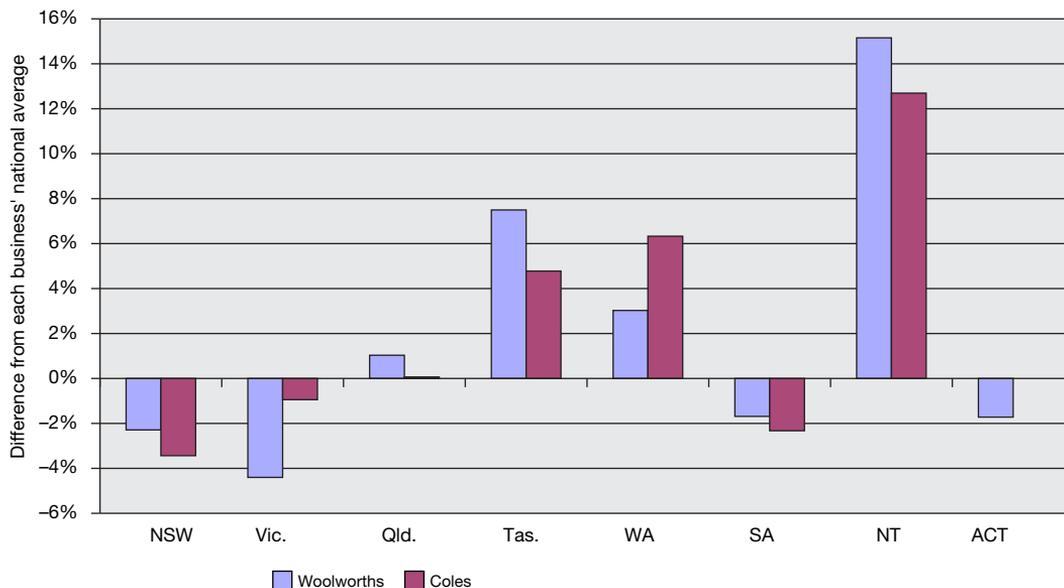
**Chart 4.12 Woolworths—metropolitan price differences for dry groceries and Coles—metropolitan price differences for dry groceries, 2007**



Notes: these differences were calculated separately for Coles and Woolworths stores. For Coles, they represent the differences between the average prices consumers paid for dry groceries in Coles stores in each state metropolitan area and the average prices consumers paid for dry groceries in all Coles stores. The price differences for Woolworths were calculated in the same way. Comparisons between the prices consumers paid at Woolworths and Coles stores cannot be made from the price differences represented in this chart. Woolworths data excludes Weipa which is a particularly remotely located store. Coles data for New South Wales includes the Australian Capital Territory.

Source: ACCC analysis based on confidential information provided by Woolworths and Coles

**Chart 4.13 Woolworths—metropolitan price differences for fresh produce and Coles—metropolitan price differences for fresh produce, 2007**



Note: these differences were calculated separately for Coles and Woolworths stores. For Coles, they represent the differences between the average prices consumers paid for fresh produce in Coles stores in each state metropolitan area and the average prices consumers paid for fresh produce in all Coles stores. The price differences for Woolworths were calculated in the same way. Comparisons between the prices consumers paid at Woolworths and Coles stores cannot be made from the price differences represented in this chart. Woolworths data excludes Weipa which is a particularly remotely located store. Coles data for New South Wales includes the Australian Capital Territory.

Source: ACCC analysis based on confidential information provided by Woolworths and Coles.

Observed differences in prices between metropolitan and regional supermarkets within most states and territories tended to be small. However, for Western Australia, Queensland and South Australia, there are a number of remotely located supermarkets. The prices consumers paid for grocery products in rural supermarkets were, on average, between 1 per cent and 2 per cent higher than in metropolitan supermarkets.

These results are not surprising given the move by Woolworths towards more uniform pricing across a large number of products. For instance, Woolworths stated:

... earlier this calendar year ... we moved to a point where we have got - except for two exceptions - one state price for groceries, dairy, freezer, general merchandise and we've got about 13 stores, I think, that are the likes of Nhulumbuy, Derby etcetera where the costs of getting product there logistically is exorbitant and so we obviously pass some of that cost on, not all of it. So that means that the price of the standard price of cornflakes, even if I take here in Melbourne, will be the same price as the price in, say, Echuca.<sup>14</sup>

14 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 52.

The ACCC has undertaken analysis of some of the reasons for the price differences across MSC supermarkets (see appendix D). The major causes appear to be differences in:

- freight costs
- the costs of doing business (such as higher rents in CBD areas)
- local competition.

The finding that consumers pay lower prices for grocery products in South Australia and Queensland may be the result of greater competitive pressure on the MSCs by competing retailers in those states. Queensland prices may be influenced by a greater number of MSC stores having a closely located ALDI (within 1 km) compared with New South Wales and Victoria.

In South Australia, although ALDI does not operate in that state, there is a greater proportion of large full-line independent supermarkets in metropolitan areas relative to the eastern states. Additionally, independent retailers in metropolitan areas of South Australia and Queensland are, on average, located closer to competing MSC supermarkets than in other eastern states.

#### 4.4.2 State and regional price differences among independent grocery retailers

The ACCC has not conducted a price analysis for independent supermarkets throughout Australia. However, submissions to the ACCC, including analysis undertaken by the Bureau of Infrastructure, Transport and Regional Economics (BITRE), have indicated that there is a relationship between the remoteness of independent supermarkets and the price of groceries. The BITRE study is discussed in more detail in section 4.4.3.

Higher prices in regional independent supermarkets are likely to result from a number of factors. Firstly, transport costs are typically higher for regional stores. Although these additional freight costs are also incurred by regional MSC supermarkets, independent operators usually must recover these costs on an individual store basis, whereas the MSCs can average prices over lower and higher cost stores.

Higher transport and distribution costs were frequently raised in submissions as a major factor for regional price differentials. The significance of these costs was, however, questioned in some submissions:

- The National Transport Commission stated that transport costs are a very small part of the costs of groceries, referring to studies which show that transport costs account for just under 5 per cent of grocery retail prices in the major cities and between 5.5 per cent and 6 per cent in rural and remote areas.<sup>15</sup>
- Metcash stated that the key differences in supply chain costs (transport and land costs) between metropolitan and regional areas tend to have an offsetting effect against each other.<sup>16</sup>

A second influence on higher prices in independent supermarkets is location. Independent supermarkets in regional areas are generally smaller and have lower turnover resulting from servicing a smaller population base. The combined result is that these stores typically face higher operating costs relative to turnover.

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<sup>15</sup> National Transport Commission, submission no. 78, p. 2.

<sup>16</sup> Metcash, submission no. 181, p. 48.

A third reason that regional independent stores may have higher prices is the level of local market competition. For smaller locations where there is not a competing MSC supermarket, independent supermarkets will be less constrained in their pricing.

### 4.4.3 Other studies

#### The Bureau of Infrastructure, Transport and Regional Economics

The BITRE surveyed prices of a range of food and non-food products sold in supermarkets across Australia. The results of the survey were provided to the ACCC as part of the BITRE's submission to the inquiry.<sup>17</sup>

The BITRE surveyed the prices of more than 250 products across 236 supermarkets in 132 locations. The products chosen represent approximately 16 per cent of total household expenditure based on the Australian Bureau of Statistics (ABS) 2003–04 Household Expenditure Survey. Survey locations were chosen to ensure a wide coverage of variables such as population, industry, income, distance from the capital city, and distance from large regional centres.

The BITRE found that grocery store prices vary widely across locations, with the highest priced store found to be 91 per cent more expensive than the lowest priced store. However, consistent with the ACCC's analysis, the BITRE found that the MSCs have a reduced range of prices across stores compared with independent retailers, offering the same price for a large number of items regardless of the location:

From the consumers' point of view, the presence of a major chain store in a locality is likely to provide groceries at price levels broadly similar to those obtained in similar stores in the capital cities.<sup>18</sup>

For independent supermarkets, distance from substantive retail centres and the size of the local population were found to impact on the price and availability of groceries. Population, however, was less influential for prices in locations with more than 4000 residents.

Prices of groceries sold by independent stores that do not compete with a major retail chain, which are generally located in smaller regional towns, were found to be, on average, 17 per cent above the major chain store average. A number of reasons for this price difference were put forward by the BITRE:

Whilst it is reasonable to assume competition is important in constraining prices, a case could also be made that prices should be higher where populations are lower and hence turnover is lower. Further, higher transport costs of goods due to greater distance may force higher prices.

Price variations between regions were reflected in all stores in a given location. This suggests that prices in all stores within a particular location, whether a major chain or independent retailer, are influenced in a similar way by factors associated with particular locations.

### CHOICE

A CHOICE survey of prices in 111 chain and independent supermarkets across Australia was undertaken in 2007.<sup>19</sup> The survey, which priced a basket of 33 items, found that prices were lowest in Queensland. The other states and territories, from cheapest to most expensive, were South Australia,

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17 Bureau of Infrastructure, Transport and Regional Economics, submission no. 188.

18 Bureau of Infrastructure, Transport and Regional Economics, submission no. 188, p. 9.

19 CHOICE, 'Best value shopping', *Choice* magazine, July 2007.

Victoria, the Australian Capital Territory, New South Wales, the Northern Territory, Western Australia and Tasmania. Although the findings of this survey are not completely consistent with the ACCC's findings, they do support the general finding that mainland east coast regions generally offer cheaper prices than the more remote regions in Tasmania, Western Australia and the Northern Territory.

The survey also found that stores in capital cities do not necessarily offer cheaper prices than stores in regional cities. The three cheapest cities, and seven of the 10 cheapest cities, were regional.

### State level surveys

Regular surveys conducted in Queensland on a basket of healthy grocery items have consistently found a significant difference in pricing between highly accessible (metropolitan) and remote locations.<sup>20</sup> The most recent survey, conducted in 2006<sup>21</sup>, found that the mean cost of the basket was 24.2 per cent higher in very remote stores compared with the same basket in major cities. For very remote stores more than 2000 kilometres from Brisbane, the difference was 32.6 per cent. The survey found a significant difference in the cost of all the basic healthy food groups by remoteness category.

Similar studies conducted in New South Wales<sup>22</sup>, the Northern Territory<sup>23</sup> and South Australia<sup>24</sup> also found average prices of the basket of goods to be higher in remote locations. For New South Wales, however, this price disparity was only significant for the fruit and vegetable component of the basket.

These studies did not differentiate between the MSCs and independent stores. It is therefore unclear whether the findings reflect the pricing of all participants in the market.

#### 4.4.4 Mainland versus Tasmanian prices

Media reports in April 2008<sup>25</sup> focused on price differences in the catalogues of an MSC issued in Victoria and Tasmania. In particular, there was concern that the promotional and standard shelf prices of a number of items were more expensive in Tasmania.

As discussed above, ACCC price analysis indicates that the average prices paid by a consumer shopping in a Woolworths supermarket in Tasmania were 2.5 per cent more for dry groceries than the prices paid by a consumer shopping in a Woolworths supermarket in metropolitan Victoria. The difference is around 1 per cent for Coles. This price difference is more pronounced in fresh produce, with a differential of 12 per cent between the states for Woolworths and 5 per cent for Coles.

Although the analysis shows that the prices consumers pay for grocery products at the MSCs in Tasmania are higher than Victoria, ABS data indicates that Tasmanian prices have been rising at a slower rate. Annual average food price increases between 1992 and 2007 were 3.1 per cent for Tasmania and 3.3 per cent for Victoria.<sup>26</sup> More information on movements in retail food prices is provided in chapter 2.

Higher prices in Tasmanian supermarkets are likely to result from a combination of the higher costs of goods and possibly a less competitive environment than an equivalent mainland supermarket. A large

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20 Remoteness is determined by looking at geographical location as well as access to services.

21 Queensland Health, *The 2006 healthy food access basket (HFAB) survey*, Queensland government, 2007.

22 The Cancer Council NSW, NSW healthy food basket cost, availability and quality Survey, 2007.

23 Department of Health and Community Services, *NT Market Basket Survey 2006*, Northern Territory government, 2006.

24 J Meedeniya et al., *Food supply in rural South Australia: a survey on food cost, quality and variety*, 'Eat Well SA—food supply in rural South Australia', 2000.

25 'Prices stack up against Tasmanian shoppers', *The Advocate Newspaper*, 17 April 2008.

26 ABS, *Consumer price index Australia*, catalogue no. 6401.0.

proportion of goods stocked in MSC stores are sourced nationally from mainland manufacturers. The need to transport these goods over large distances and across Bass Strait means that additional freight costs need to be considered.

A submission to the inquiry by Mr Peter Brohier stated that differences in freight costs for supplying grocery stores in Victoria and Tasmania are exacerbated by the failure of government freight subsidies to fully equalise the cost of transporting consumables to Tasmania by sea to road transport over a comparable distance.<sup>27</sup> The Tasmanian Freight Equalisation Scheme is designed to provide assistance to shippers of eligible goods, transported by sea between Tasmania and the Australian mainland, with the aim of reducing the freight cost disadvantage imposed by Bass Strait. This subsidy, however, does not apply to the transport of grocery items from the mainland to Tasmania.

The availability of economies of scale may also contribute to higher costs of doing business in Tasmania, with a smaller turnover moving through the wholesale distribution centres and a smaller average store size. Economies of scale are discussed in more detail in chapter 7.

Tasmanian MSC stores are also, on average, subject to less local competitive tension from other supermarkets than mainland stores. ALDI is not present in Tasmania and there are only a limited number of large-format independent supermarkets. The average distance from an MSC store to its nearest competing supermarket in Tasmania is more than double the national average. Local competitive tension is particularly important in determining the pricing of KVLs (discussed further in chapter 6).

#### 4.4.5 Conclusions on regional pricing differences

The average prices consumers paid for grocery products in 2007 at Coles' and Woolworths' stores were lowest in South Australia and the eastern mainland states and territories, with average prices up to 1.5 per cent below the national average. Price differences were the largest for goods which are more likely to be sourced regionally, such as fresh produce.

Although there is minimal competition in some areas—generally regional areas—this partly reflects the small size of the communities, which means that there is limited scope for the entry of multiple stores. Higher prices for groceries in these locations may partly reflect a lack of competitive pressure, but also results from higher operating costs relative to turnover.

### 4.5 Conclusions

Supermarkets are businesses generally offering a broad range of grocery products from the single retail location. This generally provides them with two distinct competitive advantages. First, it reduces the time consumers have to spend shopping for groceries and allows consumers to more readily compare different brands and products. Secondly, store costs can be spread over more sales and marketing and advertising costs can be spread across more stores.

Supermarket competition tends to focus on the non-price elements of the supermarket retail offer. The ACCC consumer survey indicated that particular elements are as or more important than price, such as food quality and store characteristics. The ability to compete on prices also depends on conveying lower price offers to consumers, which is achieved primarily through a smaller list of KVLs and promotions or specials.

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<sup>27</sup> Mr Peter Brohier, submission no. 219, p. 1.

Competition in grocery retailing originates with local rivalries for grocery customers that live or work locally, with the distances involved varying between metropolitan and regional areas. National or regional responses to this competition include supply chain initiatives and a degree of centralised price setting.

Important competition with supermarkets is provided by specialty stores in the fresh categories, with a large proportion of consumers also shopping at specialty stores. However competition among supermarkets is closer, because they offer consumers the option to complete the majority of their regular grocery shopping in the one visit.

# 5 Competition between the MSCs

## Key points

- Although the major supermarket chains (MSCs) compete on price, much of the competition between the MSCs is on non-price aspects of their retail offers.
- An aggressive 'price war' between the MSCs in 2007 resulted in significant price discounting. However, this price war ended quickly.
- The ACCC expects price competition between the MSCs to be stable in future, with limited prospects of further episodes of strong price discounting.
- If Coles successfully lowers its costs of doing business, the ACCC expects competition between the MSCs could intensify. However, such competition is more likely to occur on non-price elements of their retail offers.
- Stronger price competition between the MSCs is most likely to occur through disruption of their prevailing pricing behaviour caused by entry or expansion of other grocery retailers.

## 5.1 Introduction

This chapter examines competition between the major supermarket chains (MSCs). Chapters 7 and 8 consider the competitive influence of other grocery retailers, including the independents supplied by Metcash, other independents and specialist retailers.

Chapter 4 discussed the nature of competition in grocery retailing. Grocery retailers compete on a range of price and non-price elements, including product range, location and store characteristics such as improved checkouts. The focus of this chapter is on the nature of price competition between the MSCs and their incentives for price competition.

The MSCs provide similar retail offers and each is the other's closest competitor. The competitive strategies of the MSCs are somewhat interdependent, with each influenced by the competitive choices of the other.

Price competition between the MSCs tends to be more vigorous on the subset of grocery items that consumers readily compare. The MSCs' incentives towards more vigorous price competition across a broader range of products are reduced by the prospect of encouraging a price war, without lasting gains to market share.

In addition, the longer term profitability associated with less than vigorous price competition seems more appealing to the MSCs. A departure from the status quo is relatively less attractive to both. Disruption of the status quo by other grocery retailers is the most likely prospect for more vigorous price competition in future.

Investments by Woolworths in its supply chain have lowered its cost of doing business. Coles told the inquiry that it is currently endeavouring to do the same. If Coles succeeds, its scope and incentive to attempt to win market share will increase. However, more intense competition is likely to occur on non-price aspects of the retail offer, rather than on price.

## 5.2 The nature of competition between the MSCs

As discussed in chapter 4, supermarkets tailor their retail offer to attract customers. The ACCC consumer survey indicated that non-price elements, such as parking, the standard of facilities and product range, are all very important to shoppers.

Although specialty retailers, and to a lesser degree convenience stores, provide important competition, supermarkets' closest competitors are other supermarkets. Although shoppers can purchase meat, fruit and vegetables, and bread from other retailers, the offer of these fresh products along with dry groceries is unique to large-format supermarkets.

The retail offers of the MSCs are similar. They offer similar ranges of products and services. Nearly all Coles and Woolworths stores offer an in-store delicatessen and fresh produce department. They have similar proportions of stores that offer fresh meat, although some distinctions exist in the number of stores with in-store butchers. Many of each chain's stores have in-store bakeries.

The MSCs also offer a similar range of brands at similar price points, including many of the same proprietary brands and their own ranges of private label products.

The MSCs also place significant emphasis on other elements of the retail offer, including the products' freshness and quality, and the standard of store experience, including shelving displays, lighting, cleanliness and the number of checkouts. Statements to the inquiry from representatives of the MSCs confirmed these elements are considered to be very important aspects of competition in grocery retailing:

For example, Coles' Chief Operating Officer, Mr Mick McMahon, told the inquiry:

... there needs to be a significant amount of continued investment either in continuing to invest in better prices or in modernising and refurbishing the stores ...<sup>1</sup>

Media reports last year also indicated that investments by Woolworths in non-price elements are significant:

Woolworths will spend \$459 million refurbishing existing stores this year, almost double the amount spent for this purpose in fiscal 2007.<sup>2</sup>

The close similarity of the MSCs' retail offers indicates they largely compete for the same shoppers, who are mainly shoppers completing their larger weekly shop.

Moreover, the MSCs also compete in the same local areas. As shown in chart 5.1, around 80 per cent of Coles supermarkets have a Woolworths supermarket within 3 km.<sup>3</sup> The same is the case for Woolworths supermarkets (see chart 5.2).

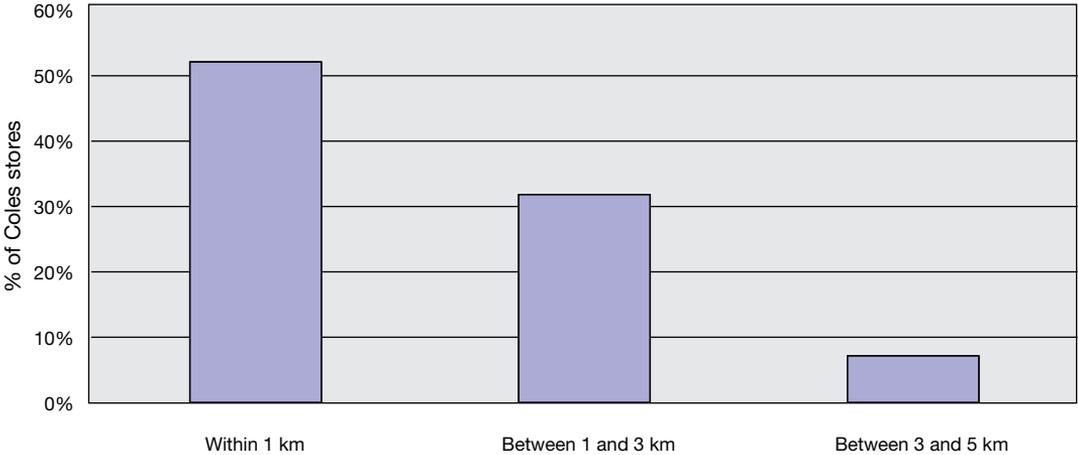
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1 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 44.

2 Nabila Ahmed, 'More price wars, warns Woolies', *The Age*, 28 August 2007.

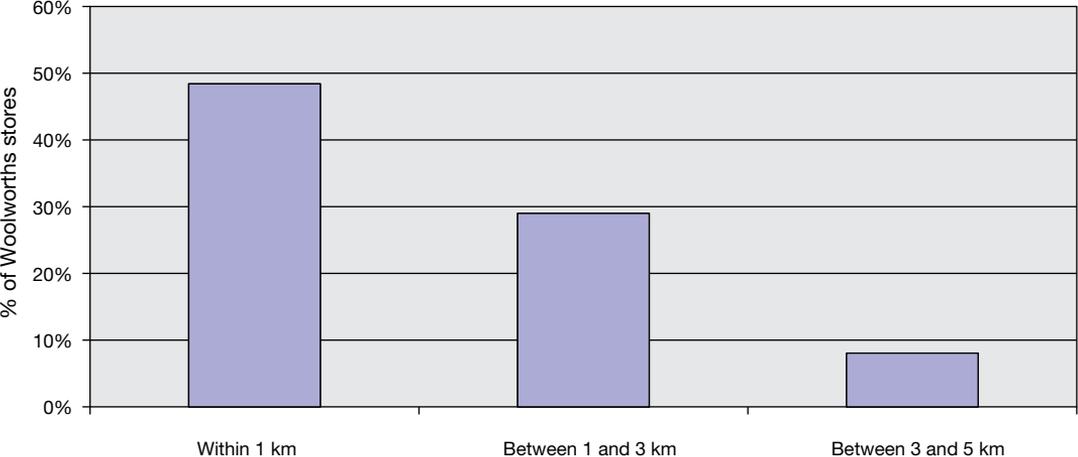
3 Of those stores with a sales area equal to or greater than 1000 m<sup>2</sup>.

**Chart 5.1 Coles stores: distance to nearest Woolworths store**



Source: MapInfo

**Chart 5.2 Woolworths stores: distance to nearest Coles store**



Source: MapInfo

## 5.3 Price competition between the MSCs

In addition to the non-price elements of the retail offer, the MSCs compete to attract shoppers to their stores using lower prices. The form this price competition takes is affected by consumers' price comparisons. As indicated in chapter 4, consumers make these comparisons in certain ways.

The analysis in chapter 4 indicated that the majority of consumers either compare prices on a limited range of products shortly before visiting the store, or compare prices over a longer period of time.<sup>4</sup> This feature of consumer grocery price comparison influences the price strategies all supermarkets employ because it directly affects their ability to use prices to attract consumers into stores.

In general, supermarkets tend to choose a subset of items for promotions, or employ a pricing strategy known as everyday low pricing (EDLP). Supermarkets may also use a combination of both pricing strategies. The MSCs employ both promotional and EDLP pricing.

### Promotional pricing strategies

Promotional pricing (also known as hi-lo pricing) is common to retailing in many countries, particularly in grocery retailing.<sup>5</sup> Promotional pricing can take various forms including multiple buys, such as 'two for one' offers, or temporary price reductions. At the most general level, this strategy uses price reductions on a smaller range of prices to attract customers performing their larger shopping trips into stores.

Particular items may be chosen more often for promotion if retailers target certain customers, or when seasonal factors cause higher demand for the items.<sup>6</sup> In general, such promotions are typically temporary, because a substantial proportion of the additional sales generated might be at the expense of other brands sold by the supermarket. Additionally, promotions can also be of limited duration because eventually the additional sales start to reduce future purchases, as some consumers stockpile items.

The choice of products and the length of time they spend on promotion is usually negotiated between supplier and retailer. From the supermarkets' perspective, the general objective is to generate additional foot traffic or to maintain current customer numbers. Promotions also provide benefits to suppliers, by encouraging consumers to buy the promoted brand over other brands. This increases sales for the duration of the promotion and also has the potential to create longer term benefits to suppliers if consumers are enticed to switch brands on a more permanent basis.

Promotions also benefit grocery retailers, by providing a point of difference to other competing grocery retailers. This can encourage consumers to change where they do their grocery shopping, generating greater benefits to the grocery retailer. In such cases the supermarket might contribute the majority of promotional funding used to reduce prices and pay for promotional advertising. In other cases, the benefits of promotions can accrue mainly to suppliers who instead provide more of the promotional funding.

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4 As discussed in chapter 4, the ACCC consumer survey indicated that a large proportion of consumers (55 per cent) do not compare prices from one supermarket to another when choosing which retailer to visit. This suggests these consumers instead assess the value of supermarkets' retail offers over time because the majority of respondents also indicated that price is very important. Of the remaining 45 per cent who do compare prices, the majority reported doing so on the basis of a limited range of items. Those who compared prices across a wide range represented 15 per cent of all respondents.

5 Although promotional pricing can in some circumstances be the result of oversupply or errors in stocking levels, it is more often a deliberate strategy aimed at improving overall profitability.

6 For example, it has been suggested that greater promotions on certain items, such as disposable nappies, might reflect the supermarkets' view of this group of consumers as more valuable, perhaps because the group tends to spend more at supermarkets than others. Discounting Christmas hams in December could reflect a similar motivation. Shoppers for the hams tend to spend more than other shoppers because they are often purchasing groceries at the same time in order to host their family get-togethers.

It is therefore important to note that promotional pricing is often evidence of inter-brand competition, rather than solely representing price competition between supermarkets.

### Everyday low pricing strategies

An additional pricing strategy used by the MSCs and other retailers overseas is everyday low pricing or EDLP. This strategy offers certain advantages over promotions in generating greater foot traffic. For example, the persistence of promotions has been known to 'wear thin' with some consumers, particularly those less willing to manage their timing of purchases with promotions or to spend additional time shopping for specials.

EDLP is a combination of pricing and communication strategies aimed at convincing consumers that prices are always lower across the broader basket of items when compared with their competitors. EDLP can have a greater impact with consumers who are less willing to adjust the timing of their purchases to take advantage of promotions. In addition, certain benefits might exist for retailers, including better inventory control and warehouse handling due to more stable and predictable demand.

The two price approaches can appeal to different customers in different ways. It is likely that EDLP is generally more attractive to time constrained consumers. Promotional pricing, on the other hand, may be more attractive to consumers who are generally less time constrained and are prepared to store items for later consumption.<sup>7</sup>

Both MSCs employ a combination of promotions and EDLP strategies.<sup>8</sup> Coles Chief Operating Officer, Mick McMahon, told the inquiry:

... normal sell ... is only one dimension of the competitive dynamic. There's the promotional activity, the way we structure our promotions, our move to try and give customers more trust in our pricing by moving to every day low prices, things like Rewind and so on.<sup>9</sup>

The likely success of either pricing strategy depends on the tastes of consumers and the relative proportions of consumers who prefer the pricing approaches at any point in time.

### 5.3.1 The pricing policies of MSCs

The pricing policies of the MSCs are based on a two-tier approach. At the first level, the head office of each MSC (or distribution centre for most produce) sets standard shelf prices and promotional offers (usually in conjunction with their suppliers) for each of their stores. The prices are set on the basis of a range of factors including the supply costs of the goods, the cost of freight to different stores, the operating costs of different stores, the retail prices of other major grocery chains and the identity and number of local competitors. This can result in different stores in the same chain having different shelf or promotional prices for the same product.

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<sup>7</sup> These distinctions, however, are rarely clear-cut. For example, retailers specialising in EDLP can be expected to also attract shoppers normally attracted to specials, who might split their purchases to obtain lower prices on certain items at predominantly EDLP stores. Similarly, time-constrained consumers can be attracted to other elements in the retail offer of stores undertaking more promotional pricing, such as better convenience or service levels.

<sup>8</sup> ALDI employs a mostly EDLP strategy, although it has used promotions in its stores on some occasions.

<sup>9</sup> ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 28.

Coles tends to more finely differentiate between its stores than Woolworths in setting its standard shelf and promotional prices. As Woolworths noted in the public hearings, it is moving to more uniform pricing across its stores. Mr Luscombe, Chief Executive Officer of Woolworths, noted during the public hearings:

... [O]ur long-term goal would be to try as much as possible to get to one price script. It's not possible in fresh food because of the varying source of supply. [However] a packet of cornflakes is a packet of cornflakes. Obviously, a banana in Western Australia comes from Carnarvon, obviously [it] comes from either Coffs Harbour or far north in terms of the eastern states and ... there are various growing regions that come into play through the year. So fresh food is always problematic but in terms of dry groceries and general merchandise, our goal eventually is to get to one national price script.<sup>10</sup>

At the second level, local store managers can reduce prices below the standard shelf prices. The local supermarket managers can make these adjustments in a range of circumstances. These include clearance of discontinued stock or stock approaching its use-by date and in response to local competition. The MSCs allow their local store managers to match the prices of local competitors, primarily for key or known value items (KVIs). Local competitors can be other supermarket chains or specialty retailers.

Mr Mick McMahon of Coles told the inquiry:

...[O]ur aim is to be competitive at a local level because customers make choices when they are in the shopping centre, when they are deciding which store to go to. So we want to be competitive at a local level...The store manager has the authority to lower prices to match on normal sells across 330-odd products.<sup>11</sup>

Woolworths' Chief Executive Officer, Mr Michael Luscombe, also described to the inquiry their local competitive pricing:

...[W]e have our local competition policy which says "for known value items"... the store manager for those items has the ability for – not when they're on special but for standard shelf price, to actually go down to meet [a price] if they need to.<sup>12</sup>

The MSCs tend to have a competitive influence on each other's price-setting undertaken at the local level, as well as more centrally at the head office level. For example, if Woolworths changes its retail prices, Coles may react by adjusting its standard shelf prices and/or promotional offers. The local Coles store manager may also react by matching the offer of a neighbouring Woolworths supermarket for KVIs. Coles' reaction can include adjusting the prices across all its stores, or it may react on a more limited basis by adjusting the prices only in certain stores, depending on whether the Coles store has a Woolworths store in its neighbourhood.

The ACCC's analysis of the pricing policies suggests that price competition is more intense on KVIs because these are the products the MSCs understand influence consumers' choice of retailer. The pricing of some other products follows an EDLP strategy, such as Coles' Everyday Low Prices items. However, the range of products this strategy is applied to by the MSCs appears narrower than, for example, the range of products it is applied to by ALDI.

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10 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 53.

11 ACCC, public hearing transcript, Melbourne, 26 May 2008, pp. 26–27.

12 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 53.

## 5.4 Evidence of price competition between the MSCs

Measuring price competition between the MSCs is difficult. Nevertheless, there is some evidence of strong price competition. However, this seems to be confined to limited periods of time.

### 5.4.1 Recent price war between Coles and Woolworths

Box 5.1 below details a series of media reports about a price war between the MSCs close to the middle of 2007. The reports indicate that Coles instigated a round of price discounting in an attempt to stem any loss of market share during the period of Coles' change in ownership. During confidential hearings of the inquiry, Coles stated that it had 'ramped up' its promotional activity in order to kick-start its sales in the second part of last year. Coles stated that Woolworths responded and within approximately six months things had returned to the previous level of promotional activity.<sup>13</sup>

#### **Box 5.1 Media coverage of the Coles and Woolworths price war in 2007**

According to ACNielsen, the episode of price discounting lasted for two months during July and August.<sup>14</sup> The change in promotional pricing was reported in the media at the time:

UBS analyst Michael Peet has been monitoring the price war between Australia's two supermarket giants. It says (sic) the pair have been battling over 'key SKUs' for a month ... [Coles] has been discounting Coke by up to 50 per cent, and Pepsi by 52 per cent, in the past month ... UBS has pointed the finger at Coles for initiating a price war ...<sup>15</sup>

Supermarket chains are slashing prices by as much as 60 per cent, triggering speculation of an all-out grocery price war as Woolworths tries to neutralise Coles' efforts to regain lost market share.<sup>16</sup>

Media reports also conveyed the views of market analysts who said at the time that the price war could not continue:

UBS says the war cannot go on. 'We view the deep discounting as a temporary phenomenon and believe pricing will return to normal levels as soon as Coles Group ownership is resolved,' writes Peet. 'With Woolworths having the larger sales base and being the lowest-cost operator, Coles or Wesfarmers would be unlikely to instigate a full-blown price war, in our view.'<sup>17</sup>

Similar suggestions were made by others:

Price discounting can be dangerous because at the company level, EBIT growth looks compelling, but if competitors respond, EBIT can fall sharply. Both Woolworths and Coles are likely to take moderate market share from smaller retailers, but the implication for their profitability is still negative.<sup>18</sup>

Reports indicating the price war had abated appeared in the media around October 2007:

[Woolworths CEO] Mr Luscombe said the discounting was starting to abate and would not have a material impact on margins. 'In business, logic doesn't always prevail – emotions sometimes get in the way – but it was short lived and our numbers show we did OK out of it,' he said.<sup>19</sup>

13 This information was sourced from Coles' confidential hearing session. The ACCC believes that disclosure is in the public interest and gave Coles an opportunity to comment on its disclosure.

14 'Retail World Annual Report,' ACNielsen, December 2007, p. 82.

15 Mark Hawthorn quoting UBS analyst Michael Peet, 'Coles hopes that things go better with Coke', *The Age*, 9 October 2007.

16 Sue Mitchell, 'Grocers bring out the big guns in price war', *Australian Financial Review*, 14 September 2007.

17 Mark Hawthorn quoting UBS analyst Michael Peet, 'Coles hopes that things go better with Coke', *The Age*, 9 October 2007.

18 Craig Woolford, 'Stock up: great grocery discounts', Citigroup Global Markets Equity Research, 24 August 2007.

19 Sue Mitchell, 'Woolworths wins grocery price war', *Australian Financial Review*, 24 October 2007.

## 5.4.2 MSC local store pricing

In order to assess the effects of local price competition, the ACCC conducted an extensive study of the MSCs' local store pricing.

In the study, the ACCC constructed indices of the prices consumers paid for the same products at different stores. This was done separately for over 700 Woolworths supermarkets and for over 700 Coles supermarkets. The indexes were constructed from the prices consumers paid for 10 000 grocery items, or stock keeping units (SKUs), across all product groups.

Once the price indices were constructed, the ACCC analysed the factors causing price differences across the stores (including the local presence of competing grocery retailers). This analysis was conducted on MSC pricing for each of three weeks in March 2007, October 2007 and May 2008, and for MSCs' pricing over the full 2007 calendar year. Full details of the study and the results can be found at appendix D.

The MSCs can affect each other's local store pricing in two ways.

First, they can influence the standard shelf prices and promotional prices set centrally by the other MSC on a store-by-store basis. As noted above, information provided to the ACCC indicates that the MSCs set different shelf prices and promotional prices depending on the presence of local competition (including the presence nearby of a competing MSC).

Second, the MSCs' local store managers can also match local pricing of its competitors, including any competing MSC.

### What the results indicate about the effects of local competition on MSC pricing

It is important to note that the statistical analysis undertaken by the ACCC is only designed to estimate the effects of price competition measured in terms of differences in prices across stores. Price discounting by Coles could, for example, produce a pricing response from Woolworths across all its stores or all Woolworths stores in a state or territory. Such effects would not be captured by this analysis. Nonetheless, the local pricing responses to competing MSCs that are estimated in this analysis provide important insights into the competitive process.

The study estimates the effect the local presence of a competing store has on local store pricing. This can be understood by considering two different Woolworths stores: Woolworths Store 1 has a Coles store within 1 km, and Woolworths Store 2 has no Coles store within 5 km. The study estimates the differences between the prices paid by consumer for grocery items at the two stores, after taking into account or controlling for a range of other factors that may affect the local pricing. The difference can be attributable to the local presence of the Coles store.

### MSCs react to the local presence of competing MSCs

The study found that during particular periods, the presence of a competing MSC had an important influence on local store pricing of the other MSC—specifically, over 2007:

- consumers shopping at a Woolworths store with a Coles store within 1 km paid prices that were on average around 0.7 per cent lower than the prices paid by consumers at a Woolworths store without a Coles store within 5 km
- consumers shopping at a Coles store with a Woolworths store within 1 km paid prices that were on average around 1.4 per cent lower than the prices paid by consumers at a Coles store without a Woolworths store within 5 km.

Although these price differences might not be immediately noticeable to all consumers, the financial impact on the MSCs is significant. A difference of around one per cent in prices can have a large impact on the MSC's EBIT margins. In 2006–07 these EBIT margins were 3.39 per cent (Coles) and 5.76 per cent (Woolworths).

These effects are important for a number of other reasons. Around 50 per cent of each MSC's stores have a competing MSC within 1 km, indicating that the effects are widespread. Moreover the effects were found across most product categories.

### Local responses to competing MSCs were smaller in 2008

The influence of a competing MSC on local pricing seems to be smaller in 2008 than in 2007. In particular, for the week ending 18 May 2008, consumers shopping at a Woolworths store with a Coles store within 1 km paid prices that were on average around 0.2 per cent lower than the prices paid by consumers at a Woolworths store without a Coles store within 5 km. A similar difference existed for Coles. Consumers shopping at a Coles store with a Woolworths store within 1 km paid prices that were on average around 0.5 per cent lower than the prices paid by consumers at a Coles store without a Woolworths store within 5 km.

There are likely to be at least three reasons for this:

- the period of price discounting, or price war, in 2007
- the move by Woolworths to more uniform pricing
- the potential sampling errors associated with using only one week of data from 2008.

### Local response to an ALDI is similar to a competing MSC

Another result from the study is that the average effect of MSCs on local store pricing is similar to that of ALDI, despite ALDI offering a far smaller product range—specifically, over 2007:

- consumers shopping at a Woolworths store with an ALDI within 1 km paid prices that were on average around 0.7 per cent lower than the prices paid by consumers at a Woolworths store without an ALDI within 5 km
- consumers shopping at a Coles store with an ALDI within 1 km paid prices that were on average around 0.8 per cent lower than the prices paid by consumers at a Coles store without an ALDI within 5 km.

ALDI appears to have a far more significant effect on MSC local store pricing across the products it stocks than a competing MSC. The effect is more significant when considering that an ALDI typically stocks around 900 SKUs, whereas a typical MSC stocks over 25 000.

### What does this mean for assessing price competition between the MSCs?

The analysis suggests that, at times, the MSCs have set significantly different prices depending on the local presence of a competing MSC. The impact of ALDI on the MSCs' price competition was similar.

As suggested above, there appeared to be a large effect due to the 2007 'price war' referred to earlier. This appears to have made the local reaction stronger.

Woolworths' decision to move towards more uniform pricing is likely to alter the nature of the response to a competing MSC in future. Specifically, the competitive response is likely to occur more at the state and territory, rather than local store, levels. The prospect of stronger price competition between MSCs in the future is also discussed below.

## 5.5 Factors making vigorous price competition less likely

Chapter 4 indicated how improvements to non-price elements of the retail offer can provide supermarkets with important advantages over rivals. The incentives for the MSCs to compete using prices depend on the profitability of doing so. In general, the profitability of price competition to grocery retailers depends on:

- the number of additional customers (or sales) the price discounting will attract
- how long the additional customers can be kept and the additional sales sustained
- the profit the retailers would lose from lower prices on existing sales.

The prospects for winning greater market share using price discounting in turn depend on:

- the response of consumers to price discounting
- any response from competing retailers to the price discounting
- the gross margins of the grocery retailers.

Each of these factors is discussed below.

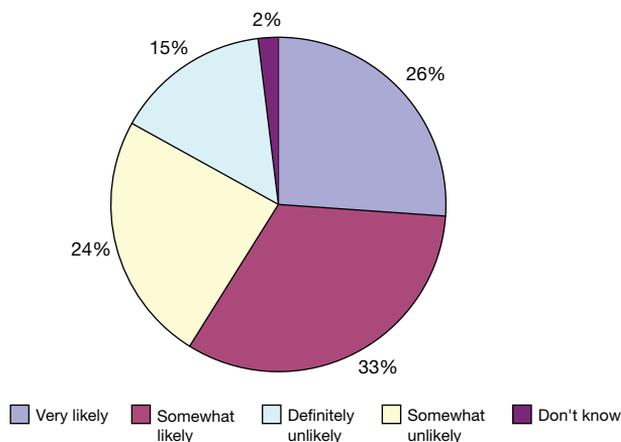
### 5.5.1 Consumer responses to price discounting

The purpose of price discounting is to increase sales by encouraging consumers to change their choice of retailer. This requires conveying a lower price offer to consumers.

As discussed in chapter 4, consumers face difficulties in comparing prices across the range of items in their typical weekly shop. As a result, many consumers build up a picture of their regular supermarket's price offer through their experiences over time. Immediately convincing those consumers of a superior price offer is likely to be difficult, even with extensive promotions and advertising.

If cheaper price offers are successfully conveyed to consumers, evidence from the ACCC consumer survey suggests many consumers would change where they shop (see chart 5.3).

**Chart 5.3 Consumers likely to change supermarkets for a 5 per cent price change**



Source: Respondents' answers to the question: 'How likely would you be to change to another local supermarket if it was 5 per cent cheaper than your current supermarket for the same products that you normally buy?' ACCC, survey of grocery consumers, April 2008.

This chart indicates that 59 per cent of respondents felt they would be ‘somewhat’ or ‘very likely’ to change to another local supermarket if it were 5 per cent cheaper. It should be noted, however, that reducing prices on average by 5 per cent across all products would be a very significant price reduction. Such a price reduction would be likely to eliminate all or most of an MSC’s current EBIT margins.

## 5.5.2 Response of competing MSC to price discounting

For those consumers who are responsive to lower price offers, the reaction of competing grocery retailers can prevent the price discounter from winning and retaining new customers. The following factors tend to make competitors’ reactions easier and more effective which impacts on the viability of price discounting.

### Price transparency

There is a high degree of price transparency in grocery retailing. In many cases retailers are aware of changes in the prices offered by competing retailers even before many consumers are aware.

Coles and Woolworths closely monitor each other’s prices. These comparisons are regular (often weekly) and cover a broad range of products. Price monitoring of KVs is conducted very frequently.

For example, Coles said:

... [W]e monitor prices very closely, and we believe that prices, at a local level, are what matter to customers and, hence, our strategy is geared at ensuring that the store manager has the authority to ensure they are competitive locally on over 331 product lines, and, as we have said earlier, at a state and zone level within a state, we make sure that we are competitive.<sup>20</sup>

Woolworths Chief Executive Officer Mr Micheal Luscombe also said:

... [W]e go out on a regular basis and check literally thousands of lines on a rotational basis every month and that gives us a much better idea of where we sit in the marketplace.<sup>21</sup>

Moreover, Coles and Woolworths have a good idea of the costs incurred by the other in sourcing products from suppliers. This enables both chains to distinguish aggressive price cuts from changes to underlying costs.

Price discounting is also more easily detected in concentrated markets. Around 80 per cent of each MSC’s stores are within 3 km of one another. Each operates around a third of all large supermarkets in Australia and, when combined, account for between 55 per cent and 60 per cent of consumer expenditure on grocery items.<sup>22</sup>

### Response of competing MSCs

After price discounting has been detected, the MSCs can and do respond rapidly. In some cases the price response can be very quick. As noted above, the MSCs’ local store managers can match the prices of local competitors (including the competing MSCs) on KVs.

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20 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 39.

21 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 47.

22 As of May 2008, Coles operated around 750 supermarkets with a sales area greater than 1000 m<sup>2</sup> and Woolworths operated around 780. As discussed in greater detail in chapter 3, it is the ACCC’s view that Woolworths accounts for at least 30 per cent and Coles around 25 per cent of consumer expenditure on grocery items.

For other products, the response can occur within a week, when both MSCs regularly review their standard shelf prices. These reviews are based on a range of factors, including the prices of competing stores. Responding via advertised promotions could take longer.

Customers gained through price discounting can also be difficult to retain. The close proximity of most of the MSCs' stores means that many consumers face negligible costs in changing the store they visit. In many cases, those customers willing to change stores in response to lower prices would be equally likely to change once a competing store responded.

The speed and effectiveness of competing MSCs' responses tend to erode any gains in volumes to the MSCs initiating price discounting. Knowing such a response is likely tends to lessen the incentives for price discounting in the first instance.

### Prospect of price discounting developing into a price war

A significant risk to the MSC initiating price discounting is that it will escalate into a price war. As discussed earlier, around 80 per cent of the stores operated by each chain are within 3 km of one another. A competitive response to price discounting has the potential to affect the sales of both MSCs across a large majority of its stores.

The potential for negative consequences for the MSCs arising from a price war can be seen in the events of 2007 (see box 5.1, above). Financial press commentary at the time indicated that there were unlikely to be any gains to Coles from the price discounting. This suggests Woolworths' response had been effective. This is likely to have dampened Coles' incentive towards undertaking aggressive price competition in future, because Woolworths has demonstrated clearly that it will respond if Coles leads prices lower.

### 5.5.3 Lower profit margin on sales

Lowering prices lowers profit margins. In order for price discounting to be profitable, the profit on additional sales must more than offset the lower margin on current sales.

An analysis was undertaken by the ACCC to determine the likely increase in the volume of sales before a given price reduction across dry groceries becomes profitable. This analysis indicated that if Coles lowered its average prices by 2 per cent, it would have to increase its volume of sales by a minimum of between 7 and 9 per cent before it could break even.<sup>23</sup> Woolworths would require between 6 and 8 per cent for the same price reduction.

This indicates that broad price competition, averaging 2 per cent across the dry groceries categories, would require winning substantial additional sales volumes to be profitable. A small fraction of such additional volumes could result from greater purchases made by existing customers. However, the bulk of such volumes would require the diversion of sales from other supermarkets, including the other MSC, which would most likely provoke a response aimed at limiting the loss of those sales.

### 5.5.4 Higher volumes driving costs down

The possibility that additional sales volumes may drive down the MSCs' costs was also examined. Such cost efficiencies, or economies of scale, could alter the analysis above if the gain in sales volumes also reduced costs at the same time.

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<sup>23</sup> Of course, it would be unlikely that Coles would lower all prices by 2 per cent. Rather, it could target the price decreases on certain items. Coles could instead decrease the prices of 10 per cent of its products by 20 per cent, for example.

To assess this possibility, a cost reduction of 1 per cent was assumed to result from the increase in sales of between 7 per cent and 9 per cent. The new analysis indicated that the minimum additional sales volume Coles would require falls to between 5 per cent and 6 per cent for a 2 per cent price discount to break even. This suggests that such economies of scale, if possible, might improve the prospects of profitable price competition. However, a minimum gain of 5 or 6 per cent remains unlikely given the competitor's likely response.

### ACCC's view

There have been periods of aggressive price competition between Coles and Woolworths. These periods have been short-lived. The MSCs monitor each other's pricing closely and react to changes in price. Apart from the recent price war, it does not appear that the MSCs aggressively pursue market share through deep price discounting. The risks to earnings and limited upside opportunities of such a strategy are well understood. Although the MSCs compete on price, the competition does not appear to be vigorous.

## 5.6 Prospects for more vigorous price competition between the MSCs

The MSCs' existing incentives for price discounting also depend on the ability to avoid more vigorous price competition. Refraining from stronger price competition is more likely under certain conditions, which will be discussed in greater detail below. An analysis of these factors can provide an indication of the prospects for stronger price competition between the MSCs.

### 5.6.1 Factors likely to sustain less vigorous price competition

The MSCs' ability to refrain from vigorous price competition over the longer term depends on the overall level of competition in grocery retailing. The more pressure from other retailers (such as other supermarkets and speciality stores), the less able the MSCs are to withhold price advantages. The ACCC considers that certain factors have added to the stable outlook for the MSCs, including barriers to effective entry and expansion, cost advantages of the MSCs and the stable nature of demand for groceries.

#### Barriers to entry and expansion

There are several factors that suggest the MSCs can expect the future competitive environment to be relatively stable. Each of the chains has long-term financial commitments to the sector so that both can expect the other will remain a significant part of the competitive landscape in the medium term. The prospect of other competitors entering the sector in direct competition also remains low at the moment.

As discussed in chapter 9, there are barriers to new entry or expansion of competitors with retail offers that would directly challenge the MSCs. The existence of such barriers reinforces a stable outlook for the MSCs in relation to the prevailing price behaviour, particularly in relation to broader standard shelf pricing.

#### Cost advantages of the MSCs

A number of smaller independently-owned retailers, such as SupalGAs, operate larger-format supermarkets, which can disrupt any weakness in competition between the MSCs where it is possible

for them to do so. For example, these retailers can compete effectively by improving their retail offer, as discussed in chapter 4. However, their cost disadvantage limits their opportunities to compete directly with the MSCs on price. Such disadvantages are analysed in detail in chapter 7. These cost constraints limit the possibility for disrupting the prevailing price behaviour.

Cost constraints have not prevented ALDI from competing more directly on price. As discussed further in chapter 8, ALDI has employed its lower cost structure to compete directly with the MSCs on the price of similar items. The ACCC's pricing analysis (appendix D) indicated that ALDI has enhanced price competition particularly in the MSCs' private label products.<sup>24</sup>

However, notwithstanding these benefits, for the broader range of items ALDI does not carry, the prospect of stable overall profits for the MSCs remains unchanged by ALDI's pricing behaviour.

### Stable demand for groceries

The effects of limited disruptions to prevailing price behaviour are more pronounced in markets with more stable demand. The grocery retailing sector has relatively stable and predictable demand when compared with other industries, subject to shifts in taste. Grocery purchases are necessary and frequent, with the industry's size generally tracking the rate of growth of gross domestic product. This stability in demand makes it easier for the MSCs and other retailers to form expectations about the likely results from continuing with the prevailing price behaviour.

## 5.6.2 Coles lowering its costs of doing business

As discussed in chapter 4, the recent ownership change of Coles has generated some expectations that business practices will improve. In particular, it is widely anticipated that Coles could achieve a lower cost of doing business. These potential gains do not depend on gaining additional market share. They are fixed cost reductions relating to lower head office costs and a more streamlined supply chain.

Coles could choose to return the cost savings to shareholders or invest it back into the business. This could involve improving its retail offer, which would bring about stronger competition. However, it is unclear if such an improved offer would include greater investments in lower prices.

The ACCC considers that Coles' achievement of these aspirations does not, on its own, alter its analysis of the likely profitability of price competition by Coles. The ACCC completed an analysis which factored in such an investment in price, rather than other aspects of its retail offer. However, this did not alter the ACCC's original analysis of the profitability from price discounting in a material way.

In general, both chains are unlikely to initiate greater price competition because this would have the effect of giving up substantial benefits associated with the prevailing price behaviour. Greater competition from Coles is more likely to occur on non-price elements, such as through improvements to its retail offer, where it has better prospects of differentiating its offer from Woolworths and gaining additional customers more permanently.

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<sup>24</sup> Coles and Woolworths told the inquiry that ALDI's limited range of around 900 mostly private label products represents a high proportion of average grocery expenditures and so it is important they remain competitive on these high volume lines.

## ACCC's view

Overall, each of these factors suggests that more vigorous price competition between the MSCs in the future is unlikely. The currently stable outlook is continually balanced by each MSC against the prospect of engaging in stronger price competition. As discussed earlier, the prospects for short-term gains through aggressive price competition appear limited. As long as the future prospects remain stable, a departure from the status quo is unlikely.

## 5.7 Conclusions

The MSCs are each other's most direct competitors. Coles and Woolworths supermarkets retail a broad range of products and brands under the one roof. Their retail offers are very similar and there is a degree of interdependence in their competitive strategies.

Competition between the MSCs takes many forms. Arguably, competition between the MSCs is the strongest on non-price elements of the retail offer, such as the freshness of produce and meat, and the quality and variety of products on offer (including private labels).

The MSCs also compete on price. This primarily occurs through discounting KVLs, as well as weekly or periodic promotions which are developed and funded by product suppliers and the MSCs. The evidence suggests ALDI's impact has disrupted the MSCs' price behaviour over the smaller range of items typically stocked in its stores.

Although there have been episodes of vigorous price competition between the MSCs, these episodes seem to be the exception rather than the norm. Market share gains from price discounting are limited and usually transitory due to the ease with which a competing MSC can detect and respond to the discounting. In general, both chains are unlikely to initiate greater price competition, because this would have the effect of giving up substantial benefits associated with the prevailing price behaviour.

A possible trigger for more vigorous price competition between the MSCs is the expected improvement in Coles' cost of doing business. The ACCC believes any increased competition is more likely to occur on non-price elements of the retail offer, such as store refurbishments and an improved fresh product offering.

The potential for stronger price competition is instead more likely to originate with other competitors disrupting the prevailing price behaviour. Competitors with smaller market shares are, in general, more likely to undertake price competition as a way to win market share. However, as mentioned earlier, with the exception of ALDI, cost constraints often limit the extent of price cutting that is possible.



## 6 Profits and margins of Coles and Woolworths

### Key points

- In 2006–07 Woolworths obtained around 6 cents in every dollar spent in its supermarkets as earnings before interest and tax (EBIT), while Coles obtained around 3.5 cents in every dollar spent in its supermarkets as EBIT. The size of these margins reflects the low margin, high volume nature of supermarket retailing.
- Woolworths is currently more profitable than Coles, achieving higher EBIT measured in both dollars earned and as a percentage of sales revenue (EBIT margin). The gap between Woolworths' and Coles' EBIT has widened significantly over the last six years.
- Coles achieves EBIT margins that are comparable to the average EBIT margins of major overseas supermarket grocery retailers. Woolworths currently achieves EBIT margins that are among the highest EBIT margins internationally. Since 2001–02, Woolworths has achieved EBIT margin growth exceeding that of all of the international grocery retailers examined by the ACCC.
- The trends in EBIT margins for Woolworths and Coles are consistent with a relatively stronger position for Woolworths compared to Coles. It appears that Woolworths is, at this point in time, the more efficient of the two MSCs.
- Gross margins achieved by Coles and Woolworths vary by trading department. The recent trends in gross margins have also varied by trading department, with margins on dry groceries and perishable products such as dairy increasing, while margins on fresh fruit and vegetables and meat were declining. These differences may reflect weaker competitive pressures in dry groceries and perishables compared to fresh fruit and vegetables and meat.
- There is evidence that gross margins have experienced larger increases in categories where Coles and Woolworths have a relatively larger share of national sales.
- The trends in gross margins are different from recent trends in food price inflation where there have been larger price increases for fruit and vegetables than dry groceries.

### 6.1 Introduction

The profit and margins of the two major supermarket chains (MSCs), Coles and Woolworths, may provide some insight into the competitive pressures in grocery retailing in Australia. The size of MSC profits in recent years has been cited in public discussion as evidence of a lack of competition in grocery retailing. However, profits in simple dollar terms alone are rarely instructive about the level of competition in a market. This chapter analyses a range of information about the profits and margins of the MSCs.

The ACCC has examined both publicly available information and information it obtained on a confidential basis about the profits and margins of the MSCs. The profits and margins of other supermarkets are examined in chapters 7 and 8.

An analysis of the level of, and changes in, profitability and margins may provide some indication of whether the MSCs are taking a comparatively larger proportion of Australian consumers' grocery expenditure than would be expected in a competitive grocery market. However, there is no particular level of profit or margin that would necessarily be evidence of a lack of competition.

## 6.2 Profits of Coles and Woolworths over time

### 6.2.1 Submissions

A number of parties provided public and confidential submissions and evidence about the profits and margins of the MSCs.

Coles submitted that its position in the market had not led to significant profit levels:

Coles' position and size in the market has not led to customers paying too much for grocery items. Coles' prices are competitive in Australia, comparable to other OECD countries, and reflect its costs of supply with a relatively small net profit margin.<sup>1</sup>

Coles also characterised the industry as having relatively low earnings:

Across the publicly listed companies that operate in the retail grocery sector, margins or earnings before interest and tax (EBIT) are generally between 3 to 6 cents in the dollar and among the lowest in the Australian economy.<sup>2</sup>

Coles' consultant freshlogic submitted that retailer profitability in Australia is comparable to that overseas.<sup>3</sup> freshlogic estimated that the average gross margin (the gap between retail selling price and amount paid to suppliers) in Australia is around 26 to 27 per cent, although it varies across categories.<sup>4</sup>

Similarly, the Australian National Retailers Association argued that returns in grocery retailing are not high:

The retail grocery market has many of the characteristics of a mature industry, not the least being relatively modest and stable returns.

Over the last eleven years, for example, annual earnings before interest and tax (EBIT) for Coles' Food and Liquor division has oscillated in a range of 3.1 to 3.65 per cent. The latest figures show an EBIT of 3.1 per cent (in 2006).

This performance is consistent with the sector as a whole. An independent study has concluded that:

A highly competitive retail sector combined with the strong presence of national and international brands has resulted in a low margin, by world standards, grocery sector operating on less than 4 per cent earnings before interest and tax.<sup>5</sup>

Other parties provided a different view on profitability and margins. For example, the National Association of Retail Grocers of Australia (NARGA) submitted that:

... there is ample evidence that the dominant supermarket duopoly has increased prices and profits significantly ahead of OECD averages and ahead of the Australian consumer price index for at least the past decade, regardless of periods of drought. Woolworths' recent (February 2008) financial report notes a 28.1 per cent increase in net profit, based on an 8.6 per cent increase in sales.

Supermarket sales have contributed the great majority of the profit increase.<sup>6</sup>

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1 Coles, submission no. 157, p. 9.

2 Coles, submission no. 157, p. 12.

3 Coles, submission no. 157, appendix–freshlogic report, p. 5, chapter 7.

4 Coles, submission no. 157, appendix–freshlogic report, p. 39.

5 Australian National Retailers Association, submission no. 91, p. 9.

6 NARGA, submission no. 129, p. 4.

Tony Zappia similarly cited recent profitability of Australian supermarkets:

In February this year Woolworths Ltd, Australia's largest retailer, announced an \$891.3 million net profit for the 27 weeks to December 30, 2007. This was up from \$695.6 million in the prior corresponding period and represented a 28.1% increase in first half yearly profit.

In making the announcement Woolworths said it expected net profit for the 2008 financial year to grow between 19% and 23% above the \$1.29 billion profit achieved in the 2007 financial year ...

Also in February Wesfarmers, which last November bought the Coles Group's \$18 billion retail assets, announced a \$601 million profit in the first half of the 2007-08 fiscal year. It was a 53% increase in overall profit in all of its divisions which was an increase from \$392 million in the prior corresponding period. The result included a first-time contribution from Coles of \$357 million in earnings before interest and tax.<sup>7</sup>

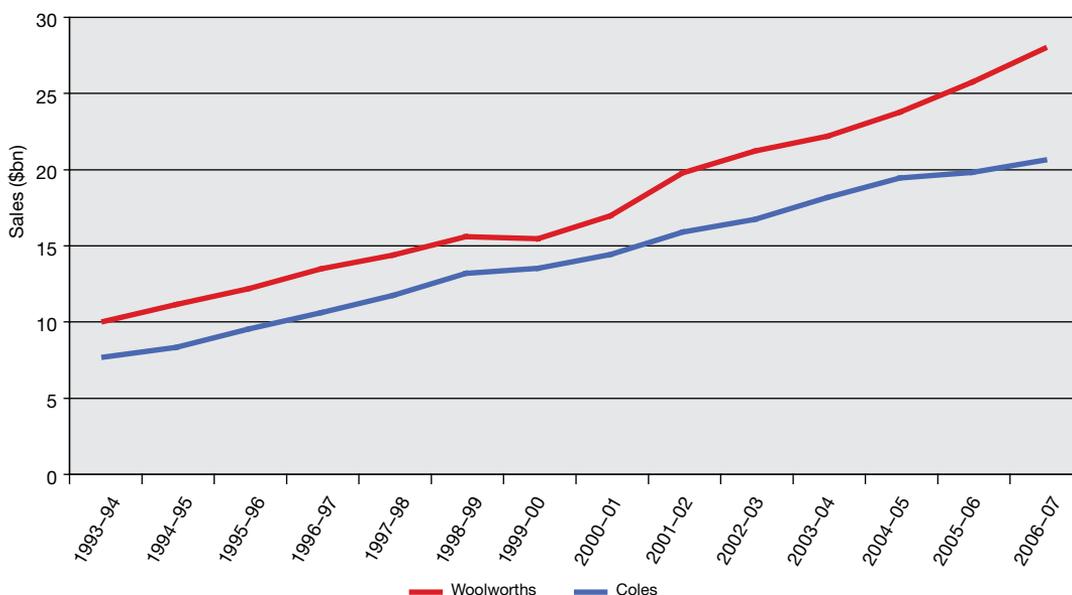
Growcom submitted that profitability of supermarkets was disproportionate to that of some suppliers:

Anecdotally, ten years ago growers worked on a rule of thumb of farm gate return being around 50 per cent of retail price. Today, this margin is generally less than 20 per cent. Growers' profit margins continue to decrease, while the profit margins of the major retailers remain at record highs.<sup>8</sup>

## 6.2.2 Coles and Woolworths sales data

Chart 6.1 shows the trend in the MSCs' sales revenue in their food and liquor divisions between 1993-04 and 2006-07.<sup>9</sup>

**Chart 6.1 Woolworths and Coles sales revenue (food and liquor divisions, \$ billion), 1993-94 to 2006-07**



Source: Woolworths and Coles annual reports, 1994-95 to 2006-07

7 Tony Zappia, submission no. 87, p. 6.

8 Growcom, submission no. 69, p. 4.

9 The public annual report figures for both companies include sales of food and liquor. The MSCs do not publicly report separate figures for groceries sales only. The Woolworths data before 1999-2000 includes sales of petrol, as Woolworths did not separately report on petrol before that time. However, the ACCC notes that petrol sales before 1999-2000 would represent a small share of overall grocery, liquor and petrol sales. Changes in accounting approaches over the period examined may have altered the basis on which sales are recorded between periods.

The sales for both MSCs increased at a fairly similar rate from 1993–94 until around 1998–99. However, between 1999–2000 and 2006–07 Woolworths experienced a greater rate of growth in sales. Of the seven years between 1999–2000 and 2006–07, Woolworths’ percentage rate of growth in sales was higher than that of Coles in all but one year. These sales trends demonstrate a weakening of Coles’ position in the market relative to Woolworths since around 2000.

### 6.2.3 Coles’ and Woolworths’ EBIT

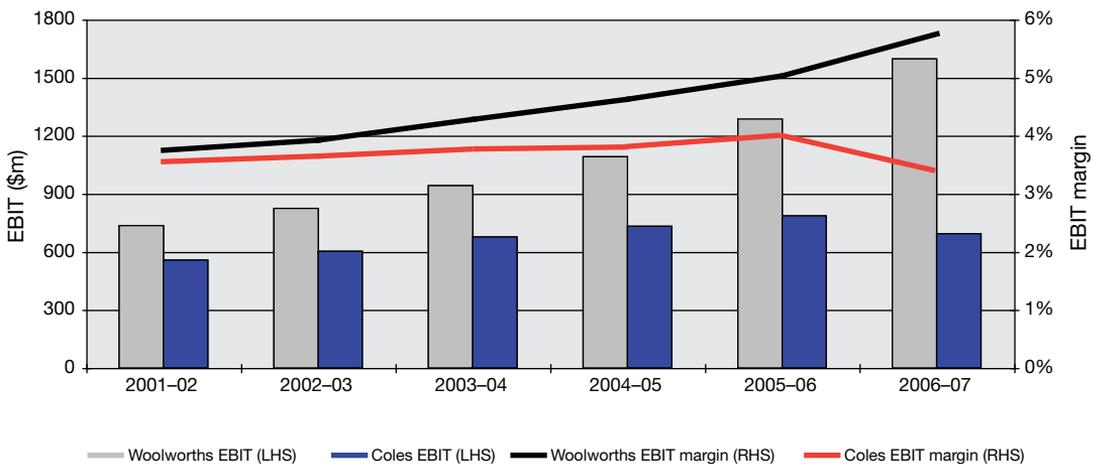
The EBIT of a company can be a useful measure to compare the relative performance of companies with similar capital structures. The ACCC considers that the EBIT or other accounting measures can provide some indication of economic profits and therefore some insight into competition.

A company’s EBIT compared to its sales (EBIT margin) provides a basis for comparing the EBIT of companies of different sizes, and is typically reported by grocery retailers in published financial reports. Broadly, the EBIT margin tells how many cents in every dollar spent by consumers in a supermarket ends up as earnings.

An increasing, constant or decreasing EBIT margin does not necessarily indicate that a company is increasing, maintaining or decreasing the retail prices of the goods it sells. As discussed below, the retail price is only one of a number of factors that may ultimately affect margins, including EBIT margins.

Chart 6.2 displays publicly reported EBITs and EBIT margins for the food and liquor divisions of the MSCs from 2001–02 to 2006–07.<sup>10</sup>

**Chart 6.2 Woolworths and Coles EBITs (food and liquor divisions, \$m and EBIT margin), 2001–02 to 2006–07**



Source: Woolworths and Coles annual reports, 2001–02 to 2006–07

<sup>10</sup> The public annual report figures for both companies include sales of liquor. The MSCs do not publicly report separate figures for groceries sales only.

Chart 6.2 shows a divergence between the EBITs and EBIT margins for the MSCs over time. The two companies achieved similar EBIT margins in 2001–02 (and Coles achieved a slightly higher EBIT margin in 1999–2000). The EBIT earned by Woolworths in 2001–02 exceeded the EBIT achieved by Coles by around \$176 million (and the difference in 1999–2000 was around \$63 million). However, by 2006–07 Woolworths' EBIT exceeded that of Coles by around \$904 million. This is reflected in Woolworths' EBIT margin of 5.76 per cent compared to Coles' of 3.39 per cent. The small percentage size of these EBIT margins reflects the high volume, low margin nature of the supermarket business.

The results display a notable weakening of Coles' performance over time relative to Woolworths. However, the ACCC notes that, over the period from 2001–02 to 2006–07, Coles' EBIT and EBIT margin only declined in absolute terms in 2006–07.

The ACCC had access to confidential information on the profitability and margins of the MSCs' grocery activities between 2001–02 and 2006–07. The trends in EBIT and EBIT margins for the MSCs' grocery business displayed similar trends to that of their publicly reported food and liquor division results.

Public and confidential data available to the ACCC demonstrates that the MSCs typically achieve higher EBIT margins in the retailing (and associated wholesaling) of groceries than in either petrol or liquor. The reported EBIT margins from the MSCs' annual reports, as presented in chart 6.2, accordingly understate the EBIT margins for their grocery business.

Woolworths' growth in EBIT margins coincides with the rise in the rate of food price inflation in Australia. In particular, the sharp increase in EBIT margins from 4.63 per cent to 5.76 per cent between 2004–05 and 2006–07 occurred during a period in which food price inflation in Australia increased significantly (see chapter 2). However, it is not necessarily the case that the increasing margins directly contributed to the rise in food price inflation. As noted in chapter 2, any potential contribution to increases in food prices resulting from increased margins of major grocery retailers and wholesalers would be relatively small compared to the overall increase in food prices. Secondly, as discussed later, improved EBIT margins can be the result of a number of factors and not just higher prices. In any case, Coles' EBIT margins declined from 3.80 per cent to 3.39 per cent between 2004–05 and 2006–07. If increasing margins from a lack of competition in grocery retailing (and associated wholesaling) were a primary cause of the recent increases in food price inflation, Coles' margins would also be expected to have increased, all else being equal.

## 6.2.4 International comparisons

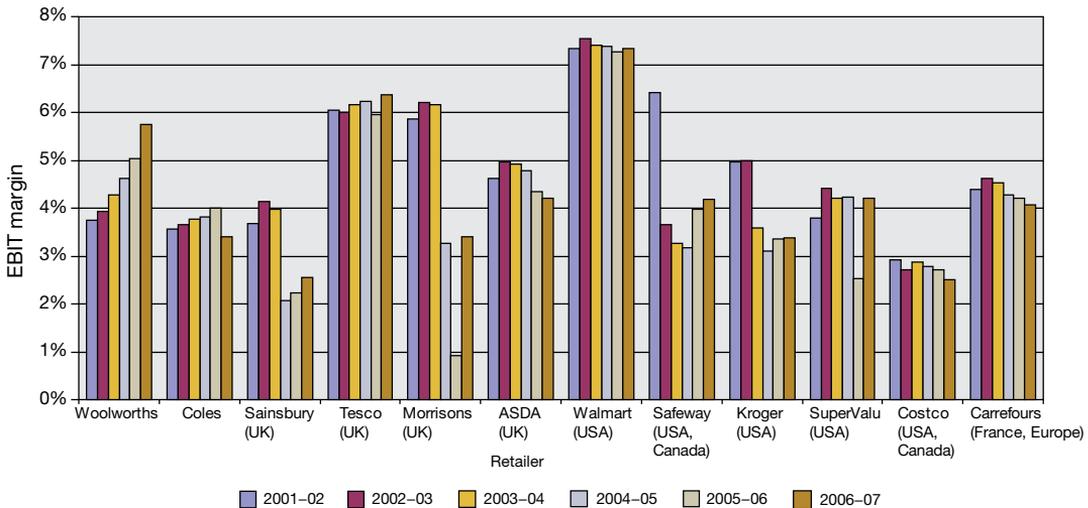
### EBITs

Chart 6.3 displays EBIT margins for the MSCs against comparable margins for the four largest grocery retailers in the UK, the five largest grocery retailers in the USA and for Carrefours, a large European grocery retailer.<sup>11</sup> The companies examined, like Coles and Woolworths, are vertically integrated companies that sell groceries at a retail level and also perform the associated underlying wholesaling in support of their retail business.

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11 The EBIT margins are for the following business segments as reported by each company: Woolworths—food and liquor; Coles—food and liquor; Sainsbury—supermarkets and convenience; Tesco—retail and associated activities; Morrisons—grocery and related retailing and vertically integrated manufacturing; ASDA—operation of food, clothing, home and leisure stores; Walmart—Walmart stores (supercentres, discount stores and neighbourhood markets); Safeway—food and drug retailing; Kroger—food, drug, department, jewellery and convenience retailing; Supervalu—retail food; Costco—membership warehouses; Carrefours—hypermarkets, supermarkets, hard discount stores and others.

**Chart 6.3 International grocery retailers EBIT margins, 2001–02 to 2006–07**



Source: public annual reports

Caution needs to be exercised in drawing conclusions from international comparisons. Like-for-like comparisons are not straightforward. In particular, the range of activities conducted by the companies in addition to grocery retailing will affect their margins. The companies may not report separately on their grocery business only. If possible, the ACCC has presented EBITs for the part of the company most closely related to the supermarket grocery business. The countries to which the data primarily relates are identified in chart 6.3.

Chart 6.3 suggests that the EBIT margins achieved by Woolworths and Coles compare well with major overseas supermarkets. Woolworths' 2006–07 margin is toward the higher margins achieved among the companies examined, while Coles' margin is towards the middle. This is consistent with the views of each of the MSCs about their position compared to the EBIT margins of international peers.<sup>12</sup> There is no particular level of EBIT margins that indicates a competition problem. Even in highly competitive markets, more efficient operators may be able to achieve superior margins. However, the comparisons do suggest that both MSCs are at least obtaining reasonable margins compared to the overseas supermarkets examined.

Woolworths is the only company among those shown that achieved consistent growth in EBIT margin between 2001–02 and 2006–07. Woolworths reported a further increase in margins for its Australian food and liquor business in the first half of 2007–08 to 6.45 per cent.<sup>13</sup> Other retailers above, including Coles, have had relatively flat or declining EBIT margins over the same period. Again, this suggests that Woolworths has enjoyed a relatively strong position over the last six years as it has been able to increase its profitability across a period of relatively constant profitability among many major grocery retailers in the United Kingdom, the United States of America and Europe.

<sup>12</sup> ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 23; ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 22.

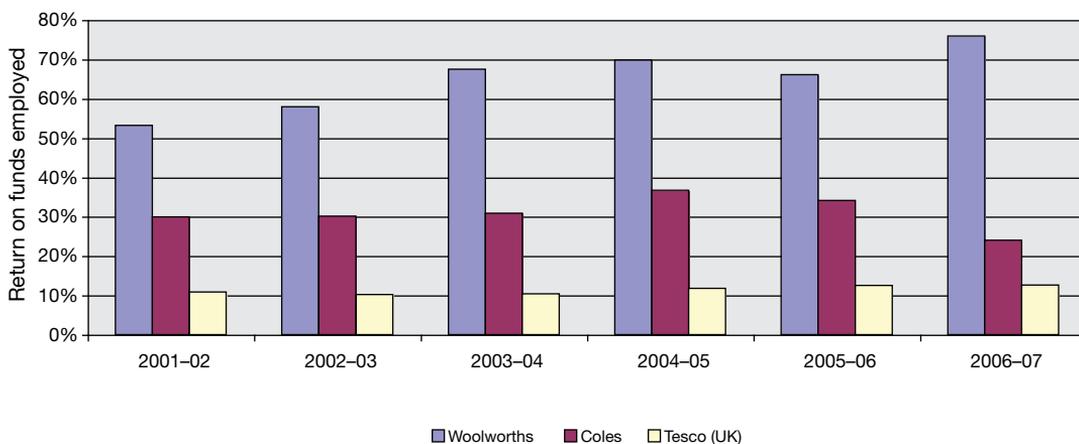
<sup>13</sup> Woolworths, *Company results, half year ended 30 December 2007*, released 26 February 2008, available at [http://library.corporate-ir.net/library/14/144/144044/items/281095/2008 Half Year Results Presentation.pdf](http://library.corporate-ir.net/library/14/144/144044/items/281095/2008%20Half%20Year%20Results%20Presentation.pdf), pp. 12–13.

## ROFE and EBITDAR

An issue raised during the inquiry was the return on funds employed (ROFE) for the MSCs. ROFE is a measure of the earnings for a given investment in a business, similar to an interest rate on a bank deposit. A high ROFE is attractive to investors and more likely to attract competitive entry and investment that would erode available returns.

The MSCs reported the following ROFE for their food and liquor businesses between 2001–02 and 2006–07.<sup>14</sup> The ACCC has provided as a comparator the reported return on capital employed for Tesco, the UK chain with the highest EBIT.<sup>15</sup>

**Chart 6.4 Returns on funds employed (Woolworths, Coles and Tesco), 2001–02 to 2006–07**



Source: public annual reports and annual results presentations

The MSCs' ROFE, on the above comparison, suggest very high returns in vertically integrated Australian grocery retailing and wholesaling. However, the MSCs submitted that the ROFE for Australian supermarket retailers may be misleading and not comparable to overseas supermarkets. Coles submitted that its lower building ownership compared to many overseas retail grocery retailers would inflate its ROFE.<sup>16</sup> Woolworths submitted that, with a long-standing business, a significant number of assets would be fully depreciated, also inflating its ROFE.<sup>17</sup> Both MSCs provided the ACCC with confidential calculations that they submitted demonstrated much lower ROFE—after adjusting for factors such as leasing and depreciation—of around 15 per cent to 20 per cent for 2006–07. The ACCC agrees that care is needed when interpreting ROFE as it is heavily influenced by the value of the underlying assets and the extent of depreciation. Given this, the ACCC considers that significant conclusions cannot be drawn from ROFE.

<sup>14</sup> Woolworths' reported numbers also include petrol sales.

<sup>15</sup> Woolworths' public ROFE reporting applies to its Australian supermarkets division, including liquor and petrol, while Coles' public ROFE reporting relate to food and liquor.

<sup>16</sup> ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 7.

<sup>17</sup> ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 20.

The issue of leasing versus owning buildings may also affect international EBIT comparisons. EBITs vary according to the rent paid and depreciation charged, which depend on the retailer's approach to leasing sites and buildings. The ACCC has looked at the earnings before interest, tax, depreciation, amortisation and rent (EBITDAR) of the companies examined above. EBITDAR should to some extent resolve building ownership or leasing as an issue in international comparisons between companies, as building-related charges are not deducted in the measure. Annual report data suggests that EBITDAR for the MSCs is typically between 4 per cent and 5 per cent higher than EBIT. For example, the reported EBIT compared to EBITDAR for the Woolworths consolidated entity is contained in table 6.1<sup>18</sup>:

**Table 6.1 EBIT and EBITDAR, Woolworths consolidated entity, 2002-03 to 2006-07**

<b>Woolworths</b>	<b>2002-03</b>	<b>2003-04</b>	<b>2004-05</b>	<b>2005-06</b>	<b>2006-07</b>
EBITDAR	7.99	8.17	8.35	8.78	9.20
EBIT	3.59	3.81	4.16	4.56	4.97
Difference	4.40	4.36	4.19	4.22	4.23

For the overseas companies examined, the gap between EBITDAR and EBIT was between 1 per cent and 3.5 per cent. This means that, before the effect of depreciation, amortisation and rents paid is accounted for, the underlying performance of the two Australian supermarkets is relatively stronger compared to overseas companies than that demonstrated by the EBIT margins in chart 6.3. A recent analyst report also concluded that leasing tends to lower margins in grocery retailing.<sup>19</sup> This is because of the increased lease costs, although they will be partly offset by lower depreciation costs.

### Woolworths in New Zealand

Woolworths bought the New Zealand supermarket business Progressive Enterprises from Foodland in November 2005. The ACCC has examined comparative margins achieved by Woolworths' Australian and New Zealand businesses since the purchase. This may provide some insight into the differing performance in the two countries.

Woolworths has commented on a need for greater 'investment in price' in New Zealand:

... significant investment in prices has been made to improve our competitiveness, and deliver lower prices and better value to the New Zealand consumer.<sup>20</sup>

... Reduction in Gross Profit margins reflects continued investment in price.<sup>21</sup>

Chart 6.5 shows that Woolworths achieved comparable EBIT margins in each country in 2005-06 but earned significantly lower EBIT margins in New Zealand for 2006-07 and the first half of 2007-08.

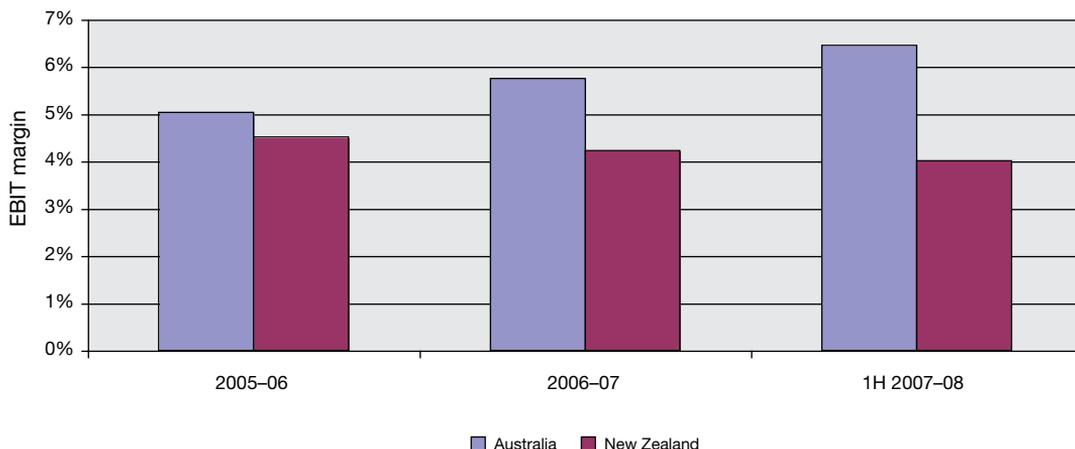
<sup>18</sup> Woolworths, *Annual report 2007*, p. 73.

<sup>19</sup> Citi, *Feeder's digest—issue 61: Measuring margins*, 20 June 2008, pp. 10-11, 21. The report suggests that the EBIT margin benefit from owning freehold property compared to leasing property can be as high as 2.5 percentage points.

<sup>20</sup> Woolworths, *Annual report 2007*, p. 13

<sup>21</sup> Woolworths, *Company results, half year ended 30 December 2007*, released 26 February 2008, available at [http://library.corporate-ir.net/library/14/144/144044/items/281095/2008 Half Year Results Presentation.pdf](http://library.corporate-ir.net/library/14/144/144044/items/281095/2008%20Half%20Year%20Results%20Presentation.pdf), p. 19.

**Chart 6.5 Woolworths EBIT margin, Australia and New Zealand, 2005–06 to 1H 2007–08**



Source: Woolworths, *Annual report 2007*, p. 9, 13; Woolworths, *Company results, half year ended 30 December 2007*, released 26 February 2008, p. 14, 18

Woolworths submitted that the cost of doing business in New Zealand is lower than in Australia.<sup>22</sup> Accordingly, the lower EBIT margins mean that Woolworths has a lower gross margin in the prices it charges in New Zealand.<sup>23</sup>

Woolworths also submitted that it is, in relative terms, the weaker competitor in New Zealand:

MR LUSCOMBE: ... We've bought a company that is an amalgamation of a number of companies that hasn't been able to do that and so their ability to actually compete on price for many years has been somewhat missing ...

We're doing the catching up in New Zealand.<sup>24</sup>

The ACCC considers that the comparative EBIT margin performances of the Woolworths Australian and New Zealand businesses, combined with the various Woolworths statements above, suggest a differing level of competitive pressure in grocery retailing on the Woolworths businesses in Australia and New Zealand. Annual reports of Foodland, the previous owner of the New Zealand business before the Woolworths' acquisition, reported earnings before interest, tax and amortisation (EBITA) margins of 4.24 per cent, 4.48 per cent and 4.42 per cent in 2002–03, 2003–04 and 2004–05 respectively. This suggests that the earnings under Woolworths are broadly similar to those experienced before the acquisition. However, based on Woolworths' public statements, it would appear that post-acquisition it has attempted to reduce prices in New Zealand which has led to some decline in EBIT margins, offset by some attempts to further reduce costs.<sup>25</sup>

22 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 9.

23 ACCC public hearing transcript, Melbourne, 19 May 2008, p. 10.

24 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 10.

25 ACCC, public hearing transcript, Melbourne, 19 May 2008, pp. 9, 11.

The above analysis only looks at one New Zealand chain and one Australian chain. Accordingly, the conclusions that can be drawn are somewhat limited. The other major New Zealand supermarket operator, Foodstuffs, consists of three separate cooperatives that report varying returns, with Foodstuffs South Island obtaining notably higher margins than Foodstuffs Auckland or Wellington.<sup>26</sup>

However, Foodstuffs' three separate cooperatives have a different corporate structure to that of Woolworths New Zealand. Each cooperative's main focus is wholesaling to its member retailers, although they also provide some property, support and franchising services, and run some stores directly.<sup>27</sup> The reported EBIT margins are returns for wholesaling, mixed with returns for some other operations, and are not comparable to the vertically integrated Woolworths New Zealand business. Accordingly, the ACCC cannot draw conclusions about the EBITs and EBIT margins for Foodstuffs retailers.

The overall conclusion from comparing the margins achieved by Woolworths in New Zealand and Australia is limited by the available information.<sup>28</sup> However, the ACCC considers that there is evidence that Woolworths has had to adopt a different competitive strategy in New Zealand. Woolworths does not appear to have had the same freedom to increase margins as in Australia. This stems from its different competitive position in that market, and may also be due to not having all the benefits of improved supply chain and business systems that Woolworths has in Australia.

It is unclear to what extent there may be structurally different competition in New Zealand (perhaps stemming from a reason such as the retailer/cooperative structure used by Foodstuffs) or to what extent the different strategy of Woolworths simply reflects its position as a weaker competitor. However, it does appear that when Woolworths entered the New Zealand market with its purchase of Progressive Enterprises, it lowered prices and its entry appeared to have an effect on price competition.<sup>29</sup> The ACCC therefore considers that there is some evidence of more intense price competition in New Zealand in recent years than in Australia.

## 6.2.5 Decomposition of changing EBIT margins

As noted before, changing EBIT margins do not necessarily indicate an equivalent change in the retail price of goods. Changing EBIT margins can be attributed to a number of factors. However, if the MSCs retain improvements in EBIT margins over time rather than being forced by competition to return some margin to consumers as lower prices, this may suggest a weakness in the competitive environment.

<sup>26</sup> Foodstuffs (Auckland), Foodstuffs (Wellington) Co-operative Society and Foodstuffs (South Island) annual reports from 2003–04 to 2006–07. The latter two companies do not explicitly report EBITs, but an equivalent value can be derived from taking the surplus before rebates and taxation, excluding gains on disposal of subsidiary, and adding back in interest expense:

	02–03	03–04	04–05	05–06	06–07
Foodstuffs Auckland EBIT margin			2.92%	2.83%	4.78%
Foodstuffs Wellington EBIT margin	4.50%	4.15%	3.77%	2.84%	2.88%
Foodstuffs South Island EBIT margin	6.96%	6.96%	6.79%	6.65%	7.40%

<sup>27</sup> For example, Foodstuffs (Auckland) Ltd, *Annual report 2007*, p. 5; Foodstuffs South Island Limited, *Annual report 2007*, pp. 1, 7.

<sup>28</sup> The comparative ROFE between Woolworths' operations in the two countries was also raised during the inquiry. Woolworths' Australian supermarkets achieved a 75.9 per cent return in 2006–07 compared to 7.62 per cent in New Zealand, based on the amount paid by Woolworths at acquisition. This suggests that returns in Australia are significantly higher than in New Zealand. However the ACCC notes again that ROFE can be less useful where one business has been significantly depreciated over time compared to another. The comparison is of little value given that Woolworths values the New Zealand business at acquisition cost rather than depreciated value of the assets.

<sup>29</sup> For example, Woolworths, *Annual report 2007*, p. 13; Foodstuffs (Wellington) Co-operative Society Limited, *Annual report 2007*, p. 6.

The EBIT margin of an MSC is dependent on both the gross margin and the cost of doing business (CODB). The gross margin is the difference between the amount for which the product is sold to the retail consumer and the amount that the retailer pays suppliers for the product (the cost of goods sold or COGS). The CODB is the amount that the MSC incurs to run the business, such as rent, wages, electricity and insurance. Accordingly, EBIT margins can broadly be improved in three ways:

- increasing the prices charged to retail customers
- reducing the effective amount paid to suppliers
- reducing the costs of doing business.

The ACCC has examined confidential and public material on the changing EBIT margins of the MSCs and the constituent gross margins and CODB. The confidential and public information at times appeared to be inconsistent. However, the ACCC has been able to draw certain conclusions about the reasons for changing margins.

### Gross margin

Gross margin is the gap between the selling price and purchase price for a particular product or category of product. It can be considered a measure of the 'value add' that a company gives to the product as it passes through the supply chain, and is an additional cost to subsequent purchasers. The gross margin directly affects the price paid by consumers—for a given purchase price paid to suppliers, a higher gross margin on a product leads to a higher price for consumers than a lower gross margin. That said, an improvement in gross margin does not necessarily mean that selling prices have risen—as a company may have reduced the effective amount it pays for products.

Both MSCs submitted that they had not significantly increased prices in an attempt to improve gross margins. Coles submitted that it had made significant 'investment in price', stating that it had invested \$100 million in price over 12 months, particularly focused on reducing or maintaining prices in fresh products, especially milk, and private label.<sup>30</sup> Woolworths submitted that 70 to 80 per cent of potential improvements in its EBIT were actually passed on to consumers.<sup>31</sup>

Confidential information examined by the ACCC suggested that the level of promotions and reductions in price more generally depended on the period examined. Certain periods were characterised by greater price competition, which as noted in chapters 5 and 6 tends to occur through promotions. Comparatively, other periods were characterised by reductions in promotional activity and by average sell prices increasing. Although the available information was not definitive, allocations of money specifically for net 'investment in price' by the MSCs were typically a small proportion of overall planned EBIT improvements. Potential savings, in either effective purchase prices or in CODB, appeared to be typically taken in increased margins rather than be specifically passed on to consumers in lower prices.

Other factors may lead to improvements in gross margin without increases in retail price. Woolworths claimed publicly that its 0.39 percentage point improvement in gross margins between the first half of 2007 and the first half of 2008 was due to 'better management of costs not higher prices'.<sup>32</sup> It identified reductions in shrinkage, change in sales mix, success of private label, reduction of direct store deliveries and improvements in buying as among the reasons for improving margins.

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30 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 44.

31 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 48.

32 Woolworths, *Company results, half year ended 30 December 2007*, released 26 February 2008, available at [http://library.corporate-ir.net/library/14/144/144044/items/281095/2008 Half Year Results Presentation.pdf](http://library.corporate-ir.net/library/14/144/144044/items/281095/2008%20Half%20Year%20Results%20Presentation.pdf), p. 15.

Reduction in shrinkage refers to limiting wastage and breakages of stock. Reduction of direct store deliveries refers to Woolworths having stock delivered to a central Woolworths warehouse rather than to individual stores. Coles is also adopting such a delivery strategy. This removes an amount of delivery cost from the prices paid to the supplier.<sup>33</sup> The ACCC understands better buying to refer to negotiations with suppliers leading to reduced prices. A related factor is increasing the vendor financial support for promotions and pricing reductions. Confidential information available to the ACCC indicated that the amount of vendor support has been generally increasing over time, meaning that suppliers would receive a smaller proportion of the sale price for their products.

Changes in sales mix refers to moving customers from lower margin stock to higher margin stock. Woolworths submitted that customers are moving from low-margin market leading brands towards higher-margin secondary brands.<sup>34</sup> A related trend is that customers are shifting from branded products towards private label products. Private label products typically have a higher starting margin than equivalent branded products. Coles stated that private label products typically offer 5 to 6 per cent more gross margin on sales than do equivalent branded products, but off a lower sale price.<sup>35</sup> Woolworths similarly stated that it 'can clearly make a better margin' on private label goods, as it does not face marketing costs that branded products face.<sup>36</sup> Private label products are examined further in chapter 16.

Overall, changes in gross margin are broadly attributable to changes in productivity (shrinkage and freight cost reductions), changes in product mix, or changes in the price charged to consumers and buying terms from suppliers. The ACCC examined confidential information from an MSC on the extent to which improved buying terms from suppliers were reflected in reduced prices to consumers. Again, the result depended on the period examined. In recent periods during 2007–08, improved terms from suppliers appeared to be mostly passed on to consumers. Improvements in gross margin were largely driven by shrinkage and freight cost reductions and changes in product mix. However, it would appear that improved deals from suppliers were largely kept by the MSC as improved margin in previous periods.

## Cost of doing business

The CODB represents the non-capital costs incurred by the retailer in selling goods to customers. Such costs include staff wages, buildings and equipment rental, electricity expenses, advertising and head office charges. CODB can alternatively be considered as the amount that the company spends creating the 'value add' of gross margin. A decrease in CODB will increase the EBIT earned by a company, but does not directly affect the price paid by retail consumers.

Information available to the ACCC on CODB largely related to supply chain transformation. Both MSCs (and Metcash) are undertaking or have undertaken supply chain changes.<sup>37</sup> These primarily relate to reductions in direct store deliveries and instead requiring suppliers to bring stock to a small number of central warehouses. The MSC then distributes from the central warehouse to its individual stores. Other supply chain transformation related to automatic stock management systems. The ACCC understands that Woolworths has made such supply chain changes relatively quickly and has now largely

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33 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 13.

34 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 14.

35 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 49; ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 53.

36 ACCC, public hearing transcript, Melbourne, 19 May 2008, pp. 13, 15.

37 For example, Coles, *Full year financial results and market update*, 19 September 2007, slide 25; Coles, *Shareholder presentation, 2006 financial results*, 21 September 2006, pp. 42-63; Woolworths, *Company results, full year ended 24 June 2007*, 27 August 2007, p. 43; Metcash, *company results financial year ending 30 April 2008*, 3 June 2008, p. 18.

completed those changes in all its distribution centres, leading to efficiency gains and cost reductions.<sup>38</sup> Woolworths submitted that it had invested \$1 billion in such supply chain enhancements.<sup>39</sup> In contrast, Coles submitted that, compared to Woolworths, it had been relatively slow in executing supply chain transformation that would allow it to compete.<sup>40</sup> Coles also placed significant emphasis on the need for reduced central office numbers in a 'business simplification' program.<sup>41</sup> It submitted that there was a need to improve the operational performance of its business.<sup>42</sup>

## Effect of gross margin and CODB changes

The ACCC has focused on the comparable changes in gross margin and CODB between the MSCs rather than on their absolute levels.<sup>43</sup>

Confidential data available to the ACCC indicates that the gross margin of Woolworths' supermarket business increased between 2001–02 and 2006–07 by over 1.5 percentage points. Comparatively, the gross margins of Coles' supermarkets business were relatively flat and increased by an amount of less than 0.5 percentage points.<sup>44</sup>

While the discussion above deals with gross margins at a company level, the ACCC has also examined store-level margin data. The data indicates that the gross margins achieved by different stores of the same company can vary greatly. The ACCC observed differences between the gross margins for the best and worst performing stores as high as 15 percentage points. In addition to any differences in price, the differences in gross margin between stores may reflect a variety of factors, such as actions of store management, certain operating costs, promotional campaigns, sales mix and local competitive conditions.

The confidential data also indicated that Woolworths' supermarkets business between 2001–02 and 2006–07 experienced a slight decrease in CODB as a percentage of sales of around 0.5 percentage points. Coles' supermarkets business experienced an overall decrease in CODB as a percentage of sales until 2004–05, followed by increases until 2006–07. This led to an overall increase from 2001–02 to 2006–07 of around 0.5 percentage points in CODB as a percentage of sales.<sup>45</sup>

As noted above, the overall effect of an increase in gross margin and decrease in CODB was that Woolworths was able to achieve an increase in EBIT margin in the order of 2 per cent between 2001–02 and 2006–07. Coles, on the other hand, was unable to achieve any significant increase in its gross margin and experienced an overall increase in its CODB late in the period, which led to an initial increase in EBIT margin but a decrease in 2006–07. The relatively better EBIT margin performance for Woolworths may reflect such factors as the relative slowness that was identified by Coles in implementing its own supply chain transformations. Given the accounting practices of the MSCs to record some freight costs against gross margin rather than CODB, supply chain transformation may have affected either or both gross margin and CODB.

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38 Woolworths, *Annual report 2007*, pp. 4, 21.

39 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 6.

40 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 49.

41 For example, Coles, *Full year financial results and market update*, 19 September 2007, slide 24; Coles, *Shareholder presentation, 2006 financial results*, 21 September 2006, p. 122.

42 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 6.

43 The levels of gross margin and CODB are sensitive to how costs are recorded, as certain costs could be recorded as COGS or CODB. For example, the MSCs typically record some freight costs as an amount that reduces gross margins rather than recording freight costs as part of the CODB.

44 These figures are in some cases inconsistent with numbers in public financial reports. However the ACCC considers that the confidential information provided to it is more likely to be reliable.

45 As with the gross margin data, these figures are in some cases inconsistent with numbers reported over time in public financial reports.

The exact reasons for changing margins are varied. Significantly, a number of reasons behind increasing gross margins or decreasing CODB are not related to increased prices to consumers.

## 6.2.6 Relationship between profitability and competition

The changes in EBIT margins and the reasons for such changes may provide some insight into competition. However, in the ACCC's view it is perhaps more relevant to consider the effectiveness of competition in placing pressure on excessive margins.

In a competitive market for the supply of retail groceries where equally positioned firms compete, one would expect that competition would lead to increased gross margins (and therefore relatively higher EBIT margins, other things being equal) being reduced over time until the firms achieve a normal rate of return commensurate with the risks of their investment. However, the ACCC also notes the situation where one firm is a relatively more efficient (or inframarginal) firm and one firm is a relatively less efficient (or marginal) firm. In such a situation, economic theory would suggest that, while the less efficient firm would still earn zero economic profits in the long run, the more efficient firm would be able to maintain prices and gross margins that achieve some economic profit. This would reflect relative advantages over the less efficient firm such as a lower cost base or an ability to obtain better buying terms.

In Australia, the last six years have produced consistently increasing gross and EBIT margins for Woolworths and overall flat gross and slightly declining EBIT margins for Coles. These trends in gross and EBIT margins may signal concerns with the competitiveness of the retail market for the supply of groceries, to the extent that there is little evidence of gross margins being reduced towards CODB for both MSCs. Notably, before 2006–07, both MSCs had achieved consistently increasing EBIT margins over five years, although Woolworths' rate of growth was higher than that of Coles. This does not seem to suggest strong price competition between the two firms, although Coles did experience a decline in EBIT margins in 2006–07.

However, the ACCC also notes that there is evidence that Woolworths is currently a more efficient firm than Coles. Woolworths' higher EBIT margins and relatively better growth in EBIT margins over time would be consistent with its position as a more efficient firm. Similarly, Coles' lower EBIT margins are consistent with a position as the less efficient competitor. Essentially, Woolworths has, by lowering its costs and improving its gross margins, outperformed Coles in the period examined. These benefits would seem to be reflected in the higher EBIT and EBIT margins that Woolworths has been able to obtain.

A scenario with one efficient and one less efficient firm could be a potential competition concern in that the competitive constraint imposed by the less efficient firm may be weak. The extent of concern would depend on the ability for the less efficient firm to improve its position and the extent of barriers to entry and ability for other firms to compete in the market.

It might be expected that, if Coles were more efficient, it would compete with Woolworths such that Woolworths' relatively larger EBIT margins would be reduced. This view is based on the idea that Woolworths' strong returns are not due to a weak competitive dynamic in the market but rather a temporarily weak competitor. It is unclear whether the relative strength of Woolworths (compared, for example, to its position and the competitive strategy it has had to adopt in New Zealand) is brought about by a temporary weakness in Coles as a competitor or whether a lack of competition would persist even if Coles' relative performance improves.

Coles' position could improve to the extent that it reduced its CODB or obtained better buying terms, leading to greater EBIT margins and improving its competitive position against Woolworths. It is relevant

that Coles was acquired by Wesfarmers in November 2007, which may reflect the relative weakness of Coles in recent years. The new Coles management has been reported as describing Coles as an ‘underperforming retailer’.<sup>46</sup> Wesfarmers’ acquisition of Coles may lead to management and operational improvements in the running of the Coles grocery business. For example, Coles pointed to a poorly executed re-branding of its BI-LO stores, which led to reduced customer numbers, sales and earnings, as being responsible for relatively weak performance.<sup>47</sup> The ACCC similarly notes Coles’ planned CODB improvements, including its business transformation program and submissions that it needs to improve its supply chain to compete. Coles submitted that a past failure to meet shareholder expectations was a reason for the change in ownership.<sup>48</sup>

It is unclear that any improvement in Coles’ relative position against Woolworths would necessarily lead to more vigorous price competition and a reduction of some EBIT margin. It would be possible for Coles to simply take higher margins in the form of profits, rather than seeking to engage in price competition. In that regard, the ACCC notes its conclusions in previous chapters about the nature of price competition in grocery retailing. In particular, the ACCC notes its conclusions in chapter 5 that, given the nature of the industry, price competition as a way of attracting market share is unlikely to be a rational strategy for Coles to pursue, even after its CODB is reduced. As such, the competitive strategy of lowering prices adopted by the new owner of Progressive (Woolworths) in New Zealand may not be replicated by the new owner of Coles (Wesfarmers) in Australia.

As such, the ACCC considers that improvements in Coles’ management and supply chain cannot be relied upon to increase price competition in the Australian retail grocery market. Final ACCC conclusions in relation to the degree of competitiveness in the market for retail groceries are discussed in chapter 10.

## 6.3 Gross margins for different products

In addition to overall trends in profits and margins, the ACCC has examined the gross margins in particular product categories. This may provide insight into the differing levels of competition for different products and the resulting effect on retailers’ ability to maintain margin improvements for those products. This issue was raised in relation to the comparative margins available on dry groceries compared to other products such as fresh produce.

### 6.3.1 Gross margins by trading department

The ACCC required the MSCs to provide data on the gross margins that they achieved in their different product trading departments between 2002–03 and 2006–07. Although the MSCs do not use identical departmental breakdowns, they do broadly align.

#### Observed trends

The ACCC found several notable trends in MSC gross margins in different product categories. The ACCC has averaged the changes in gross margins of the two MSCs:

- Gross margins for dry groceries increased across the period from 2002–03 to 2006–07 by an average across both MSCs of around 2 percentage points. Both MSCs showed a consistent increase in the dry groceries gross margins each year.

46 Ari Sharp, ‘New Coles supermarket chief Ian McLeod outlines his task’, *Sydney Morning Herald*, 23 May 2008 available at <http://business.smh.com.au/new-coles-chief-outlines-plans-20080523-2hh9.html> accessed 3 July 2008.

47 Coles, *Annual report 2007*, p. 3; ACCC, public hearing transcript, Melbourne, 26 May 2008, pp. 16, 29.

48 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 6.

- Gross margins on perishable products, such as dairy, similarly increased from 2002–03 to 2006–07 by an average across both MSCs of over 2 percentage points across the period. Again, the increase in margin was fairly constant year on year.
- Gross margins for fresh fruit and vegetables declined from 2002–03 to 2006–07 for both MSCs, although one MSC did experience an increase in gross margin in 2004–05. The average decline across the period from 2002–03 to 2006–07 across both MSCs was around 1.5 percentage points, while the average decline from the highest observed gross margin to the gross margin in 2006–07 was over 2 percentage points.
- Gross margins in meat also dropped overall for both MSCs, although there was not a consistent decline year on year. The average decline across both MSCs between 2002–03 and 2006–07 was more than 2 percentage points across the period.
- Trends in gross margins in bakery categories were mixed, with gross margins either staying relatively flat or increasing. Trends in gross margins in deli products were also mixed, with one MSC experiencing increases in gross margin while the other experienced declines in gross margins.

Woolworths was typically able to achieve larger increases or smaller decreases in gross margins compared to Coles over the period examined. Overall, Woolworths was able to increase gross margins across its total product offering, while Coles' overall gross margins were relatively flat. This may indicate a relatively stronger position for Woolworths that allowed it to achieve the gross margins it did.

In relation to the absolute level of gross margins, the ACCC notes that bakery, deli and dairy tended to be higher gross margin product areas. Dry groceries and produce tended to have more moderate margins while meat was consistently a lower gross margin area.

The ACCC does not consider that it can draw particular conclusions from comparing the level, as compared to the trend, of gross margins for particular product areas between the MSCs. This is because there can be differences between chains in whether any particular costs might be recorded in gross margins or CODB, which would affect the level of gross margin recorded.

The ACCC also examined gross margins by trading department for Woolworths' New Zealand operations compared to Woolworths' Australian operations. The analysis confirmed that Woolworths has, on average, higher gross margins in Australia than it does in New Zealand. It also revealed, however, that the gross margins in Australia were not higher in all product categories. In particular, margins in the two highest sales volume trading departments of dry groceries and perishables were higher in Australia, while margins in other departments were higher in New Zealand. The ACCC notes that the departments will not sell exactly the same products in both countries.

### Relationship between trends in gross margin by trading department and MSC share of sales

The two categories in which both MSCs were able to achieve increases in gross margin across the period examined—dry groceries and perishables, such as dairy—are product groups where there is some evidence that the MSCs achieve a higher proportion of retail sales compared to other product groups. As noted in chapter 3, certain available data suggests that the MSCs account for around 70 per cent of national packaged groceries sales and up to 60 per cent of national dairy sales. This may indicate a relative lack of competitive pressure from other retailers such that additional margin is not competed away between the MSCs.

Comparatively, the areas where gross margin trends were declining were product areas where there is evidence that the MSCs account for a relatively lower proportion of sales. As noted in chapter 3, available data suggests that the MSCs may make as low as around 42 per cent and 44 per cent of national fruit and vegetable sales respectively (and that they are unlikely to make more than 50 per cent of fruit and vegetable sales). The data similarly suggests that MSCs may make around 50 per cent of national fresh meat sales. In the fresh produce and meat product areas, the MSCs experienced significant declines in gross margins, which perhaps indicates an increased competitive pressure on MSCs in the sale of those products.

However, there is no clear link between proportions of national sales and trend in gross margins. While there is evidence that the MSCs account for around 40 per cent to 50 per cent of bakery sales, gross margins for bakery products either stayed flat or increased. Equally for deli products, where there is evidence suggesting that the MSCs account for around 60 per cent of national sales, one MSC was able to increase gross margins while the other experienced a decrease in gross margins.

The ACCC also notes the differences in the margins for Woolworths in Australia and New Zealand. This data would appear to be further evidence that margins in different trading departments will vary according to the competitive pressure in that department. The differing level of gross margins between Australia and New Zealand could be a product of differing competitive pressures in New Zealand. The differing gross margins may also reflect other factors such as differing products or structural cost differences such as differing taxes, laws or freight requirements.

There does not appear to be a relationship between the MSC share of sales in a particular product area and the absolute level of MSC gross margins for that product area. One factor that may explain this is that differing product areas have differing CODB that may require a different gross margin. For example, product departments such as deli or fruit and vegetable typically require more labour costs and have different supply chain and freight requirements than dry groceries. The ACCC saw evidence that MSC dry grocery gross margins are not lower than the gross margins for all other categories. Meat in particular appears to be a lower gross margin product than other categories. This perhaps indicates that submissions that money cannot be made on dry groceries across the industry are not accurate.

### Relationship between trends in gross margin by product category and food price inflation

In chapter 2 it was observed that the largest price increases observed between 2002 and 2007 among selected food items in the ABS CPI were for fruit and vegetables, which experienced annual price increases of 5.6 per cent and 6.8 per cent respectively compared to the overall annual increase for food (excluding meals and takeaway foods) of 3.8 per cent. As noted above, the decline in gross margin on fresh fruit and vegetables from 2002–03 to 2006–07, averaged across both MSCs, was around 1.5 percentage points. This initially sounds counter-intuitive, as it might be expected that increasing margins would be a cause of large price increases, and that margin increases and price increases would be positively related. However, a decrease in MSC margins while prices increase may indicate that the MSCs absorbed some of the potential price increase as reduced margins. Instead of maintaining a particular percentage margin that would lead to greater dollar returns where prices were increasing, the data may indicate that the MSCs did not pass on the full possible price increase to consumers.

While gross margins increased significantly in the dry grocery category, the ACCC notes that price increases for a number of products in this category were relatively low among the selected food items in the ABS CPI. Overall, increases in price for dry groceries were lower than overall food price inflation.<sup>49</sup> Increased MSC gross margins for dry groceries therefore would appear to have formed a relatively large part of the price increase for dry groceries, compared to that for fresh fruit and vegetables.

In other categories the relationship between margin and price changes are more consistent with the 'intuitive' story—for example, declines in gross margins were also observed in meat categories. Meat products examined generally experienced smaller price increases than overall food price inflation between 2002 and 2007.<sup>50</sup>

The ACCC notes that a retailer will not necessarily attempt to obtain only percentage gross margin, but is ultimately seeking a certain dollar gross margin. Coles submitted to this effect.<sup>51</sup> Accordingly, a retailer may not increase or maintain percentage gross margins in all cases, but may be content to earn a particular dollar amount where the underlying cost is increasing. This may explain the results noted for fresh fruit and vegetables.<sup>52</sup>

### 6.3.2 Category average margins

A related issue to gross margins that may provide insight into the degree of competition in grocery retailing is the MSCs' use of category average margins. These are target margins, based on the average margin for a particular category of product, which a supplier would have to demonstrate a particular product could achieve to get a place on the supermarket shelf. For example, a new product might be expected to achieve a 30 per cent retailer gross margin before the retailer would agree to stock that item. Category average margins are also used in some cases to review existing products. The ACCC received public submissions about the use of category average margins, such as the following from SPAR:<sup>53</sup>

We believe that the latest negotiating tool being used by the MSC's is to advise the suppliers that they require a minimum gross profit on the sale of a product before they will consider ranging.

A number of suppliers indicated to the ACCC in confidential hearings that category average margins were increasing over time.

The ACCC sought information from the MSCs about their use of category average margins and the levels of current and recent category average margins. The responses confirmed that category average margins are a comparative measure used by the MSCs' buying managers to analyse the contribution to potential profits of particular products when conducting buying reviews or range reviews. The MSCs submitted that category average margins were only indicative, were only one of a number of factors

49 Food items that fall into the dry grocery category and experienced annual price increases lower than the overall food price increase between 2002 and 2007 include cakes and biscuits; tea, coffee and food drinks; food additives and condiments; food not elsewhere classified and breakfast cereals. These had annual percentage changes in price of 3 per cent, 0.6 per cent, 1.6 per cent, 2.1 per cent and 2.5 per cent respectively between 2002 and 2007. However, soft drinks, water and juices; snacks and confectionary; and jams, honey and sandwich spreads had annual price increases that were slightly higher, at 4.1 per cent, than the overall annual food price increase of 3.8 per cent.

50 Fish and other seafood; bacon and ham; poultry; pork; beef and veal; and 'other fresh and processed meat' had annual price increases between 2002 and 2007 of 2.5 per cent, 1 per cent, 0.1 per cent, 3.1 per cent, 3.0 per cent and 2.0 per cent respectively that were below the overall food price increase of 3.8 per cent. However, 'lamb and mutton' prices increased by an annual 4.3 per cent between 2002 and 2007.

51 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 49.

52 For example, a retailer may be making 60 cents a kilo on the retail sale of bananas for \$2 a kilo that it buys from suppliers at \$1.40 a kilo. This is a 30 per cent gross margin (60 cents divided by \$2). If the supplier's price increases to \$2 a kilo, a 30 per cent gross margin would mean the bananas were sold to consumers at \$2.85. However the retailer may be happy to continue to earn 60 cents a kilo of profit on those bananas, and sell them for \$2.60, which would be a gross margin of 23 per cent.

53 SPAR, submission no 195, p. 3.

that would be examined in assessing a product and did not take into account any CODB.

The responses also indicated that category average margins were not used by buyers in all departments and tended to be used for long-life categories such as dry groceries rather than meat or produce. The category average margins can be at a variety of levels of granularity from product level to departmental level.

The ACCC was not provided with evidence that category average margins had consistently increased in all categories. Differing trends were noted in different trading departments, and the overall trend for the category average margin in a particular trading department would not necessarily be representative of the trend in category average margin for a more granular product category.

However, the evidence provided by the MSCs indicated that category average margins have, on the whole, increased for goods in the dry grocery trading department for both MSCs, mirroring the trend in actual gross margins achieved by both MSCs for that trading department. As noted above, there is evidence that the MSCs have a higher share of national sales in dry groceries than in any other category.

The trend in other relevant categories such as deli, bakery and perishables, such as dairy, were more mixed and varied between the two MSCs. In deli, category average margins had overall not changed significantly over time. For one MSC the deli category average margins had increased overall, while for another they had on the whole decreased. In bakery, trends in category average margins were mixed depending on the type of bread product sold. For perishable products such as dairy, the ACCC observed category average margins that were increasing for one MSC and relatively constant for the other MSC over the periods covered by the data provided.

Accordingly, the ACCC considers that the evidence on category average margins is mixed. While there have clearly been increases in category average margins in certain categories, there was no evidence of increases across the board. Further, the use by MSCs of category average margins at varying levels from aggregated trading department to a relatively granular product category means that the experience of particular suppliers can be quite varied.

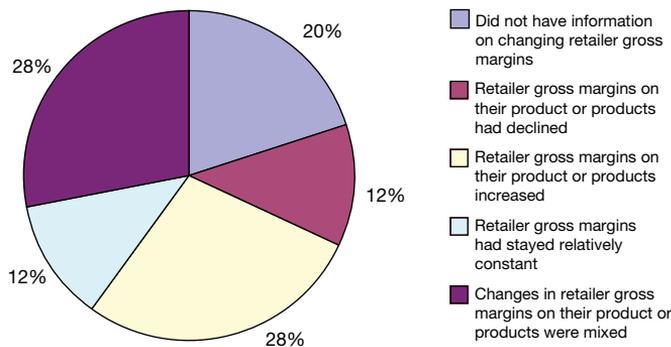
The ACCC considers that the observed trends in category average margins show two things. Firstly, the ability to raise category average margins is consistent with a view that the MSCs have some buyer power in the supply of certain categories, as they can require suppliers to ensure a certain level of gross margin on products sold. Secondly, the ability to raise category average margins is not consistent with the idea that competition will reduce increased gross margins over time. However, the evidence on the category average margins suggests mixed results across the different categories of groceries.

### 6.3.3 Retailer gross margin information provided by suppliers

The ACCC issued notices under s. 95ZK of the Trade Practices Act to a number of companies that supply products to the MSCs. The notices required them to provide the ACCC with any information they had on changes in margins achieved by the MSCs on particular products or product ranges between 2001–02 and 2006–07. The ACCC also required suppliers to provide any information they had on the reasons for margins changing.

Of the companies whom the ACCC directed to provide information, the ACCC received the breakdown of responses shown in chart 6.6.

**Chart 6.6 Supplier responses on retailer gross margins**



Source: supplier responses to ACCC s. 95ZK notices

It can be seen that the supplier views on margins were varied. As the information in some cases related only to particular products and/or had limited time series, the ACCC considers that the inferences that can be drawn from the responses are somewhat limited. However, some relevant information from suppliers relates to the reasons for changes in margins.

Of the suppliers that were able to provide views on changing retailer gross margins, 30 per cent referred to revised trading terms with MSCs as a relevant factor explaining improvements in retailer gross margins. These terms included increased promotional expenditure provided by the supplier, harmonisation of terms between Australian and New Zealand operations, increased rebates, warehousing allowances, increased remittances and increased off-invoice discounting.

All suppliers that stated that retailer gross margins had decreased considered that the decrease was due to increased retail competition in the market for their product.

Of the suppliers that presented information that showed retailer gross margins had increased over the period, reasons cited for the increases in margins included direct decreases in the list price charged by suppliers, increased financial support from the supplier for promotions and in one case both increased financial support and decreased list price. More than half of the suppliers had no particular view as to why the retailer gross margins had increased.

Of the suppliers that presented information showing that retailer gross margins had either been mixed or stayed roughly constant, half were unable to provide any real views on reasons for changes in margins, 40 per cent referred to improved trading terms or promotional discounts being a concern and 10 per cent considered that margins were attributable to market forces.

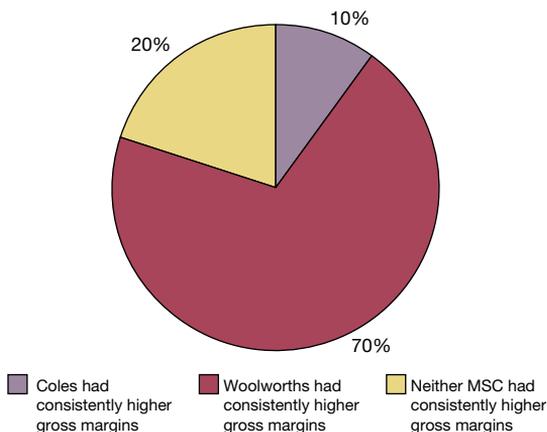
### 6.3.4 Sample of particular products

The ACCC also required the MSCs to provide sales revenue, sales quantity and cost of goods sold for a range of specific products. The ACCC has used this data to examine relative level of costs and margins for certain products.

The ACCC compared, for a series of identical products sold by both MSCs, the selling price less unit cost paid by the MSCs to the supplier during the calendar years 2006 and 2007. Each MSC may not account for price and unit cost in identical ways, which may mean that these results should be treated with some caution. However, as the comparison deals with simply the selling price compared to the

amounts paid to the supplier for identical products, and the ACCC sought the exact same data from each MSC, the ACCC considers it is valid to compare the level of margins between the MSCs in this way. The results are shown in chart 6.7.

**Chart 6.7 Product comparisons 2006 and 2007 – which MSC had higher gross margins?**

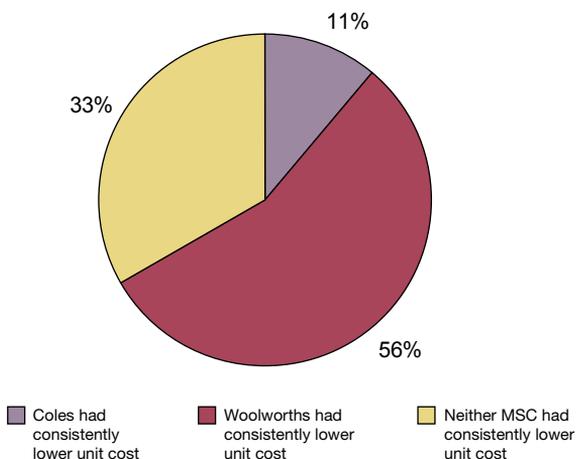


Source: MSC responses to ACCC s. 95ZK notices

Chart 6.7 does not examine the size of the difference in margins. However, the result would tend to support the conclusion that Woolworths has been able to generally obtain higher gross margins than has Coles over recent years.

Similarly, the ACCC examined the unit costs paid by the MSCs to the suppliers of the products. The results are shown in chart 6.8.

**Chart 6.8 Product comparisons 2006 and 2007 – which MSC had lower unit costs?**



Source: MSC responses to ACCC s. 95ZK notices

This result supports information on margins above—Woolworths obtained lower costs from suppliers across a larger proportion of the products examined, which allowed it to obtain higher margins. This may suggest that some part of Woolworths' EBIT advantage over Coles stems from lower supply prices, although the ACCC notes that it has only examined a small subset of the products sold by the MSCs.

The ACCC notes that there was typically not a substantial difference in price between the two MSCs for the products examined. This also mirrors conclusions reached about the comparative prices of the MSCs generally in chapter 5.

The ACCC also received data on the margins of comparable private label and branded products. The ACCC's assessment of private label products is in chapter 16.

## 6.4 Conclusion

The ACCC has examined a range of financial data on the profitability and margins of the MSCs. EBIT margins for Woolworths are among the world's best EBIT margins and have steadily been increasing over the last five years. Coles' margins are not as high as those of Woolworths, nor have they continuously increased. However, Coles' margins remain among a typical range for grocery retailers worldwide, and before 2006–07 had increased EBIT margins between 2001–02 and 2005–06. The ACCC considers that both MSCs appear to achieve reasonable earnings compared to some indicative international comparator firms.

In a market for the retail supply of groceries where retailers were competing on price, the ACCC would not generally expect that EBIT margins would continue to increase over time. Rather, the lowering of prices to consumers as part of the competitive process would lead to some reduction of the improved EBIT margin (for at least a less efficient marginal firm). The relative performance of Woolworths compared to Coles is consistent with a view that the relatively more efficient Woolworths is able to achieve high EBIT margins and growth given weaker competitive pressure from Coles.

The trends in gross margins provide some further insight into competitive tension. In particular in the dry grocery area where the MSCs account for a large proportion of sales, both MSCs have been able to increase the gross margins on their sale of products. The same is also true of perishable products such as dairy goods. Comparatively, gross margins in areas such as meat and fresh produce, where the MSCs account for a smaller share of sales, have declined. A smaller share of sales may suggest greater competitive tension from other retailers, such as specialty butchers or greengrocers, which has led to reduced gross margins. Accordingly, the ACCC considers that the data on gross margins may suggest that there is a mixed picture on the amount of competitive constraint on the MSCs in different parts of the retail grocery market.

The ACCC's overall conclusions on the level of retail competition are contained in chapter 10 of this report.

# 7 Competition from Metcash and Metcash-supplied independents

## Key points

- Independent supermarkets provide a competitive force in grocery retailing often providing consumers with a more convenient alternative to the major supermarket chains (MSCs).
- Although the independent grocery retailing sector serviced by Metcash has grown in recent times, the growth of large independent stores has been at around the same rate as the growth of the MSCs.
- It appears that Metcash sets wholesale prices to independent retailers under the umbrella set by the MSCs.
- Small independent supermarkets rarely compete on price, choosing to compete on other elements such as convenience, range and service.
- Large independents which do opt to compete on price with the MSCs are often only able to do so by earning little net margin on goods supplied by Metcash.
- The inability of independent retailers to source grocery products from Metcash at competitive prices makes it difficult for large independent retailers to compete aggressively on price.
- It is unclear if inferior terms from suppliers or lack of scale relative to the MSCs contribute to the weakness of Metcash's wholesale prices. However, it is clear that Metcash has expanded its profit margins and now achieves margins in excess of those achieved by Coles.
- Metcash is able to achieve healthy margins primarily because it is the only national wholesaler to independent retailers. There is some evidence that Metcash is acting to protect this position by locking in retailers and suppliers.
- The ACCC believes that efforts to reduce impediments faced by independent retailers to seek alternative wholesaling arrangements will increase the pressure on Metcash to improve its offer to retailers, particularly its price offering.
- The implications of another large-scale wholesaler entering the market are unclear. As the only national wholesaler to the independent sector, Metcash can take advantage of significant economies of scale. If there were two large-scale wholesalers, it is possible that neither would achieve the same economies of scale that Metcash has achieved.

## 7.1 Introduction

A significant issue in this inquiry has been the degree of price competition provided by independent grocery retailers. As discussed in chapter 5, price competition between the MSCs is not fully effective. Price competition in grocery retailing depends on the position of independent retailers and their incentives to compete on price.

This chapter focuses on the competition provided by independents supplied by the grocery wholesaler Metcash. Metcash-supplied independents make up the majority of non-MSC supermarkets in Australia.

An underlying issue in this chapter is whether Metcash is inhibiting the price competitiveness of the independent sector through a degree of monopoly pricing.

Metcash and the independent grocery sector it services have grown strongly since 2000 through acquisitions and new store openings. Metcash's annual revenue from its IGA>D division (which primarily supplies independent grocery retailers with packaged groceries) has more than doubled since 2001–02. Metcash has increased its EBIT threefold and its EBIT margin from 3 per cent to over 4.5 per cent. Also, the growth of large Metcash-supplied stores (in excess of 1000 m<sup>2</sup>) has been at around the same rate as the growth of the MSCs.

In general, large independent retailers located close to competing MSCs offer prices that are comparable with the MSCs. However, while there are some exceptions, the MSCs pay closer attention to the pricing of each other and ALDI than to Metcash-supplied independent retailers.

Metcash, to a large degree, is constrained by the MSCs. Metcash sets wholesale prices to independent retailers recognising that at least the larger independent retailers must be able to set retail prices comparable to the MSCs.

However, Metcash appears to price under the umbrella set by the MSCs. The ACCC has found no evidence that Metcash sets wholesale prices that enable independent retailers to aggressively pursue market share through price discounting. Evidence indicates that Metcash-supplied independent retailers who compete aggressively with the MSCs on price achieve small net margins on the products that Metcash supplies to them. These retailers do this to attract sales on products they do not source from Metcash, such as fresh produce, on which they achieve larger margins.

It is uncertain if inferior terms from suppliers or lack of scale relative to the MSCs contribute to the weakness in Metcash's wholesale prices. However, the ACCC considers that Metcash is extracting some 'monopoly' profits because of the lack of alternative wholesaling arrangements available to most independent retailers. The size of these 'monopoly' profits is likely to be a small percentage of retail prices. However, given that grocery retailing is a high turnover business with low EBIT margins, this is significant. Moreover, there is some evidence that Metcash is acting to protect its position as the only national grocery wholesaler supplying independent retailers. Metcash is implementing strategies that appear to unnecessarily impede independent retailers from dealing directly with suppliers or leaving Metcash to set up their own wholesaling operations.

The ACCC considers that the lack of other wholesalers enables Metcash to act without a strong direct competitive constraint. However, the implications of another large-scale wholesaler entering the market are unclear. As the only national wholesaler to the independent sector, Metcash can take advantage of significant economies of scale. If there were two large-scale wholesalers, it is possible that neither would achieve the same economies of scale that Metcash has achieved. However, on balance the ACCC considers that the 'monopoly' profit that Metcash achieves by being the only significant wholesaler to the independent sector outweighs any economies of scale efficiency benefits which Metcash might be passing on to the independent supermarkets.

## 7.2 Metcash and independent grocery retailers

### 7.2.1 Metcash

Metcash is an ASX-listed marketing, wholesaling and distribution company that services independent and franchise grocery retailers throughout Australia.

Metcash distributes groceries and liquor through four channels:

- IGA Distribution (IGA>D), which comprises 12 distribution centres and distributes packaged groceries to approximately 2500 independent retail grocery stores throughout Australia. IGA>D supplies the IGA Network, Foodland IGA, FoodWorks and other independent grocery retailers.
- IGA Fresh, which supplies fresh fruit, vegetables, meat, deli and bakery products to 240 independent retail stores.
- Campbells Wholesale, which supplies small business customers and convenience stores.
- Australian Liquor Marketers, which supplies liquor to hotels, liquor stores, restaurants and other licensed premises.

### 7.2.2 Metcash's recent financial performance

Metcash's sales have grown strongly since 2001–02. Since 2001–02 Metcash's annual revenue from its IGA> D division has increased by 107 per cent to nearly \$6 billion in 2007–08.<sup>1</sup> This growth has largely been due to the growth in the number of independent grocery retailers that Metcash services—an increase of around 50 per cent.<sup>2</sup>

**Table 7.1 IGA>D Sales EBITA and EBITA margins**

IGA>D	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Sales (\$m)	2898	3634	3856	3817	4373	5581	5994
EBITA (\$m)	83.6	110.6	129.4	141.8	175.8	247.3	275.1
EBITA/sales	2.89%	3.04%	3.36%	3.71%	4.02%	4.43%	4.59%

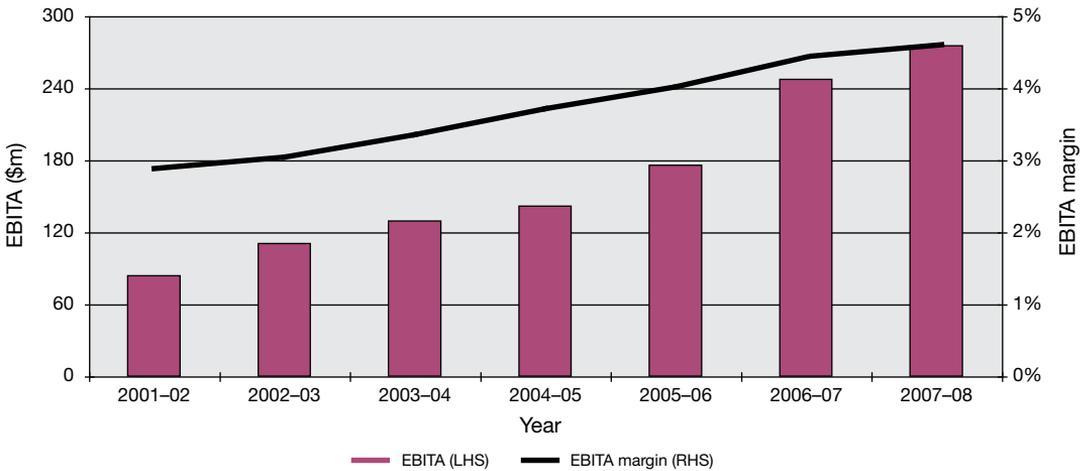
Analysis of new store openings by the MSCs, and new arrangements entered into by Metcash to service independent metropolitan retailers with a floor space greater than 1000 m<sup>2</sup>, shows that both the MSCs and Metcash have been increasing the number of metropolitan grocery retail outlets at a similar rate between 2002 and 2007.

As Metcash increased its revenues it also expanded its margins. As shown in chart 7.1 Metcash has achieved EBITA margin growth in its IGA>D division from 3 per cent in 2000–01 to 4.5 per cent in 2007–08. As discussed later, Metcash's current EBITA margin appears healthy for a grocery wholesaler.

<sup>1</sup> Metcash, Company results, financial year ended 30 April 2008, 3 June 2008, p. 16.

<sup>2</sup> Metcash, information provided to the ACCC through an informal information request, 23 April 2008.

**Chart 7.1 Metcash EBITA and EBITA margins, IGA>D division, 2001–02 to 2007–08**



Source: Metcash

Further, Metcash's IGA>D wholesaling business experienced increases in gross margins, primarily in the period from 2004-05 onwards, that totalled an amount between 0.5 and 1 percentage point. Metcash also experienced consistent decreases in its cost of doing business (CODB) relative to sales over the period from 2001-02 to 2006-07, totalling around 0.5 percentage points. This overall increase in gross margin and a steady decrease in CODB has led to an overall increase in IGA>D's EBIT and EBIT margin over the period from 2002-03 to 2006-07, during which IGA>D's EBIT and EBIT margin has increased each year.

Similar trends in EBITA and EBITA margin to those for IGA>D were also observed for the Metcash entity as a whole (see table 7.2).

**Table 7.2 Metcash Sales EBITA and EBITA margins**

Group	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Sales	5421	6117	6577	6565	7705	9451	10045
EBITA (\$m)	117.5	152.7	183.8	194.5	226.9	315	335.7
EBITA/sales	2.17%	2.50%	2.80%	2.96%	2.95%	3.33%	3.34%

Data published by Metcash indicates that in the last six years, its CODB as a percentage of overall gross profit has reduced from 75.22 per cent in 2001-02 to 66.86 per cent in 2006-07.<sup>3</sup>

The ACCC considers that an explanation for consistent decreases in IGA>D's CODB is Metcash's increased ability to service stores in a more efficient manner perhaps partly stemming from supply chain investment it has made and the economies it is enjoying as a result of increased scale.<sup>4</sup> The increase in gross margins are likely to be improvements in trading terms with suppliers (again possibly related to scale) that are not passed on to independent retailers.

<sup>3</sup> Metcash, various annual results presentations.

<sup>4</sup> Metcash, Company results Financial year ending 30 April 2008, 3 June 2008, slide 18.

### 7.2.3 Recent changes to grocery wholesaling in Australia

In 1992 there were nine, predominantly state-based, wholesalers operating in Australia.<sup>5</sup> Currently there is one national wholesaler, Metcash.

A series of transactions, many of which were examined at the time by the ACCC, the Federal Court and the Trade Practices Tribunal (now the Australian Competition Tribunal), have led to Metcash becoming the only national wholesaler to independent supermarkets. Further details of these transactions are set out in appendix E.

Other wholesalers operating in Australia include medium-sized players that operate on a state-by-state basis, such as SPAR (see chapter 8), Conga Foods and PFD Food Services<sup>6</sup>, and numerous small privately owned wholesalers that serve niche markets. Smaller wholesalers often specialise in either particular products or products not covered by the major wholesalers or are located in rural areas and provide products to local businesses in their area.

Independent retailers in Tasmania are serviced by Statewide Independent Wholesalers (SIW). Woolworths currently has a 60 per cent ownership stake in SIW.<sup>7</sup> The remaining 40 per cent is owned by the Tasmanian Independent Retailers Co-Operative Society Limited, trading under the name Tasmanian Independent Retailers, which is a cooperative of independent retailers/traders.<sup>8</sup>

### 7.2.4 Independent retailers supplied by Metcash

As noted above, Metcash IGA>D supplies packaged groceries to a range of grocery retailers including the IGA Network, Foodland IGA, FoodWorks and other independent grocery retailers. Metcash also supplies some fresh groceries.

In the IGA Network there are 416 Supa IGAs, 719 IGAs and 249 IGA X-press convenience stores.<sup>9</sup> Metcash reports that 70 per cent of all IGA Network purchases are through Metcash with the remainder through fresh markets or other suppliers.<sup>10</sup> IGA Network stores also receive marketing support and training services from Metcash.

There are around 100 Foodland IGA stores located throughout South Australia, the Northern Territory and Broken Hill.<sup>11</sup>

There are around 700 FoodWorks stores, 400 of which operate under the FoodWorks brand. Stores operating under the FoodWorks brand are bound to FoodWorks by a unity agreement. While some of the non-branded stores operate under the same unity agreement as branded stores, most operate under standard approved store agreements. These agreements provide the stores less benefits (including lower rebates), but require fewer obligations. All FoodWorks retailers have a commercial trading relationship with Metcash through IGA>D. Approximately 58 per cent of FoodWorks' purchases (predominantly dry groceries) are from Metcash through IGA>D.<sup>12</sup> FoodWorks retailers source the remainder (predominantly fresh products) directly from suppliers.<sup>13</sup>

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5 Jewel Food Stores group, Independent Holdings, John Lewis Foodservice, Campbells Cash & Carry, QIW, Composite Buyers, AIW, and Foodland Association Ltd and Davids Holdings.

6 These wholesalers do not stock a full range of goods and generally cater to specialist stores in a particular niche.

7 [www.smartcompany.com.au/Premium-Articles/Industry-Trends/Income-sauce.html](http://www.smartcompany.com.au/Premium-Articles/Industry-Trends/Income-sauce.html).

8 Statewide Independent wholesalers, *About us*, viewed on 4 June 2008, [www.tasiw.com.au/sector.php?id=894](http://www.tasiw.com.au/sector.php?id=894).

9 Metcash, submission no. 181.

10 Metcash, submission no. 74.

11 Foodland, viewed 18 June 2008, [www.foodlandsa.com.au](http://www.foodlandsa.com.au).

12 Included in the 58 per cent are liquor purchases made through ALM.

13 FoodWorks, submission no. 90, p. 5.

Metcash also supplies independent grocery retailers that are not affiliated with any chain or banner group. The financial arrangements are different for those stores not operating under the IGA banner as Metcash does not do any marketing on their behalf.

## 7.2.5 Recent growth of independent retailers supplied by Metcash

The number of independent stores in Australia has grown by roughly 50 per cent since January 1999. Confidential information provided to the ACCC indicates that only around 25 per cent of these new stores have a floor space greater than 1000 m<sup>2</sup>.

The growth of independent retailers supplied by Metcash has been through acquisition and the opening of new supermarkets or stores. Metcash submitted at a hearing that:

... Each year we add somewhere between 35 and 50 new stores. We do approximately 95 major refurbishments through our store development department, and we have organisations such as the FoodWorks banner which have some, you know, three, 400 new stores on their radar. Unfortunately, one of the rules, or one of the phenomenons in our industry is that the most difficult thing for a single store IGA retailer, or a FoodWorks retailer, is to get the second store.<sup>14</sup>

Several submissions from interested parties, including the Australian Food and Grocery Council and the Australian National Retailers Association (ANRA), discussed the acquisition of the majority of Franklins and Foodland stores by Metcash as a significant factor in the subsequent growth of Metcash.

In 2005 Metcash acquired a total of 60 Action stores in Western Australia and Queensland, which became part of the IGA group. These acquisitions increased Metcash's wholesale turnover by over \$1 billion and its earnings by \$87 million.<sup>15</sup>

The ANRA contended that Metcash as a company has grown more quickly than the market as a whole, through acquisitions and higher retail sales.<sup>16</sup> In 2001 Metcash absorbed most of Foodland (104 stores) and in 2005 Metcash acquired 60 Action supermarkets in Western Australia, Queensland and northern New South Wales.<sup>17</sup> The wider takeover of Foodland Associated Ltd saw Metcash obtain 250 franchised operations in Western Australia.<sup>18</sup> As noted in the ACCC's issues paper, 82 of the 91 supermarket acquisitions reviewed by the ACCC in the last three years have been acquisitions by Metcash. For further information on these acquisitions refer to appendix E.

In November 2006 Metcash reported a 36 per cent increase in first-half yearly net profit, which chief executive Andrew Reitzer attributed to organic growth and the benefits of its \$949 million acquisition of Foodland's wholesale and supermarket businesses in 2005.<sup>19</sup>

In April 2007 Citigroup estimated that 42 per cent of the sales of the failed BILO-branded supermarkets would be redistributed to Metcash.<sup>20</sup>

The ANRA submitted that the number of food retailing businesses with annual turnovers between \$500 000 and \$1 million doubled between 2003–04 and 2005–06. Since 2001, 270 new independent supermarkets have been opened as a part of the Metcash distribution network.<sup>21</sup>

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14 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 68.

15 Metcash *Annual report 2007*, p. 3.

16 Australian National Retailers Association, submission no. 91, p. 8.

17 Australian National Retailers Association, submission no. 91, p. 9.

18 Chamber of Commerce and Industry of Western Australia, submission no. 65, p. 22.

19 B Speedy, *Grocers queuing up to join IGA supermarkets*, 3 April 2007, viewed at [www.theaustralian.news.com.au/story/0,20867,21493513-643,00.html](http://www.theaustralian.news.com.au/story/0,20867,21493513-643,00.html).

20 Citigroup, *Equity research: sales growth for Metcash and Woolworths—the Coles bonanza*, 13 April 2007, p. 8.

21 Australian National Retailers Association, submission no. 91, p. 8.

In 2006–07 IGA investments included:

- 42 new stores (total of more than 40 000 m<sup>2</sup>—average store size less than 1000 m<sup>2</sup>)
- 23 replaced or extended stores (total of 13 000 m<sup>2</sup>—average store size less than 600 m<sup>2</sup>).<sup>22</sup>

In summary, Metcash-supplied independents have expanded significantly, but the vast majority of this growth has been in smaller stores or by acquisitions.

## 7.2.6 Profitability of independent retailers supplied by Metcash

The evidence on the profitability and margins of independent retailers supplied by Metcash is mixed.

The National Association of Retail Grocers of Australia (NARGA) stated to the inquiry that:

Independent grocery retailers are in the main profitable, however, there are many variables including the structure and overheads of each individual business.

Margins and profitability of independents do not necessarily differ depending on the size or location of the store. They are more likely to differ depending on the product mix of the sales of the store.

Profit margins in some independent stores have increased over the last 15 years with a lot more emphasis being placed on fresh offers which will increase the percentage of higher margin sales.<sup>23</sup>

FoodWorks argued that independent supermarkets were not earning excessive profits:

... our retailer margins are not excessive and indeed are only barely sufficient to provide an acceptable rate of return in order to remain viable and competitive over the longer term ...

... if margins were excessive, there would be an influx of new prospective retailers or the prices for the sales of supermarket would be soaring. Neither of these is occurring. There is no 'boom' in independent supermarket retailing, there are no lines of prospective proprietors beating down our doors to establish new stores, there has been no increase in the sale prices of stores.<sup>24</sup>

NARGA provided evidence at a public hearing that suggests that the independent retailers typically earn EBIT margins which are lower than the margins achieved by the MSCs, although this depends on the local competitive environment.<sup>25</sup> Given that independent retailers do not undertake the wholesaling function, this is not surprising.

Mr Reitzer, chief executive officer of Metcash submitted in a public hearing that independent retailers were highly profitable and stated:

Despite what was said earlier, return on investment and profitability in the independent sector, to the best of our knowledge and according to our numbers, has never been better. And what happens, as a result of that, is there is significant growth opportunities in the sector.<sup>26</sup>

## 7.2.7 Characteristics of independent grocery retailers supplied by Metcash

Metcash supplies to a more diverse and widespread range of grocery retailers than the MSCs. As shown in chart 7.2, with the exception of IGA X-press stores, a higher proportion of stores supplied by Metcash are located in non-metropolitan areas compared to the MSCs.

22 Australian National Retailers Association, submission 91, p. 9.

23 NARGA, submission no. 129, p. 54.

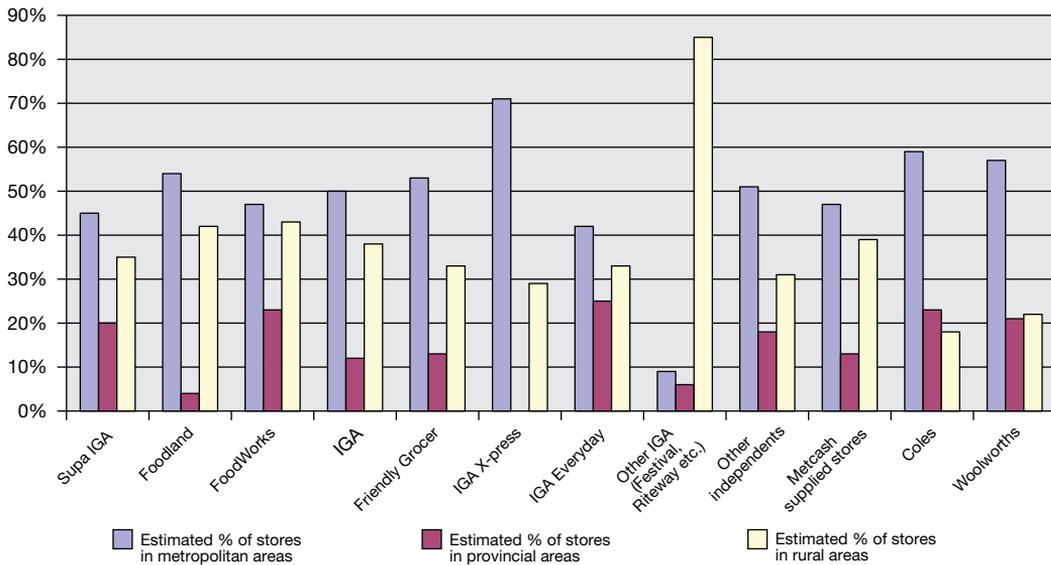
24 FoodWorks, submission no. 90, p. 3.

25 ACCC, public hearing transcript, Canberra, 9 April 2008, p. 28

26 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 68.

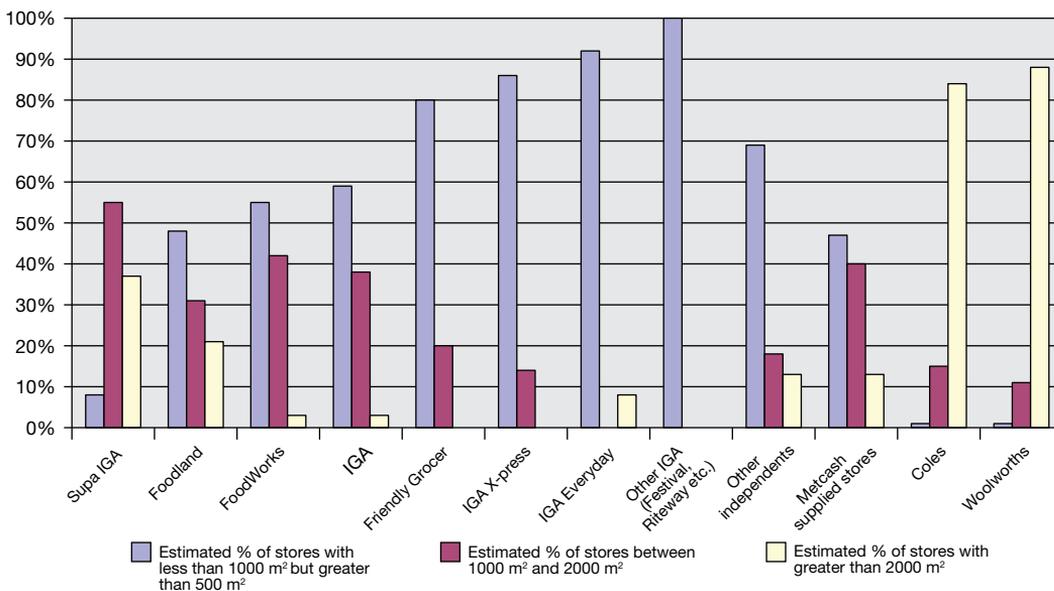
There are significant differences in the size of the floor space of the MSCs and the grocery retailers supplied by Metcash. As can be seen from chart 7.3 Metcash predominately supplies smaller format grocery retailers, with around 50 per cent occupying a floor space of less than 1000 m<sup>2</sup>. Less than 1 per cent of MSCs stores occupy floor space of less than 1000 m<sup>2</sup>. FoodWorks, the biggest banner group (by number) supplied by Metcash has around 400 bannered stores, but only around 60 per cent of these stores have a floor space greater than 500 m<sup>2</sup>.

**Chart 7.2 Estimated percentage of independent stores and MSCs with a floor space greater than 500 m<sup>2</sup> situated in metropolitan, provincial and rural areas**



Source: MapInfo

**Chart 7.3 Estimated percentage of independent stores and MSCs with stores by size**



Source: MapInfo

## 7.2.8 Ways in which independent retailers supplied by Metcash compete

Independent grocery retailers compete for customers in a variety of ways. The primary offer of a large number of the smaller independent grocery retailers is convenience. Many of the smaller independent retailers are located in street shopping strips. Others are located in regional towns. In general, these small grocery retailers do not compete aggressively on price.

FoodWorks submitted that independent supermarkets must find a niche market to operate in, as they cannot compete on range and cannot sustain price competition from the MSCs:

FoodWorks' competitive advantage is primarily in its neighbourhood/local store locations.

FoodWorks' customers desire the convenience of local shopping and require a comprehensive, but not excessive, range of products.

In rural and provincial locations, there is a shift in buying behaviour to local shopping. With FoodWorks, the owner of the store is in the store. Being closer to the customer means the retail offer can be more relevant. Prices can be adjusted by the storeowner to reflect immediate requirements. FoodWorks exists to serve its customers.

FoodWorks cannot compete on range and cannot sustain price competition. FoodWorks' members do not have a number of stores to subsidize competitive behaviour. FoodWorks does not have the advantages of vertical integration. FoodWorks can only source dry groceries from one warehouse.<sup>27</sup>

There tend to be two reasons why independent retailers are not competing directly on price with the MSCs. Firstly smaller stores usually do not achieve sufficient volumes to survive on the lower margins that result from price discounting. Secondly many smaller independent grocery retailers are in regional towns where they are the only grocery retailer.

As was noted in chapter 4, supermarkets compete on the basis of their total retail offer. While the ACCC has received many submissions discussing the difference in price between independent retailers and the MSCs, there are many other factors that attract consumers to a supermarket, including but not limited to location, community presence, size of store, product range, stock quality and availability and convenience. In considering many of these factors it is evident from information received from both independent retailers, including FoodWorks and Metcash, that factors other than price continue to attract consumers to independent retailers. NECG has previously stated:

Some [independent retailers] compete aggressively on price, while others place greater emphasis on service and convenience. Nevertheless, all independents can place an effective (quality adjusted) price constraint on the chains, particularly given the importance which consumers place on non-price factors.<sup>28</sup>

Metcash argued that:

... consumers benefit from improvements in the 'retail offer', which includes a variety of elements such as convenience and service quality as well as price.<sup>29</sup>

Peter Bunn contended that one of the greatest competitive advantages enjoyed by independent retailers is their 'ability to adapt and tailor the retail offering of their supermarket to the requirements of the community in which it operates.'<sup>30</sup>

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27 FoodWorks, submission no. 90, 11 March 2008, p. 36.

28 NECG, *Creeping acquisitions in the Australian grocery industry—a report to the ACCC prepared on behalf of Metcash Trading Ltd*, 2003, p. 1.

29 Metcash, submission no. 217, 28 May 2008, p. 1.

30 Peter Bunn, submission no. 58, 10 March 2008, p. 30.

NARGA submitted that:

... through their capacity to tailor their offering to local needs and demographics, and their attempt to customise their product range and store layout to the preferences of local shoppers, independent retailers are able to add value to their sales offering.<sup>31</sup>

NARGA also submitted that:

Independent retailers seek to provide a service of convenience to a wide range of smaller community areas across Australia, especially in remote areas. Their smaller size, more community based retail environments with a more restricted range of products comprise the majority of grocery stores and offer a unique customer offering, contributing to consumer welfare and choice.<sup>32</sup>

Price competition from independent retailers comes from larger stores—often those with floor space in excess of 1000 m<sup>2</sup>. In many cases these larger stores are in direct competition with the MSCs. They have a similar range to the MSCs and tend to be located close to the MSCs. For example, approximately 75 per cent of independent retailers over 1000 m<sup>2</sup> are located within 3 km of an MSC. These larger stores need turnover to be profitable, which requires them to be competitive on price.

The Koundouris Group, which operates the Supabarn chain (which has three stores in excess of 1000 m<sup>2</sup>), submitted that:

... we see ourselves as the real competitor to the majors, we successfully compete with them on price, service and quality. On the issue of price, we, as a family company, will often sacrifice the bottom line in order to compete.<sup>33</sup>

The level of price competition provided by Metcash-supplied independent retailers is discussed in detail later.

### ACCC's view

The ACCC considers that the success and growth of many smaller independent grocery retailers can be largely attributed to their location. In metropolitan areas smaller independent grocery retailers provide consumers with a convenient shopping option. In many regional towns, smaller independent retailers are the only grocery retailer. In many of these towns the population size and grocery turnover is not sufficient to maintain a major supermarket. As a result these locations are less attractive to the MSCs. Smaller independent retailers have the flexibility to structure their offerings to service these towns.

The ACCC considers that the ability of independent retailers to alter their product range to meet the specific needs of the local community gives independent retailers a competitive advantage over the MSCs. The ability to tailor product range at short notice or in response to consumer demands is easier for an independent store than an MSC. While the ACCC notes that this is an advantage enjoyed by independent retailers, it is not possible to quantify the benefits enjoyed by an independent retailer as a result of this advantage.

Larger independent retailers (those with sales area in excess of 1000 m<sup>2</sup>) are generally located in metropolitan areas and major regional centres. Although these independent retailers have some of the advantages of the smaller independent retailers, the need for turnover means that they must offer prices that are at least broadly comparable with the MSCs.

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31 NARGA, submission 14 (part A), p. 27.

32 NARGA, submission 14 (part A), p. 21.

33 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 5.

Due the difficulty of obtaining comprehensive price data from independent stores (Metcash does not keep retail price data), it is difficult to assess in detail the degree to which these stores compete on price. The issue of price competition is discussed in detail in the next part of this chapter.

## 7.3 Price competition provided by independent retailers supplied by Metcash

As noted in chapter 5, price competition in grocery retailing between the MSCs is not vigorous. Given that independent retailers supplied by Metcash make up a significant proportion of grocery retailers in Australia, any price tension these stores provide is a key component of the competitive environment.

A number of views have been expressed on the degree of price competition provided by the large independent retailers supplied by Metcash. Metcash argued that:

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

- keep retail prices competitive for customers through heavy promotional activity and maintaining local competitive tension against the MSCs
- help prevent the abuse of pricing power by Woolworths and Coles in a 'cosy duopoly' which would be damaging to customers
- help prevent the abuse of pricing power by Woolworths and Coles through practices such as delisting products which would damage suppliers and
- reduce the risk that Woolworths and Coles would dominate the entire supply chain further by increasing their private label sales.<sup>34</sup>

FoodWorks submitted that

... independents have little or no influence on the MSC prices and do not really compete with the MSCs. Independents have too little market share and are too widespread to provide any competitive force. Where independents are located proximately to the MSC, they must find a particular niche market and track comparable or higher pricing to the MSC to avoid the prospect of being forced out of business through intense competition.<sup>35</sup>

It should be noted that FoodWorks stores are generally smaller and are located in regional areas.

### 7.3.1 Evidence of price competition between Metcash-supplied independents retailers and the MSCs

According to Metcash, much of the price competition in grocery retailing is through promotional pricing. Metcash claimed that:

... in terms of promotional programs and promotional pricing for 30 to 40 percent of the sales, we are providing competitive tension ... All three participants, independents, Woolworths and Coles, compete, and where it is evidenced in pricing is on the promotions [sic].<sup>36</sup>

Metcash's promotional offers (and shelf pricing more broadly) can influence the pricing of the MSCs in a number of ways. First, they can influence the promotional activity of the MSCs, including the number and types of promotions and the size of promotional discounts. Second, they can influence the shelf prices set by the MSCs. Third they cause local MSC store managers to price match on key or known value items (KVIs).

<sup>34</sup> Metcash, submission no. 181, p. 47.

<sup>35</sup> FoodWorks, submission no. 90, pp. 26–27.

<sup>36</sup> ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 37.

## Competitive influence of Metcash-supplied independents on the promotional activity of the MSCs

According to Metcash, in any given week, stores under the IGA banner have between 2000 and 4000 items on special depending on the size of the store. Metcash submitted that items on special equate to roughly 40 per cent of total sales in those stores.<sup>37</sup> The MSCs also have a large number of products on promotion each week. Woolworths indicated that its stores typically have around 4000 items on promotion at any one time.<sup>38</sup>

Promotional pricing creates a strong point of difference between supermarkets. Many promotions are on KVIs and often heavily advertised. Promotions are a clear source of competitive tension between the MSC and larger independent supermarkets. It must be recognised, however, that promotions are largely funded by the product suppliers. Promotions are used by product suppliers to shift consumers to their brand.

## Competitive influences of Metcash-supplied independents on MSCs standard shelf prices

The MSCs take into account a range of factors when setting standard shelf prices. One factor is the prices of the same or like products offered by other major grocery retailers. The ACCC understands that Woolworths regularly checks the standard shelf prices of a wide range of items across a range of stores including large independent retailers supplied by Metcash. Coles also checks the prices of Metcash-supplied independents but to a smaller degree. However, both Woolworths and Coles appear to more intensively monitor each others' prices than the prices of Metcash-supplied independents. This may suggest that Metcash-supplied independents are of lesser importance in influencing the standard shelf prices of the MSCs.

## MSCs local pricing

To assess the effects of local competition, as part of the inquiry, the ACCC conducted an extensive study of the MSCs local store pricing.

In this study, the ACCC separately measured differences in the prices consumers paid for the same products in individual Woolworths' supermarkets and in individual Coles' supermarkets. Once these price differences were measured, the ACCC analysed the factors causing the price differences across stores (including local competition). Full details of the study and the results are detailed in appendix D.

## What the results indicate about the effects of Metcash-supplied independents on MSC local store pricing

It is important to note that the statistical analysis undertaken by the ACCC is only capable of detecting the effects competition may have on differences in prices at the store level. The extent to which price discounting by Metcash-supplied independent retailers produces a pricing response from Coles or Woolworths that is the same across all stores in a distribution area will not show up in the analysis. As a result, this analysis is unlikely to estimate the full effect of competition on MSC pricing.

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<sup>37</sup> ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 30.

<sup>38</sup> ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 59.

Metcash-supplied independent retailers can affect the MSCs local store pricing in two ways, either by:

- influencing the standard shelf prices and promotional prices set by the MSCs. Information provided to the ACCC indicates that the MSCs set different shelf prices and promotional prices depending on the presence of local competitors, or
- MSC store managers matching the prices of local Metcash-supplied independent retailers.

The results from the study indicate that Metcash-supplied independent retailers do have an effect on the MSCs local store pricing. The study found that Metcash-supplied independent retailers (with sales area in excess of 1000 m<sup>2</sup>) influence the pricing of Woolworths stores located within 3 km. For example, in 2007 consumers shopping at a Woolworths store with a Metcash-supplied independent retailer within 3 km, paid prices that were on average around 0.4 per cent lower than the prices consumers paid at Woolworths stores without a Metcash-supplied independent store within 5 km.<sup>39</sup> Around 55 per cent of Woolworths stores are located within 3 km of a Metcash-supplied independent retailer.<sup>40</sup>

The analysis was unable to detect that the local presence of a Metcash-supplied independent retailer had a similar influence on Coles local store pricing, except for a small range of products. These findings are consistent with confidential information provided by the MSCs.

The study found that Metcash-supplied independents have a smaller effect on MSCs local store pricing compared to that of ALDI. For example, a local Metcash-supplied independent has about half the effect on Woolworths' local store pricing as a local ALDI store. This is despite the fact that ALDI stores stock around 900 stock keeping units (SKUs). A large Metcash-supplied independent store stocks over 20 000 SKUs.

## Other studies

These results differ somewhat to the findings of a similar study by Walker and Webber.<sup>41</sup> Walker and Webber found that Coles' local store pricing in Victoria was more strongly affected by local independent grocery retailers than Safeway (Woolworths) stores.

The Bureau of Infrastructure, Transport and Regional Economics (BITRE) submitted findings from its ongoing research into the spatial variation in the costs of living from the capital cities to very remote areas. Part of this study focuses on food prices. The BITRE surveyed the prices of 250 food and non-food grocery items from 236 supermarkets throughout Australia. The prices were collected throughout 2005 and 2006. The supermarkets included in the study were Coles, Woolworths and a range of independent retailers including IGA, Action, FoodWorks and Franklins. ALDI was not included. Although the primary objective of the BITRE study was not to assess price competition between independent retailers and the MSCs, the results from the study provide helpful insights into this issue.

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39 This difference was found after controlling for a broad range of other factors that may affect MSCs' local store pricing, such as the local presence of other competing grocery retailers, store characteristics, the regional location of the store and local demographic characteristics.

40 With sales area in excess of 1000 m<sup>2</sup>.

41 J Walker, and T Webber, 'Retail grocery prices in Victoria: the relevance of local market conditions', *The Australian Economic Review*, September 2004, vol. 37, no. 3, pp. 317–28.

BITRE found that in some locations independent supermarkets offered lower prices (on average) than the MSCs. BITRE noted:

Clearly, independent grocery stores in some locations are able to compete with the major chains on price, with some even undercutting their competition. However, some independent supermarkets have indices which are greatly higher than the major chains, suggesting that they either cannot compete with them on price, or choose not to.<sup>42</sup>

The BITRE study further noted:

Regardless of the differences between the chains and the independents, consumers in towns with access to both types of stores have the advantage of choice, prices and associated services.<sup>43</sup>

### ACCC's view

Many large Metcash-supplied independent grocery retailers add competitive price tension to grocery retailing. The evidence available to the ACCC suggests that in some cases Metcash-supplied independent retailers may offer groceries at prices comparable to, or cheaper than, the MSCs. For example, it appears that Foodland IGA create significant price tension in South Australia.

While this is the case, the MSCs appear to pay more attention to each other and ALDI than Metcash-supplied independent retailers in setting their prices. Local store pricing data examined by the ACCC suggests that while Woolworths reacts to local Metcash-supplied independent retailers across a number of product groups, the reaction of Coles is more limited. This is consistent with confidential information provided to and examined by the ACCC.

## 7.4 Reasons why price competition from large Metcash-supplied independents may not be vigorous

The ability of large independent retailers to compete with the MSCs on price primarily depends on:

- the prices at which they source grocery products from Metcash and other grocery wholesalers
- their ability to achieve the same economies of scale and scope in grocery retailing as the MSCs.

### 7.4.1 Prices at which independent retailers source grocery products from Metcash and other grocery wholesalers

Some interested parties submitted that the prices charged by Metcash do not allow independent retailers to make a sustainable margin on dry, chilled or frozen products. Further, some interested parties submitted that the price paid by independent retailers would be more comparable to the MSCs if Metcash was operating in a more competitive wholesaling environment.<sup>44</sup>

FoodWorks estimated that the difference in wholesale costs faced by small independent retailers relative to the MSCs is 'in the order of 2 per cent' and stated that 'in a high volume, low margin industry, 2 per cent is a substantial disadvantage.'<sup>45</sup> Metcash supports this estimate of cost savings available to the major supermarket chains and stated:

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<sup>42</sup> BITRE, submission no. 188, p. 11.

<sup>43</sup> BITRE, submission no. 188, p. 12.

<sup>44</sup> Peter Bunn, submission no. 218; and FoodWorks, submission 90.

<sup>45</sup> FoodWorks, submission no. 90, p. 37.

Due to the confidential nature of many of the terms, empirical evidence of the impact of scale economies is difficult to find. However, anecdotal evidence suggests that the level of promotional terms and other discounts obtained by the MSCs is around 2% higher than obtained by Metcash.<sup>46</sup>

In relation to margins achieved by independent retailers by product categories, NARGA submitted in public hearings that it was not possible to make money selling only packaged groceries that had been sourced from Metcash and that independent supermarkets could only make a profit if, in addition to packaged groceries, they sold fresh food such as fruit and vegetables. Further, Mr John Cummings of NARGA submitted that:

MR CUMMINGS (NARGA): If I only buy half of what I sell from Metcash, right, I might be making no margin out of what I buy from Metcash and twice the margin out of that other 50 per cent, mightn't I?

THE CHAIRMAN (ACCC): Yes. Now, that's - - -

MR CUMMINGS: In effect, in effect, if I was to show you and I would show you privately, if that's what you wanted, I will show you my Metcash invoices for one week and I lose money on what I sell out of their warehouse.<sup>47</sup>

NARGA issued a news release clarifying their position on the ability of independent retailers to compete. NARGA stated that:

...Woolworths and Coles were in the same position [as independent retailers] – they covered overheads from the sale of packaged grocery products and the success of their businesses depended on the mix of packaged and fresh products.

...We sell packaged grocery products at the same price or similar prices to those of Woolworths and Coles and cover our overheads from those sales, as they do - the overall profitability of an independent grocery business comes from the overall mix.<sup>48</sup>

Franklins stated that its former arrangement with Metcash did not leave it with sufficient margin to compete with the MSCs.<sup>49</sup>

Metcash denied the positions put by both NARGA and Franklins.<sup>50</sup> Metcash estimated that the margins made by retailers on fruit and vegetables would be up to 38 per cent before shrinkage and stock losses, and on packaged groceries would be about 18 per cent to 19 per cent.<sup>51</sup> Horticulture Australia submitted that 'anecdotal evidence collected for its submission suggests that Independent Supermarkets aim for gross margins in fresh fruit and vegetables of 35 per cent to 45 per cent.'<sup>52</sup>

Overall, evidence presented to the ACCC suggests that a large proportion of the profits achieved in the independent sector chain are achieved by Metcash at the wholesale level. As such, the ACCC considers that Metcash is able to use its position as the only national wholesaler to make profits above a competitive level. The ACCC considers that the structure Metcash has in place limits the ability of independent retailers to compete with the MSCs on price.

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46 Metcash, submission no. 181, p. 37.

47 ACCC, public hearing, Canberra, 9 April 2008, p. 29.

48 NARGA, ACCC grocery inquiry misrepresents evidence, news release, 2 June 2008.

49 ACCC, public hearing transcript, Sydney, 1 April 2008, p. 48.

50 ACCC, public hearing transcript, Melbourne, 2 June 2008, pp. 25–6.

51 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 33–4.

52 HAL, submission no. 92, p. 11.

## 7.4.2 Evidence of the prices Metcash charges independent retailers

### Metcash's pricing policy

The manner in which Metcash charges independent retailers is complex. Metcash described its pricing policies to retailers in the following manner:

... there are certain terms in Australia that are public or published terms. So we take the wholesalers price provided to us by the manufacturer, which we assume is the same as what they charge the chains, and then we take off all the public published terms, like trade discounts, quantity buyer discounts, buy a full truck load of product, cash discounts ... and we arrive at what we call net strip cost ... And we charge all our customers that price.

If there is a promotion going on, or a case deal from a manufacturer which is always for a limited period—so a manufacturer might come over and say over and above all of that there's a promotion, or a special or whatever it is, there's another \$5.00 a case, we take that off as well, and that goes through to every single retailer that buys out of IGA irrespective of whether they're a Supa IGA, FoodWorks, Independent, they get paid that price. Plus they pay us a service fee, and the service fee is a percentage of that order, and it depends on the size of the order and it's a user pay.

It's a sliding scale service fee. And that's where from, as a percentage, bigger stores pay a lesser percentage than smaller stores ...

Then it depends what banner you join as to what your rebate would be. So if you're an IGA banner there's certain rebates for certain performance, and certain ... we pay for marketing. If you're a FoodWorks they have a totally different set up in terms of what their rebates are and how they pay ... and obviously if you don't join FoodWorks or if you don't join IGA then you get no marketing support and no rebates.<sup>53</sup>

And further:

In terms of organisations such as IGA retailers or FoodWorks retailers, in terms of the boxes that move through the warehouse and the price at which those goods are invoiced to the retailer, it's exactly the same. So we take off all the published discounts, or case discounts, trade discounts, and any case deal. And in the case of FoodWorks, they negotiate their own promotional deals and then pass them to us and we deduct them and pass them through to them.<sup>54</sup>

Given the complexity of the Metcash pricing policy, it is not possible for the ACCC to determine whether there is anything inherent in Metcash's pricing policy that limits the price competitiveness of the retailers it supplies. It is worth noting, however, that Metcash's pricing policy does not explicitly offer lower prices to those independent retailers who compete most directly with the MSCs. In a public hearing, Metcash noted that Supa IGAs do not receive any preferential pricing other than a higher volume rebate as a result of the higher volumes purchased from Metcash:

MR O'DONOVAN: Right. Okay. So then looking at the Super IGA, the only pricing advantage that it gets over and above a normal IGA is that it gets a lower service fee because of the higher volumes?

MR REITZER: That's correct. If you order in big quantities so if you send through a small order, you made a mistake with something, you'll pay the high percentage for that one order but, generally speaking, they pay, they organise themselves, and they only place big orders.<sup>55</sup>

53 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 27.

54 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 49.

55 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 32.

## Franklins' experience

In 2004, following the termination of its supply agreement with Metcash, Franklins began its own wholesaling operations. Franklins currently has 80 stores with annual turnover of \$812 million. Franklins had been supplied by Metcash since 2001 (following the sale of Franklins by Dairy Farm International). Franklins stated that it found Metcash's pricing of packaged grocery products was such that it was impossible to make a profit. Franklins stated in an ACCC public hearing:

MR O'DONOVAN (ACCC): Now, you've said in your public submission to the commission that the decision made by the company was that it was uneconomical to survive as a retailer competing with Coles and Woolworths while buying from a wholesaler?

MR ZELINSKI (Franklins): Correct.

MR O'DONOVAN: Okay. Now, if I can just unpack that idea, is it because of the particular wholesaler you had to deal with or is there something fundamentally uncompetitive about dealing through a wholesaler when you're dealing with an integrated ... when you're competing against integrated, vertically integrated supermarkets?

MR ZELINSKI: I think as a retailer who is trying to ... Franklins tried to establish itself as a third chain in New South Wales. In order to be successful, one would have to compete with Woolworths and Coles on price, amongst other things, that being the most important. And the arrangement with Metcash at the time did not leave us with sufficient margin to compete equally with Coles and Woolworths.<sup>56</sup>

Franklins further stated that the prices it received from Metcash meant that it was unable to operate competitively in the changing grocery industry.

MR ZELINSKI: I can only talk for our experience. We were not competitive while we were with Metcash and I think if we had remained with Metcash, we might have a very different model of a convenience business today, as opposed to a third supermarket chain.

MR O'DONOVAN: Okay. All right.

THE CHAIRMAN (ACCC): Just to test that one step further and I think Dr King has a question, what that's implying is that ... correct me if I'm wrong, but what that's implying is that you have been able to establish your own vertically integrated wholesaler and distribution operation and to deal with suppliers on terms and conditions which give you a better financial return than utilising the wholesale and distribution arrangements offered by Metcash. Is that correct?

MR ZELINSKI: Absolutely correct.

THE CHAIRMAN: I think Mr O'Donovan [ACCC] was asking a question before and I am not sure that we actually got to the final point of the question which is that by breaking up the wholesaling operations within New South Wales between Metcash and ... I am going to call it for this purpose ... Franklins, that reduces the total volume of purchasers by Metcash, clearly, by the reduction of volume that is going over to Franklins. Franklins itself, in terms of its own internal wholesale operation, has a lower volume than would otherwise have been the case, clearly, if it had been all totally aggregated within Metcash. Has that resulted in less favourable terms from suppliers or have you been able to maintain the same terms from suppliers that has enabled you to ... do you follow me ... to get the more favourable commercial result?

MR ZELINSKI: I think our terms have improved since we have become self-sufficient. How do they compare to other retailers? I would have no idea. I think that for us the relationship of dealing with suppliers has given us an advantage in terms and also the rebates that are passed on to owning your own warehouse adequately cover the cost of the warehouse for use.<sup>57</sup>

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<sup>56</sup> ACCC, public hearing transcript, Sydney, 1 April 2008, p. 48.

<sup>57</sup> ACCC, public hearing transcript, Sydney, 1 April 2008, p. 55.

The ACCC recognises that in leaving Metcash, Franklins took on a great deal of financial risk. As noted by Franklins, it has only reached the critical mass it considers it needs to be profitable in the last 12 months.<sup>58</sup> Before this year, Franklins operated at a loss; however, it was able to maintain a position in the grocery industry as a result of the backing of its parent company, Pick n' Pay.

As articulated by Aubrey Zelinsky, Managing Director of Franklins, at a public hearing, Franklins were faced with:

... one of three choices at that time [2003–04]. The decisions were either to stay with Metcash and not be competitive or to do our own distribution and logistics even though we had not achieved the critical mass that we were needing [sic], or the third radical was to actually sell our business and move back to South Africa, and that was serious consideration as well, as one of the options.

It is clear from the evidence given by Franklins that the pricing of goods supplied by Metcash placed Franklins in a position where it was unable to compete on price with the MSCs. Franklins has recently reported an annual profit of \$2.3 million, which is the first year it has made a profit since Pick n'Pay took over in 2001.<sup>59</sup> Although Franklins experienced a lengthy period of time without making a profit, it appears that the risk involved in moving away from Metcash and becoming vertically integrated did not outweigh the costs of staying with Metcash.

### ACCC pricing study

The ACCC's MSC local pricing study provides some indirect evidence on the prices that Metcash charges independent retailers. In the main, Metcash supplies independent retailers with packaged groceries through IGA>D. Metcash does offer independent retailers fresh products (through IGA Fresh), but in most cases independent retailers use other sources of supply.

As noted above, the ACCC study examined the effects of local competition on local store pricing. This includes an examination of the effects of the local presence of a Metcash-supplied independent supermarket on the pricing of the local Coles and Woolworths stores.

The study found that consumers paid lower prices for fresh produce at Coles supermarkets with a Metcash-supplied independent nearby than at other Coles supermarkets. For dry groceries, the local presence of Metcash-supplied independent had no effect on Coles local store pricing. The study found that consumers paid lower prices for both fresh produce and dry groceries at Woolworths stores with a Metcash-supplied independent nearby. The effect was, however, much larger for fresh produce.

There can be a number of explanations of these findings. One is that supermarkets in general compete more aggressively on the prices of fresh produce than dry groceries. Some evidence of this has been presented to the ACCC. It may also imply that Metcash-supplied independents are in a better position in fresh produce than packaged groceries to compete with the MSCs on price.

### ACCC's view

Although some of the evidence discussed above is indirect and not certain, it is the ACCC's view that overall the evidence does indicate that Metcash supplies packaged grocery products to large independent retailers at prices that on the main make it difficult for the independent retailers to compete with the MSCs on price. This evidence is supported by confidential information the ACCC has received, including information that indicates that independent grocery retailers in direct competition with

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<sup>58</sup> ACCC, public hearing transcript, Sydney, 1 April 2008, p. 54.

<sup>59</sup> For more information, go to [www.freshplaza.com/news\\_detail.asp?id=20710](http://www.freshplaza.com/news_detail.asp?id=20710).

MSC stores achieve gross margins on packaged groceries that are low compared to other product categories. This evidence must be weighed up against evidence that suggests that some very large independent retailers are aggressive price discounters.

### 7.4.3 Ability of independent retailers to achieve the same economies of scale and scope in grocery retailing as the MSCs

Many costs of grocery retailing, including administration, management and advertising costs, do not appear to increase at the same rate as sales or store sizes. While leasing costs will increase as store size increases, leasing costs will not increase proportionately with store size.

Grocery retailers that can achieve lower (unit) costs of operating their business can, all else the same, gain a competitive advantage over their rivals.

The MSCs appears to be able to achieve lower (unit) costs than many independent retailers.

As noted previously, on average, the MSCs operate retail stores that have greater sales areas than independent retailers. This allows the MSCs to spread many of the costs of retailing over a large product range (economies of scope) and over large sales volumes (economies of scale). This is not the case for all independent retailers. However, as shown in chart 7.3, some Supa IGA stores and IGA Foodland stores have sales areas in excess of 2000 m<sup>2</sup>. It is likely that these stores achieve many of the economies of the large MSCs.

Economies of retailing are also achieved from the size of the supermarket chain. The effectiveness and efficiency of advertising campaigns and promotions tend to increase with the size of the supermarket chain. This is especially the case if the stores offer a standard range of products. Supermarket chains can also achieve economies from spreading administration, management and business support costs over a larger base. There is also a greater potential for investment in operating systems and processes, which allow for enhanced information and data management.

Independent supermarkets typically attempt to take advantage of some of these economies by being part of a supermarket chain and/or operating under a banner group (for example, IGA or FoodWorks). As FoodWorks noted:

In the independent retail sector, the various ‘banner’ groups have been forced to consolidate to derive economies of scale from their purchasing, merchandising and marketing support in an endeavour to survive in the face of the MSC.<sup>60</sup>

However differences in product range between independent supermarkets under the same banner tend to make large-scale product marketing less effective than the MSCs.

#### ACCC’s view

The size and number of MSC stores is likely to provide the MSCs with a cost advantage over independent retailers. The cost advantage over smaller retailers is likely to be substantial. Larger independent retailers are likely to be able to achieve similar store level economies as the MSCs. Nevertheless, the MSCs are likely to have cost advantages in advertising and marketing resulting from their national coverage. These cost advantages may limit the degree to which independent retailers (including those supplied by Metcash) can aggressively compete on price with the MSCs.

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<sup>60</sup> FoodWorks, submission no. 90, p. 14.

## 7.5 Possible reasons why Metcash's prices may not enable large independent retailers to compete aggressively on price

There are a number of possible reasons why Metcash's prices may not enable large independent retailers to compete aggressively on price, including:

- Metcash may pay more to suppliers for grocery products than the MSCs.
- Metcash may be unable to achieve the same economies of scale, scope and density in wholesaling as the MSCs.
- Metcash may be achieving excessive margins as the only national wholesaler to independent retailers.
- The vertical separation between Metcash and independent retailers.

### 7.5.1 Comparison of what Metcash and the MSCs pay suppliers for grocery products

Metcash submitted that:

Due to the confidential nature of many of the terms, empirical evidence of the impact of scale economies is difficult to find. However, anecdotal evidence suggests that the level of promotional terms and other discounts obtained by the MSCs is around 2% higher than obtained by Metcash.<sup>61</sup>

The pricing terms between product suppliers and Metcash and the MSCs are complex. Although suppliers usually have standard wholesale list prices, these are not the prices that Metcash and the MSCs actually pay. The MSCs and Metcash receive a range of rebates (or discounts) from suppliers, such as ullage, settlement and volume rebates, as well as promotional discounts.

Given the complexity of the pricing terms, comparisons of what Metcash and the MSCs pay for grocery products are difficult and subject to error. Moreover, comparisons of pricing terms are by their nature incomplete as they do not take into consideration non-price terms which also affect the cost of acquiring products from suppliers.

While the ACCC notes the importance of this issue, due to the complex nature of the pricing policies of Metcash, the ACCC is not in a position to definitively state whether the prices paid by Metcash are significantly higher or lower than the MSCs.

In an effort to determine the possible differences in the prices Metcash and the MSCs pay for particular products, the ACCC has reviewed both the pricing data recorded by Metcash for its Queensland and Victorian distribution centres, and the trading terms Metcash has in place for a selection of different products. The ACCC has found that on certain products Metcash is able to achieve marginally higher rebate discounts than the MSCs, however on other products it is unable to achieve the same trading terms. The ACCC notes that there does not appear to be any clear pattern in the level of rebates obtained by Metcash between products. As a result of the apparent variability, the ACCC is unable to judge definitively whether Metcash is receiving similar prices to the MSCs.

#### Supplier rebates paid directly to independent retailers

Confidential information received from a number of interested parties during the inquiry indicated that

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<sup>61</sup> Metcash, submission no. 181, p. 37.

part of the reason Metcash often receives lower rebates from suppliers is that it is limited in its ability to ensure that all its retailers follow the supplier's requirements for promotions and other advertising. As a result, suppliers find that they need to visit individual stores and provide additional discounts to individual shop owners.

The ACCC understands that these discounts may be a cash or cheque payment or some form of deal with the supplier whereby additional stock is obtained for either a reduced price or for free. In exchange, retailers are required to maintain specific displays or other promotional activity in store for a specified period for the particular products. As suppliers are required to provide additional funding to individual stores and employ people to directly negotiate with the stores supplied by Metcash, the ACCC assumes that these factors are taken into consideration by suppliers in setting the rebates paid to Metcash. The direct payment of rebates to individual stores may at least partly explain any differences in the prices Metcash and the MSCs pay suppliers.<sup>62</sup>

Rebates tend to be given to individual stores by suppliers only in certain circumstances:

- When an individual store creates specific displays or undertakes other promotional activity on behalf of the supplier. In some cases, suppliers find it more effective to deal directly with the store, rather than to go through Metcash. This allows suppliers to more effectively communicate their requirements.
- Where the only service Metcash offers to suppliers is a 'charge through service'. This means that the individual retailer will order the goods required, and the supplier will deliver the goods direct to store with the paperwork being sent directly to Metcash for payment. A number of suppliers have confidentially advised the ACCC that additional rebates are provided to individual stores where Metcash provides only a charge through service.

### ACCC's view

Evidence on the relative prices that Metcash and the MSCs pay suppliers is limited and varied. For some products during some periods it appears that Metcash is able to source the same products at prices lower than that paid by the MSCs. For other products, the opposite is the case. The evidence is consistent with the view that, on average, Metcash pays prices for products that are higher than those paid by the MSCs. These price differences may be partly offset by rebates suppliers pay directly to some suppliers.

## 7.5.2 Economies in wholesaling and distribution

A second reason Metcash may not be able to supply grocery product to independent retailers at competitive prices is the inability of Metcash to take advantage of the same economies of scale and density as the MSCs.

Economies of scale refer to reductions in unit costs resulting from increasing a businesses scale of operation. Economies of scale in grocery wholesaling come from a range of sources. Larger wholesaling operations can spread the costs of distribution centres over greater volumes and can often better manage their working capital. Economies of density refer to reduction in unit costs in serving more stores within a given area. Increasing the number of stores serviced within a given area can reduce transport costs through better route planning and reduced working capital.

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<sup>62</sup> The ACCC has not been able to source information on the size of these rebates.

The availability of scale opportunities in the supply chain may differ between product categories. Factors such as the ability to centralise product distribution, product shelf life and geographic density of retailers will all affect the level of economies that can be achieved. Freshlogic, engaged by Coles, stated that potential efficiencies are lower in fresh produce and meat than for other grocery categories.<sup>63</sup>

Whether or not a company needs to be national or just regional to take advantage of these scale economies depends on the typical supply chain for different product lines (i.e. whether the products are sourced nationally or regionally). Although purchasing for some product lines may occur on a national level, most distribution occurs on a state, regional or store level - indicating that a new entrant may not necessarily need to operate nationally to be cost competitive.

It is unclear whether Metcash achieves similar economies in wholesaling and distribution as the MSCs. NARGA suggested that a critical mass of upwards of \$500 million-worth of goods must pass through each warehouse to be cost competitive at the wholesale level.<sup>64</sup>

SPAR estimates that the turnover required annually to establish a profitable wholesale distribution operation is around several hundred million dollars.<sup>65</sup>

The experience of Franklins, which had around \$80 million in sales but operated at a loss, suggests that \$800 million may represent the minimum efficient sales level for a wholesale operation.

FoodWorks contended in its submission:

The recent FAL acquisition by Metcash should have been reflected in greater efficiencies gained by the larger volumes. None of the published gains have translated to lower prices, lower service fees, or better service levels. There has been no flow of benefits to FoodWorks.<sup>66</sup>

Given the IGA>D and Campbell's Cash & Carry division has a reported annual turnover of around \$7.5 billion, it is significantly above the minimum efficient scale as claimed by other interested parties.<sup>67</sup>

### ACCC's view

It is likely that Metcash is unable to achieve the same economies of scale in wholesaling and distribution as the MSCs. The MSCs wholesaling operations are substantially larger than Metcash's wholesaling operations. This is likely to enable the MSCs to lower their unit costs relative to Metcash. The size of the cost disadvantage is unclear. The ACCC notes, however, that Metcash has been able to increase its margins over the past five years. This period is coincident with a large increase in Metcash's scale. Evidence suggests that Metcash has probably now exceeded the size where most of the cost advantages from scale are reached, suggesting the advantage may be minimal.

## 7.5.3 Metcash is able to achieve excessive margins as the only national wholesaler to independent retailers

A third possibility is that Metcash is able to achieve excessive margins on the grocery products it supplies to independent retailers.

Independent retailers have little or no choice of wholesaler for packaged groceries. Combined with the barriers to entry into grocery wholesaling, which is discussed further later in this chapter, this may

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<sup>63</sup> Freshlogic, *Report on issues relevant to the ACCC inquiry into the competitiveness of retail prices for standard groceries*, March 2008 (included in Coles supermarkets, submission no. 157).

<sup>64</sup> NARGA, submission, no. 129, p. 35.

<sup>65</sup> SPAR, submission, no. 195, p. 3.

<sup>66</sup> FoodWorks, submission no. 90, p. 39.

<sup>67</sup> Metcash, Full year results presentation, 2008.

give Metcash some degree of pricing power. The lack of an alternative grocery wholesaler may enable Metcash to achieve excessive margins and a degree of 'monopoly' profit.

As noted above, from 2000–01 to 2007–08 Metcash's EBITA margin in its IGA>D division (which supplies packaged groceries to independent grocery retailers) increased from 3 per cent to 4.5 per cent. A range of evidence suggests this is a healthy margin for an operation that only wholesales groceries and does not bare the capital and other costs of retailing.

## Comparison of Metcash margins and MSC margins

In a public hearing Metcash submitted the following:

MR O'DONOVAN: All right. But – so you wouldn't accept that that one per cent improvement in your EBIT percentage represents in any way Metcash taking a bigger margin?

MR REITZER: It does represent Metcash taking a bigger margin because, if you look at the overall profitability in the industry in the year 2000, and if you specifically look at my competitor that sets that profitability, Woolworths determine how much profit there is on the table for the independent retailers and Metcash to share. And back in the year 2000 – and that's the competitive tension that I referred to that gets created at retail – so back in 2000 I can't remember what EBIT Woolworths were operating at in their grocery, but I think it was half of what it is now as well. And that was the profit pool, if you want, that was available for the independent retailers and Metcash to share. Now it's doubled.

MR O'DONOVAN: All right. So you have effectively followed your – your network has followed Woolworths up ...

MR REITZER: Yes.

MR O'DONOVAN: ... in terms of the margin that you make.

MR REITZER: That's correct.

MR O'DONOVAN: And your margin, as the wholesaler, has improved, and you have captured one per cent of that improved margin?

MR REITZER: That's correct.

And further:

MR O'DONOVAN: Okay. So why then, if it's just you performing better internally, why then is the fact that Woolworths has pushed out its margins at all relevant to what margins you're making?

MR REITZER: Because that's what's available in our industry. So if you have a model where you work as hard you possibly can to get your costs as low as possible on the distribution and the running of the retail store, and you join banner groups, and you create buying power in the brands to get the costs of goods in your promotions as good as possible, and then you go out and monitor your opposition. And, as the Commissioner said, you can't afford to sell, you know, lower than them, but it's more or less at their price. If their margin goes up so does the margin go up in your sector of the industry. That's how it works.

MR O'DONOVAN: Okay. And so, in that sense, a lack of competition in the retail sector has not caused – sorry, as a consequence of – there's been not enough competition in the sector either from you or from Woolworths to shrink that margin back down to what it was three years ago?

MR REITZER: That's absolutely correct. If something happened tomorrow and Woolworths made a decision to make half the EBIT that they're making today, our EBIT, as Metcash the wholesaler, would half and so would our retailers.

MR O'DONOVAN: Sure. Right. But Metcash is not going ...

MR REITZER: That's what happens in a free market, yes.

MR O'DONOVAN: Sure. And Metcash certainly isn't going to make a decision to half its margins to increase volume?

MR REITZER: Halving our margins wouldn't increase volume. I mean, there's other things that one employs as a retailer and a wholesaler to increase your volume. So that wouldn't – and, no, we wouldn't make a decision like that on our own.<sup>68</sup>

The above exchange contributes to the ACCC view that Metcash prices under the umbrella of Woolworths retail pricing. Metcash is taking advantage of the increasing profits available to it as a result of the MSCs pricing policies. As a result of pricing under this umbrella, Metcash is not supplying packaged grocery products at a wholesale price to enable independent retailers to compete with the MSCs aggressively on price.

A comparison between the margins achieved by Metcash and those achieved by the MSCs is somewhat difficult as the MSCs undertake both grocery wholesaling and retailing, where Metcash only undertakes grocery wholesaling. Nevertheless the following analysis is informative. Metcash submitted that IGA>D achieves an EBIT margin of 4.25 per cent on its wholesale sales to independent retailers.<sup>69</sup> Metcash has stated that independent retailers achieve a gross margin of around 18 to 19 per cent on dry groceries. Assuming this level of mark up, the 4.25 per cent EBIT margin that IGA>D earns on its wholesale revenue represents around a 3.59 per cent proportion of retail prices. Confidential documents confirm that this is an appropriate estimate.

This is less than the EBIT margin of 5.76 per cent achieved by Woolworths in 2006–07 for its food and liquor divisions and is greater than the 3.39 per cent EBIT margin achieved by Coles in 2006–07 for its food and liquor division. Metcash does not own or operate stores, or face any significant part of the capital and operating costs of the retail stores. For every \$100 spent by consumers on:

- packaged groceries at a Metcash-supplied independent grocery retailer, Metcash on average received \$3.59 in profit or EBIT
- groceries and liquor at a Coles supermarket, Coles on average received \$3.39 in profit or EBIT
- groceries and liquor at a Woolworths supermarket, Woolworths on average received \$5.76 in profit or EBIT

Although the products included in these comparisons differ, it appears that Metcash captures a significant proportion of dollars spent on packaged groceries in independent grocery retailers.

### Comparison of the margins of Metcash and United Kingdom grocery wholesalers

Chart 7.4 replicates a figure from the UK grocery inquiry report.<sup>70</sup> It details the operating margins of 10 of the major 'direct to store' grocery wholesalers and five cash and carry wholesalers in the UK. According to the UK inquiry report, these wholesales account for between 15 and 20 per cent of total UK grocery supply.<sup>71</sup> Also included in the figure are Metcash's EBITA margins.<sup>72</sup> The 'delivered' grocery wholesalers provide comparable services to those offered by IGA>D.

68 ACCC, Public hearing, Melbourne, 2 June 2008, 42-3

69 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 38.

70 Competition Commission, *The supply of groceries in the UK market investigation*—provisional findings report, appendix 5, A5(5)-2.

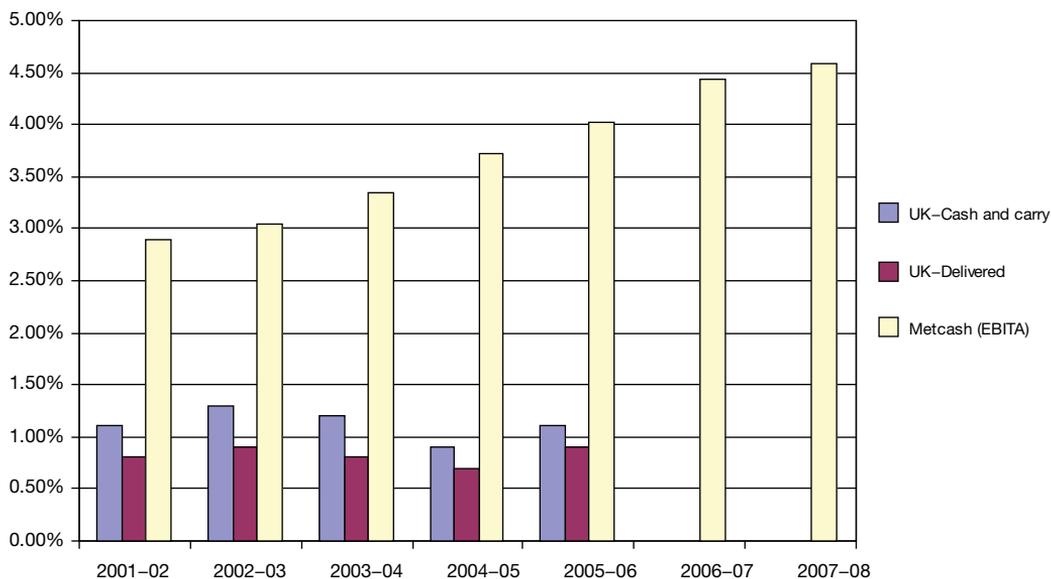
71 *ibid.*

72 As an EBITA margin, these figures will overstate the EBIT margins achieved by Metcash's IGA>D division. However, the ACCC notes that Metcash has claimed relatively little amortisation in its accounts and that, based on Metcash's published accounts, amortisation would be expected to only have up to 0.3 percentage points on margins. Relevantly, in the course of public hearings Metcash stated that its IGA>D division achieved an EBIT of 4.25 per cent on its grocery sales to retailers.

Caution needs to be exercised in drawing conclusions from international comparisons. Like-for-like comparisons are not straightforward. In particular, the range of activities conducted by the companies and the number and density of the grocery retailers they supply will affect their margins.

Nevertheless, from 1995–96 to 2005–06, the delivered wholesalers achieved operating margins or EBIT margins<sup>73</sup> of around 1 per cent.<sup>74</sup> These are significantly lower than those achieved by Metcash.

**Chart 7.4 EBIT margins of UK grocery wholesalers vs EBITA margin of Metcash, 2001–02 to 2007–08**



Source: UK Competition Commission and Metcash<sup>75</sup>

Although the operations of these wholesalers and Metcash are not identical, the evidence suggests that Metcash margins are healthy. In the UK there are over 400 wholesalers, the largest of which has only a 20.8 per cent of grocery wholesaling revenues, and the largest 15 wholesalers cover 78.8 per cent of the wholesale market.<sup>76</sup> The lower EBIT margins in the UK may reflect increased competition resulting from this comparatively less concentrated market structure.

The ACCC notes the QIW case in 1993, which involved the merger of independent grocery wholesalers. In that case, Justice Spender suggested that it could be expected that with the exit of a wholesaler such as QIW, the prices charged by Davids could potentially increase by 2 per cent to 3 per cent.<sup>77</sup> Justice Spender also emphasised the importance of 2 per cent to 3 per cent in a high turnover industry such as grocery wholesaling. His Honour stated:

73 The term operating margin in the UK report is consistent with the EBIT margin term used by the ACCC.

74 Competition Commission, *op. cit.*, A5(5)–7.

75 Competition Commission, *The supply of groceries in the UK market investigation*—provisional findings report, appendix 5, A5(5)–8; Metcash, *Company results financial year ended 30 April 2008*, 3 June 2008, p. 16. Metcash, viewed on 30 June 2006, [www.metcash.com/index.cfm?page\\_id=2152](http://www.metcash.com/index.cfm?page_id=2152).

76 Competition Commission, *The supply of groceries in the UK market investigation*, vol. 1, p. 40.

77 *QIW Retailers Limited v Davids Holdings Pty Limited & Ors; Attorney General of the Commonwealth v Davids Holdings Pty Limited & Anor* (1993) ATPR 41-226.

What actually occurred when Davids entered into Australia in 1986 is instructive. The effect of that entry was to significantly lower prices. In an industry where the margins are generally very small, the lowering of prices was in the order of 2 to 3 per cent—a dramatic reduction. This experience on the evidence is mirrored in the position in Western Australia and I think it right to conclude that the margin charged by F.A.L. has resulted in the invitation by some independent retailers to Independent Holdings Limited to enter that market.<sup>78</sup> [p. 41 145]

This example may also be relevant in relation to Metcash, as it is now the only wholesaler with national coverage. If a new entrant did begin wholesaling to the independent sector, it could potentially be the case that wholesale prices to the independent sector could fall by 2 to 3 per cent.

### ACCC's view

Most independent retailers have little or no choice of wholesaler from which they can acquire packaged groceries. This lack of choice may provide Metcash with some pricing power. The evidence suggests that Metcash is achieving a healthy margin for a grocery wholesaler. Metcash does not appear to have passed on to independent retailers much of the benefits of the economies of scale it has achieved through the expansion of the independent retail sector it supplies.

The ACCC considers that Metcash achieves a margin due to its pricing power—a margin only accessible because of its position as the sole national supplier to the independent sector. This is likely to reduce price competition from Metcash-supplied independent retailers.

## 7.5.4 Vertical separation between Metcash and independent retailers

Although Metcash has recently taken equity stakes in some of the retailers it supplies, for the most part they are separately owned. Metcash's major competitors (the MSCs) are vertically integrated.

Vertical integration may provide the MSCs with some advantages over Metcash and independent grocery retailers. A number of these advantages have already been discussed. One is the ability to ensure that all its stores diligently implement promotions. This increases the effectiveness of promotions and arguably reduces their cost. Another is the ability to ensure certain elements of the retail offer are standardised across stores. This can improve consumer perception of the retailing brand and can make marketing and advertising expenditure more effective and efficient.

Probably the most significant benefits of vertical integration between grocery wholesaling and retailing is the improved alignment of incentives.

This can be illustrated by an example. Assume Metcash wished to pursue market share in wholesaling by competing with the MSCs on price. One way it could do this is to reduce the wholesale prices it charges independent retailers. However, as Metcash does not own the retailers, it cannot be assured that the retailers will pass through all or most of the reduction in wholesale prices in lower retail prices. The smaller the pass through to retail prices, the smaller the increase in the sales of independent retailers will be and therefore the smaller the increase in market share achieved by Metcash. Uncertainty about the pass through may reduce the incentive to Metcash to follow such a strategy. A vertically integrated wholesaler and retailer does not face this concern.

There are ways in which Metcash can reduce this incentive problem. One way is to reduce wholesale prices on advertised promotions where retailers are required to charge a specified price. However, as noted before, the effectiveness of promotions can be limited by the vertical separation of Metcash and the independent retailers it supplies.

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<sup>78</sup> *ibid.*

## ACCC's view

There are number of possible reasons why Metcash's wholesale prices may limit the ability for independent retailers to compete aggressively on price, including:

- Metcash would appear to pay more to suppliers for grocery products than the MSCs.
- Metcash appears unable to achieve the same economies of scale, scope and density in wholesaling as the MSCs.
- Metcash appears able to achieve excessive margins at the only national wholesaler to independent retailers.
- The vertical separation between Metcash and the independent retailers it supplies.

It is possible that each of these factors affect the ability and incentives for Metcash to price to large independent retailers to enable them to aggressively pursue market share through price discounting.

Metcash's wholesale EBIT margins appear healthy, which may be the result of the lack of competition on wholesaling packaged groceries to independent retailers. Nevertheless Metcash appears to face cost disadvantages relative to the MSCs, through to the cost of acquiring goods from product suppliers and the relative scale of their operations. Even if these disadvantages can be resolved, Metcash's incentives to seek market share through discounting may be dampened by the different ownership of the grocery retailers it supplies.

## 7.6 Competitive constraints on Metcash

Even though Metcash appears to achieve healthy margins, it does not operate without constraint. A number of factors limit Metcash's pricing power. To varying degrees, these include constraints imposed by:

- the MSCs
- the possibility of bypassing Metcash
- independent supermarkets establishing their own wholesale operations
- retailers switching banners
- the MSCs offering wholesale supply to independent stores.

### 7.6.1 Constraints imposed on Metcash by the MSCs

Metcash submitted at the public hearing that it is significantly constrained in its pricing to retailers by the retail pricing of the MSCs:

... the real competition is at retail level and it competes with the two major chains. So the constraint in saying the word monopoly comes from the retail level in terms of what our prices are, what our promotions are, how much we can charge for service fees. That's where the competition is.<sup>79</sup>

BITRE found that:

... for many small towns independent stores are the only local source for groceries. In locations where there is no major retail chain operating, independents face either minimal competition, competition from another independent, or partial competition from stores in neighbouring towns. However, the overall market size is typically much smaller, so turnovers are likely to be constrained.

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<sup>79</sup> ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 25.

Given the differences in market conditions, it is reasonable to expect pricing strategies of independents in smaller towns to differ from those located in larger, more competitive centres.<sup>80</sup>

As a wholesaler, Metcash is not in direct competition with the MSCs. Its sole direct customers are independent grocery stores and not final retail customers. However, Metcash does compete indirectly with the MSCs. The close relationship between Metcash and the retailers it supplies means that to some extent Metcash pricing is constrained by competition from the MSCs.

Metcash noted that while it is:

... not normally a retailer, it provides pricing advice to its retailers through undertaking price checks and assisting retailers to choose a pricing strategy appropriate for their store. Metcash's pricing advice is a guide only and independent retailers are largely free to set their own prices.<sup>81</sup>

Metcash supplies retailers with an invoice, which includes a recommended retail price that the retailer can use in their store. The ACCC understands from confidential information received that retailers are then able to choose different price files that reflect the level of price competition they wish to engage in.<sup>82</sup> For example, a large independent retailer who is trying to compete with Coles and/or Woolworths on price for biscuits may request a pricing file that prices biscuits at a certain percentage below Woolworths' or Coles' pricing, but for other product categories may choose the base price file. The ACCC also understands that in certain circumstances retailers will specify the gross profit they wish to make on certain product categories, and Metcash will tailor their price file accordingly. The pricing invoices also include the gross profit that will be made if the recommended price given by Metcash is adopted.

If Metcash decides to increase its wholesale prices to independent retailers, independent retailers are faced with two options:

- either absorb the cost increases in the form of lower per-unit margins or
- pass on the increased wholesale price to consumers, thereby maintaining their per-unit margins.

Either of these responses is likely to result in Metcash losing sales volumes. If independent retailers increase their retail prices (to recover higher wholesale prices), it is likely that they will lose customers to other grocery retailers including the MSCs. If independent retailers accept lower per-unit margins, they will have less profit to reinvest in their business to improve their retail offer, and some may even go out of business. Either way, Metcash may lose volume to the MSCs. This (indirect) competition with the MSCs has the effect of constraining Metcash's wholesale pricing.

### ACCC's view

The ACCC considers that competition with the MSCs does constrain Metcash. If Metcash raised its prices too far, it would clearly damage the large independent retailers, who would stand to lose substantial amounts of business. This would in turn damage Metcash as its revenue would fall.

However, the constraint of retail competition on Metcash's wholesale pricing is not as strong a constraint as it would be on a vertically integrated company equivalent to the Metcash – IGA network. A vertically integrated grocery retailer will ultimately absorb the entire downside to increased wholesale prices. In contrast, Metcash as a non-vertically integrated wholesaler has a certain ability to pass on some of the impact of increased wholesale prices to independent stores that may be willing to accept lower margins. This arguably gives Metcash a certain 'cushion' from the full effects of retail competition.

<sup>80</sup> BITRE, submission no. 188, p. 12.

<sup>81</sup> Metcash, submission no. 181, p. 47.

<sup>82</sup> ACCC, public hearing transcript, Canberra, 9 April 2008, p. 16.

## 7.6.2 Constraints imposed by the possibility of bypassing Metcash

One of the constraints operating on Metcash is the possibility that retailers will source a higher percentage of products directly from producers, thus cutting Metcash out of the supply chain.

NARGA noted that:

... an independent retailer is likely to purchase from the major wholesaler as little as 45 per cent of what he sells, sourcing the rest direct.<sup>83</sup>

FoodWorks in particular noted that independent retailers can go direct to suppliers in certain circumstances, but that this is rare and suppliers are generally unwilling to deliver small quantities of goods to individual stores, preferring to go through Metcash.

The cost of distribution across the retail network is usually prohibitive for direct supply arrangements to be able to compete with the major distribution centres.<sup>84</sup>

### ACCC's view

The ACCC, while noting that in certain circumstances suppliers are prepared to supply direct to retailers, does not consider that, on the whole, the possibility of sourcing supply directly from suppliers is a real constraint on Metcash. This issue is discussed further at section 7.7.5 in relation to specific clauses Metcash has with suppliers deterring direct dealings with stores.

## 7.6.3 Constraints imposed by independent supermarkets establishing their own wholesale operations

A potential risk for Metcash is the possibility of a large independent supermarket chain establishing its own wholesaling operation. Establishing a wholesale operation would give the retailer greater direct control over its sources of supply. However, establishing a wholesaling operation requires considerable investment, management effort and risk. For such investment to be commercial, the retailers serviced by any new wholesaler must be of sufficient size to achieve unit costs comparable or better to those offered by Metcash. Barriers to entry into wholesaling are discussed later in this chapter.

Although Metcash has argued that this is a potential constraint on its pricing, other parties have argued that independent supermarkets establishing their own wholesale operations (or alternatively joining a new wholesale operation that may enter the market) is extremely unlikely.<sup>85</sup>

### ACCC's view

While it may be possible for a number of independent supermarkets to establish their own wholesale operation, the ACCC considers that the initial costs of setting up a rival wholesale network either within one state or nationwide may be prohibitive. Franklins had a distinct advantage over other chains of independent retailers, such as FoodWorks, in that it was only located in New South Wales. This meant that when Franklins established its own wholesale operation it only had to establish warehousing and transport infrastructure in New South Wales, rather than across all of Australia. Franklins was also in a different position to other independent retailers in that it had backing from its parent company, Pick n' Pay, who were prepared to outlay significant capital to establish Franklins' wholesaling operations.

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83 NARGA, submission no. 129 (part B), pp. 26–27.

84 FoodWorks, submission no. 90, p. 44.

85 Mr Peter Bunn submission no. 58, p. 12.

The risks involved in establishing a nationwide wholesale distribution network are great, and may be considered too great for most retailers or groups of retailers, therefore preventing independent retailers breaking away from Metcash. The ACCC considers that a more feasible option may be for a new entrant to set up a wholesale distribution network within one state or throughout the east coast states. This issue is discussed further at section 7.7.2.

#### 7.6.4 Constraints imposed by retailers switching banners

A further alternative for independent retailers may be to join another established supply chain. For example, it may arguably be open to some independents seeking to obtain better terms of supply to join the Franklins or SPAR banners. Franklins stated that 'in order to entertain our prices and our ranges of house brands, the independent would have to take the ... to operate under the Franklins banner.'<sup>86</sup>

A further alternative for some stores could potentially be to realise the value of their retail site by selling it to an MSC, ALDI or other retailer, rather than continuing in business. The MSCs have previously used acquisitions of independent stores as a means of expansion. This issue is discussed further in chapter 19.

##### ACCC's view

The ACCC acknowledges Metcash's argument that independent retailers may be able to access 'an alternative supply chain with Franklins'<sup>87</sup>, and while considering that this may be true in certain circumstances in New South Wales, the ACCC also considers that the required rebranding of stores to Franklins is likely to act as a deterrent for many existing independent retailers.

The ACCC notes the various acquisitions in the past of independent retailers by the MSCs. In particular, the acquisition of ex-Franklins stores by Woolworths and various acquisitions by both Coles and Woolworths of individual stores around Australia is a clear indication that where independent stores are not profitable, yet offer a potentially profitable site for another chain, there is a willingness of these chains to acquire the sites.

In terms of the typical store size of independent retailers, the ACCC is of the understanding that the sizing limitations of sites may mean many stores are unattractive for the MSCs, which tend to prefer large sites that are easily adaptable to their preferred format.

#### 7.6.5 Constraints imposed by the MSCs offering wholesale supply to independent stores

A further possible constraint on Metcash is direct competition in wholesaling from the MSCs.

Up until 2002, Woolworths ran its own wholesaling operation, AIW. Since AIW ceased operations, neither Woolworths nor Coles have made any obvious moves towards commencing a wholesaling business that would supply independent retailers.

##### ACCC's view

The ACCC considers that it is highly unlikely that either Coles or Woolworths would consider setting up their own wholesaling operations to supply independent retailers.

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<sup>86</sup> ACCC, public hearing transcript, Sydney, 1 April 2008, p. 50.

<sup>87</sup> ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 49.

## 7.6.6 Constraints imposed by the possibility of collective bargaining

The ACCC notes the above constraints and considers that they limit the ability of independent retailers to compete on price with the MSCs. One means by which small businesses can seek to establish a degree of countervailing power in negotiations with a larger business is by coming together and collectively negotiating with the larger business. While such arrangements would ordinarily raise concerns under the Act, the ACCC is able to grant immunity for collective bargaining arrangements where it considers that such arrangements are in the public interest.

For example, in September 2007 the ACCC granted authorisation for a group of stationary retailers, Office Choice Limited, Office National Limited and Office Depot Products Limited, and their franchisees, to collectively bargain the terms and conditions on which wholesale suppliers of office products will supply them.<sup>88</sup> In authorising the arrangements the ACCC considered that, amongst other things, allowing the stationary retailers to collectively negotiate with stationary wholesalers would allow them to obtain wholesale supply at lower cost than would otherwise be the case, and that this was likely to be reflected in lower prices for consumers. The ACCC's consideration of applications for immunity from the Act for collective bargaining arrangements is discussed in further detail in appendix H.

The ACCC assesses each application on a case by case basis. While the ACCC is not able to give guarantees to prospective applicants, independent retailers wishing to negotiate better terms and conditions with Metcash for the supply of packaged groceries may wish to consider the benefits associated with collective bargaining.

Often, an industry association will coordinate an application for authorisation of a collective bargaining notification on behalf of their members. However, to that end the ACCC notes that NARGA has publicly stated that its role is not to facilitate such coordination, but rather is to lobby government.<sup>89</sup>

NARGA gave evidence at a public hearing that its funding is primarily sourced from Metcash (around 80 per cent). The remainder of NARGA's funding is sourced from individual independent retailers or state based associations representing independent stores.<sup>90</sup>

The ACCC considers that NARGA's position as a representative of independent retailers is compromised as a result of their majority funding coming from Metcash, the only national supplier to NARGA's members. For example, the ACCC does not consider that NARGA can represent the independent retailers effectively in relation to issues of wholesale supply arrangements when NARGA receives 80 per cent of its funding from the only national wholesaler, Metcash.

## 7.7 Factors limiting the competitive constraints imposed on Metcash

The most likely way in which Metcash will face greater competition is the entry of a second major independent wholesaler. This would likely come through the sponsorship of a new entrant by a major independent retailer such as FoodWorks, Foodland or Ritchies.

This section discusses the barriers to such entry.

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88 ACCC Determination, application for authorisation A 91058 lodged by Office Choice Limited, Office National Limited and Office Products Depot Limited in respect of collective bargaining with office product suppliers, 19 September 2007.

89 ACCC, public hearing transcript, Canberra, 9 April 2008, p. 37.

90 ACCC, public hearing, Canberra, 9 April 2008, pp. 42–43.

## 7.7.1 Economies of scale in wholesaling

When Metcash was questioned in the ACCC's public hearings about the margins it makes given its position in the wholesale market, and the effect that any possible entry into the wholesale market may have on its margins, the following discussion took place:

MR O'DONOVAN: Sure, but even if they could do things exactly the same, they could also deliver to customers goods at a lower margin?

MR REITZER: I suppose they could, yes.

MR O'DONOVAN: All right. So it's possible that there might be an improvement in the independent sector in terms of its price competitiveness if there was a competitive wholesaler introduced to compete against Metcash?

MR REITZER: Yes, the barriers to entry in terms of wholesale distribution are quite low, as was evidenced by the Franklins case. They went to a transport company. They had a spare warehouse, and they set up a warehouse with them very, very quickly, and obviously very, very cheaply. And so it's not, like, difficult to get a warehouse in Australia; it's not difficult to get the trucks, the technology. Everyone knows exactly what technology we use. You just buy it off the shelf. We don't have a technology. So they would be able to set up a warehouse. The big question is how much volume they can pump through it.<sup>91</sup>

This exchange indicates that there is the potential for improvement in wholesale price competition if another wholesale competitor entered the market. However, Metcash contends that the real barrier to entry is aggregating sufficient volume to make the operation viable.

Evidence presented to the ACCC indicates that Franklins had an advantage in setting up their wholesale business as they were situated only in New South Wales and therefore did not have the logistics issues which are likely to arise for products being shipped all over Australia. Further, Franklins had the backing of Pick n' Pay who were able to fund their wholesaling division.

Metcash stated that new entrants into the wholesale market could deliver goods to retailers at lower margins than those currently achieved by Metcash. This illustrates the lack of competition in the wholesale market. As a result, retailers are potentially paying higher prices to purchase goods than might otherwise be the case.

Franklins noted:

Economies of density, scale and scope in grocery retailing are extremely ... Without these economies the costs to operate a profitable and competitive retail chain is prohibitive.<sup>92</sup>

Metcash noted that:

An effective 'third force' in the grocery retailing market would need to achieve significant economies of scale, scope and density in order to compete effectively with the MSCs ...<sup>93</sup>

The ACCC believes that the difficulty for vertically integrated players such as Franklins and ALDI to build a critical mass of stores within new regions—to gain access to these economies of scale and density—has hampered their ability to expand in Australia.

Taking Franklins as an example, its approximately 80 stores are all located within New South Wales, which takes advantage of economies of density. If Franklins' stores were instead spread around Australia, it would suffer from a lack of economies of density.

91 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 42.

92 Franklins Pty Ltd, submission no. 104, p. 4.

93 Metcash, submission no. 181, p. 35.

The ACCC notes that while Metcash's dollar CODB has generally been growing, in every period from 2001–02 to 2007–08, it grew by less than sales (and was negative in 2004–05). This might suggest some economy of scale benefits from its significant sales growth.

The ACCC considers that there are substantial barriers to entry to establishing a new wholesale operation on either a national or state-wide basis. The ACCC does not consider that a new wholesaler could be immediately profitable. For a new wholesaler to be profitable the ACCC considers that it would be necessary for the new wholesaler to attract a significant number of retailers to ensure that significant volumes are passing through the wholesaling operation.

The ACCC also considers that the wholesaler would need to not only attract individual retailers, but also larger 'chains' of retailers, such as FoodWorks or Ritchies. As noted above, this may be difficult for a new wholesaler to do, as Metcash has recently taken minority shares in some of the larger independent chains. Another alternative may be for an independent chain to break away from Metcash and set up their own wholesaling operation (as done by Franklins.)

The ACCC does not consider that the minimum efficient scale to run a profitable wholesaling operation are as great as Metcash's current scale. Further, the ACCC considers that a wholesaling operation run on a state-wide basis, rather than a national operation, may more easily achieve the economies of scale needed. This is particularly true in some of the heavily populated east coast states. That said, it is impossible to comment definitively on the exact conditions needed in the wholesale grocery market to allow a second large wholesaler to compete against Metcash. The ACCC notes that Franklins, who have 80 stores, publicly stated that they have reached the critical mass required to run a profitable vertically integrated chain in New South Wales.<sup>94</sup> As such, the ACCC considers that on a state basis, a wholesaler would need to have guaranteed annual sales of between \$800 million and \$1 billion to be viable.

## 7.7.2 Barriers to switching from Metcash

The ACCC has received confidential information from various parties relating to barriers to switching that have the potential to cement Metcash's position as the only nationwide wholesaler. While the ACCC has not at this stage investigated the allegations made by various parties to determine if there is a breach of the Act, the ACCC is concerned that the potential for Metcash to take advantage of its position as the only national wholesaler may be limiting the ability of independent retailers to break away from Metcash.

Evidence received suggests that Metcash engages in conduct that has the potential to prevent independent retailers using alternative supply arrangements, such as establishing their own wholesaling operations. The alleged conduct is varied, but involves Metcash including specific clauses in contracts making it difficult for retailers to exit supply arrangements, withholding of rebates and lowering of service levels. Confidential evidence suggests that such barriers would make it uncommercial for independent retailers to terminate their supply arrangements with Metcash.

The ACCC understands from interested parties that a drop in service levels not only reduces short-term profits, but also has a long-term detrimental impact on the store's reputation with customers. Confidentially, the ACCC has received submissions from independent retailers suggesting they are reluctant to consider the possibility of leaving Metcash, as if they do Metcash has the ability to damage their reputations by reducing service levels. A reduction in service levels might, for example, lead to stock shortages in critical product lines.

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<sup>94</sup> ACCC, public hearing transcript, Sydney, 1 April 2008, p. 54.

It has been confidentially submitted that if Metcash were to withhold rebates for a sustained period, independent retailers would fail. The ACCC would be concerned if Metcash were to withhold rebates in an attempt to prevent independent retailers sourcing an alternative supply arrangement.

### 7.7.3 Equity stakes by Metcash

The ACCC also notes that while Metcash does not operate independent retailers, it has in the last few years taken a financial interest in some of the larger independent retail chains, such as Ritchies in Victoria. Metcash's financing can help independent retailers to grow their stores and improve their competitiveness. It can also have the effect of tying these retailers to Metcash.

At a public hearing Metcash explained their strategy for taking minority equity stakes in some of the larger more successful independent chains:

MR O'DONOVAN: Okay. And is one of the consequences of taking that equity position that they're, effectively, locked into the or, at least, Metcash is able to strongly influence them to retain acquiring their volumes from the Metcash group?

MR REITZER: That's correct.

MR O'DONOVAN: Okay. So its part of a lock in strategy?

MR REITZER: That's correct.

MR O'DONOVAN: Okay. And it's primarily employed in those larger groups?

MR REITZER: It's only employed in the larger groups.<sup>95</sup>

The ACCC understands Metcash has also employed a strategy of taking equity investments in fresh fruit and vegetable wholesalers. On 4 December 2007, Mr Reitzer commented that:

... instead of growth by knocking on the door, it is going to be growth through acquisition ... There are about eight (fruit and vegetable wholesalers) that we got lined up [sic].<sup>96</sup>

#### ACCC's view

The ACCC considers that Metcash taking minority equity positions in large independent chains can assist in making the chains more competitive. However, it may also have the effect of limiting the ability of a group of retailers breaking away from Metcash and commencing their own wholesaling operation.

Similarly, the ACCC considers that taking equity investments in fruit and vegetable wholesalers is ensuring that Metcash not only has capable wholesaling facilities for fruit and vegetables, but is also able to limit the number of alternative wholesalers available to supply independent retailers.

### 7.7.4 Barriers to dealing directly with product suppliers

Following a review of documents obtained from Metcash and various suppliers, the ACCC has found that Metcash includes clauses in supply agreements that require suppliers to pay rebates to Metcash for products stocked by IGA>D even where the supplier has dealt directly with retailers. The ACCC considers that such clauses make it economically unattractive for suppliers to deal directly with retailers. The ACCC is concerned that these agreements discourage direct dealings between the supplier and independent retailers by increasing the cost of direct supply and/or reducing the discounts that might otherwise be available to the retailer.

<sup>95</sup> ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 69.

<sup>96</sup> *Sydney Morning Herald*, 'Metcash books 30 per cent rise in H1 profit', viewed 26 June 2008, [www.smh.com.au](http://www.smh.com.au).

The arrangements ensure Metcash is made aware of the details of direct supply. This information would enable Metcash to identify competitive threats and employ responses to deter emerging competitive supply.

Given Metcash's dominant position in the wholesale market any restriction on potential competitive tension may have a significant anti-competitive effect. The ACCC will closely examine any these arrangements and any complaints received that relate to such clauses in agreements with Metcash.

### 7.7.5 IGA Fresh

IGA Fresh is a division of Metcash which supplies fruit, vegetables, meat, deli and bakery to independent retailers. The fresh food capability was acquired by Metcash as part of Foodland Associated Limited and operates as a division of IGA>D until it was formally established as a separate division in November 2007. Metcash submits that it has plans to grow the IGA Fresh business, which currently services around 280 stores in Western Australia and Queensland.<sup>97</sup> In its evidence at a public hearing, Metcash noted that the fresh component of a retailer is vital to success, commenting that:

in retail today, if you don't have good fresh mix in your supermarket you don't have as profitable supermarket as one that only sells dry groceries [sic].<sup>98</sup>

In relation to fresh produce, Metcash has devised a separate set of trading terms, rebates and pricing to their packaged grocery operations through IGA>D. Metcash submits that its pricing format is determined by the quality of produce desired by each retailer.<sup>99</sup> A further addition to the rebates, allowances and various discounts that will relate to fresh produce is the teamwork score or teamwork rebate, which is based on the volume of both packaged and fresh grocery items sourced from Metcash. Metcash submits that retailers will:

... get your [their] trading terms on dry, frozen and chilled, you would get your [their] trading terms on fresh, and then over the top of that there would be an umbrella that says if you ... buy from us ... 85 per cent there might be another X percentage over that which is sharing the benefits of the volume—more volume coming out of one distribution centre.<sup>100</sup>

Metcash further contends that they will not use the power they have as the only national wholesaler to force independent retailers to source their fresh produce from Metcash.<sup>101</sup>

In a public hearing, the Kondouris Group noted that their ability to source fruit and vegetables directly from the supplier allowed them to be more competitive with the MSCs.<sup>102</sup>

The ACCC has received confidential evidence from industry participants expressing concerns about Metcash's move into wholesaling of fresh products. In particular, concerns have been raised about Metcash attempting to take over the supply of fresh produce and, subsequently the potential for Metcash to limit the independents' ability to deal directly with producers. Concerns also relate to the possible inclusion of exclusivity clauses in trading terms and supply agreements which would result in Metcash taking a percentage of any rebates, allowances or other discounts negotiated between retailers and suppliers, as they currently do for other products.

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97 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 63.

98 *ibid.*, p. 35.

99 *ibid.*, p. 63.

100 *ibid.*, p. 64.

101 *ibid.*, p. 64.

102 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 19.

## ACCC's view

The ACCC has concerns that Metcash intends to use its move into IGA Fresh and the subsequent use of the teamwork score to exert influence over those retailers who continue to buy their fresh produce directly from suppliers.

While the ACCC acknowledges that increasing volumes supplied by Metcash decreases its costs, Metcash should not use its position as the only national wholesaler of packaged groceries to compel retailers through the teamwork score initiative to buy fresh produce from Metcash. The ACCC would be concerned if Metcash moved to decrease rebates on packaged groceries to those independent retailers who did not source fresh products from IGA Fresh, or introduced a teamwork structure that created disincentives for its retailers to acquire fresh product from other wholesalers.

The ACCC is also concerned that Metcash may be seeking to extract a greater proportion of the joint surplus arising from the Metcash-independent value chain. There is reason to believe that independents' sales activities and returns in fresh foods contribute very substantially to any commercial buoyancy that currently exists in independent grocery retailing. There is similarly reason to believe that Metcash may be attracted to the strong margins that independents enjoy on fresh foods that are non-Metcash sourced, and may be seeking to use its pricing power in wholesaling packaged groceries to effectively compel its associated independents to transfer some of the resulting surplus to Metcash by sourcing those items from Metcash, on terms favourable to Metcash. There is consequently some concern that the further move into IGA Fresh, and the kind of terms and conditions which may be utilised by Metcash, could have a further negative impact on the financial and competitive health of the independent grocery retail sector.

Concerns that have been raised by interested parties will be the subject of further examination by the ACCC.

### 7.7.6 Lack of transparency in Metcash pricing to retailers

It is industry practice for suppliers to give various discounts and allowances to wholesalers and retailers. The discounts and allowances Metcash receive can be incorporated into the trading terms of supply agreements between Metcash and the retailers it supplies. Discounts, for example, can include early payment discounts, promotional advertising discounts, and 'efficiency' discounts from efficient ordering practices or purchasing economic volumes that result in a reduction in overall logistical costs.

Concerns regarding information asymmetry and, more generally, a lack of transparency in Metcash's prices have been raised during the inquiry and at the hearings. For example, Peter Bunn submitted:

... due to the lack of disclosure by Metcash to its customers, the independent retailers, those retailers have no way of identifying, or understanding, the inputs to the cost of groceries to [sic] which they pay.<sup>103</sup>

From the independent retailers' perspective, the information disadvantage could affect their bargaining position and make it difficult to monitor supply agreements with Metcash. As contended by Franklins:

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.<sup>104</sup>

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<sup>103</sup> Peter Bunn, submission no. 194, p. 10.

<sup>104</sup> Franklins, submission no. 104, p. 2.

Some parties have suggested that the ACCC should recommend imposing binding requirements on Metcash to ensure transparency of wholesale costs to enable retailers to put downward pressure on prices. As noted by Peter Bunn:

So as to enable independent grocery retailers the ability to make fully informed commercial decisions as to wholesale purchasing, and subsequent retail pricing of grocery products in Australia, and assist in creating more active retail pricing of grocery products in Australia, the ACCC should consider the recommendation of legislation for full disclosure by grocery wholesalers as to the pricing inputs that are included in the final wholesale price charged by grocery wholesalers to grocery retailers, as this would provide truth and accuracy on which grocery retailers could make retail pricing decisions that would eventuate in a more aggressive retail pricing strategy, resulting in far more competition for the grocery consumer.<sup>105</sup>

Peter Bunn submitted, following on from a discussion of the lack of competition in the wholesale area:

... This in turn has created a detrimental position for independent retailers in that due to the lack of number of broad-based wholesalers they have been forced to enter into terms of supply with Metcash that both restricts their [independent retailers] ability to find alternative wholesale supply, and secondly hinders any party who may consider entering into the wholesale supply of grocery products to independent retailers, as the majority of independent retailers are contractually 'handcuffed' to Metcash ...<sup>106</sup>

The ACCC has received other evidence similar to that provided by Mr Bunn.

### ACCC's view

When businesses are better informed about their costs than their rivals, they will have an incentive to use such information to their advantage. Indeed, Metcash has an incentive to legitimately hold the terms negotiated with its suppliers confidential and subsequently increase its own bargaining power in dealings with the independent retailers.

The ACCC has some concerns about the substantial litigation costs arising from disputes regarding supply agreements as, for example, experienced by Franklins. However, intervention in the form of a legal requirement to compel Metcash to disclose the supply terms it enjoys would potentially create a situation where the MSCs and other wholesalers enjoy a competitive advantage over Metcash in negotiations with suppliers. Further, incomplete information is the normal situation when economic decisions have to be made, and it is not the ACCC's practice, nor does it have a statutory mandate, to intervene every time informational asymmetry favours one party to a transaction.

The issue of transparency is, to a degree, a distraction from the more fundamental issue facing independent retailers. Even if independent retailers knew precisely what terms Metcash was receiving from suppliers, there are no realistic alternative sources from which they can obtain supply. With few alternatives for independent retailers in supplying packaged groceries, an independent retailer is not in a position to demand a greater share of the rebates and discounts that Metcash is receiving even if they knew the precise terms.

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<sup>105</sup> Peter Bunn, submission no. 58, p. 11.

<sup>106</sup> Peter Bunn, submission no. 58, 10 March 2008, p. 12.

## 7.8 Conclusion

Although the independent grocery retailing sector serviced by Metcash has grown in recent times, the ACCC has found that this is mainly in smaller stores that largely compete on location and convenience rather than price. Large independent retailers may be able to more readily compete on price with the MSCs if Metcash priced packaged groceries in a more competitive manner. The ACCC has found that Metcash appears to price 'under the umbrella' set by the MSCs pricing, therefore allowing very few stores to aggressively compete with the MSCs on price. Evidence indicates that independent retailers supplied by Metcash who compete aggressively with the MSCs on price make small net margins on the products Metcash supplies them.

The ACCC has found that although there are some exceptions, evidence suggests that the MSCs pay closer attention to the pricing of each other and ALDI than Metcash-supplied independent retailers.

There is some evidence that Metcash is acting to protect its position as the only national grocery wholesaler supplying independent retailers. Given Metcash's dominant position in the wholesale market any restriction on potential competitive tension may have a significant anti-competitive effect.

The ACCC believes that efforts to reduce impediments faced by independent retailers to seek alternative wholesaling arrangements will increase the pressure on Metcash to improve its offer to independent retailers, particularly its price offering. In turn this may improve price competition in grocery retailing by enabling the larger independent stores to compete more aggressively with the MSCs on price.

## 8 Competition from other retailers

### Key points

- ALDI has a significant effect on the pricing of the major supermarket chains (MSCs). This is most pronounced on the products that the MSCs consider are most comparable to those offered by ALDI. These are primarily private label products.
- Franklins has a strong impact on the pricing behaviour of Coles, although this is restricted to the geographic area in which it operates (New South Wales). ACCC analysis suggests the direct effect of Franklins on Woolworths' pricing behaviour is weak.
- Specialty retailers provide consumers with a significant alternative to supermarkets in purchasing fresh products. The vast number of specialty retailers and the low barriers to setting up specialty grocery outlets mean specialty retailers provide a strong competitive force in retailing fresh products.
- Entry or expansion of retailers with models such as ALDI's or Costco's provide the most likely source of greater competition in grocery retailing in the immediate future.

### 8.1 Introduction

The preceding chapters examined competition firstly between the MSCs, followed by the competitive impact of Metcash-supplied independents. This chapter examines the competition from those independent retailers that are not supplied by Metcash, namely ALDI, Franklins, retailers supplied by SPAR and Costco. It also examines competition from specialist retailers, such as fruit and vegetable shops, bakeries, butchers and fishmongers.

### 8.2 ALDI

ALDI is one of the world's largest retailers, operating in 16 countries with over 7500 sites worldwide. It is privately owned.

Since entering the Australian grocery industry in January 2001, ALDI's network has grown to approximately 170 stores operating across New South Wales, the Australian Capital Territory, Queensland and Victoria. Many ALDI stores were developed on vacant or greenfield sites, but more recently it has established stores in shopping malls. The majority of ALDI stores are located in metropolitan and urban areas, but it also has more than 20 stores in rural areas. ALDI states that an attractive prospective location should have an immediate catchment population of more than 20 000 people.<sup>1</sup>

In late 2007, ALDI introduced unit pricing in its Australian stores for most grocery items and remains the only grocery retailer to have done so to date. This involves the display of both the sale price, and the per-unit cost of the item. Typically, unit prices are displayed per 100 grams, kilogram or litre and allow consumers to readily compare the relative price of items across different product sizes.

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<sup>1</sup> [www.aldi.com.au](http://www.aldi.com.au).

Like the MSCs, ALDI is vertically integrated and deals directly with suppliers. Most products are delivered to stores via one of ALDI's centralised distribution centres. The majority of products sold by ALDI are its own brand labels. These products are often packaged and presented in a way that mirrors a leading brand sold at Coles and Woolworths. ALDI's product range is similar in all its stores across Australia.<sup>2</sup>

### 8.2.1 How does ALDI compete with the MSCs?

ALDI focuses on the price conscious consumer, offering what it submits is a 'carefully selected range of 900 products, designed to match the needs of a consumer's weekly shopping requirements'.<sup>3</sup> ALDI stocks a wide range of products but generally has a limited number of brands for each product type. This smaller range represents one of the main differences between ALDI and the MSCs and enables ALDI to operate out of smaller stores than its competitors. It therefore has reduced overheads, including rent, utilities and payroll, compared to competitors with larger premises.<sup>4</sup>

Over half of the respondents to the ACCC's consumer survey stated that they had shopped at ALDI and that price was the key reason for doing so. The main reason given in the survey for not shopping at ALDI was that it was too far away or not yet in the respondent's state. Perceptions of quality have not been a significant factor in deterring shoppers from shopping at ALDI, with only 2 per cent of respondents stating that quality was the reason why they had not shopped at ALDI.<sup>5</sup>

In an attempt to reduce overheads and keep prices low, ALDI stocks products on shelves in pallets or boxes and customers have to purchase plastic bags. The number of service staff is also kept to a minimum, and its checkout system is designed to minimise both labour costs and queue times, with customers packing their own items. ALDI also minimises its costs by generally not undertaking significant advertising and marketing campaigns. Submissions to the inquiry have also indicated that ALDI is thought to have lower overheads than the IGAs and FoodWorks.<sup>6</sup>

The introduction of ALDI and its predominately private label offer drew a competitive response from the MSCs. As discussed in section 16.3 of this report, the introduction of ALDI was the primary driver behind the MSCs significantly increasing the number of private label products they offer.<sup>7</sup>

ALDI made submissions on issues that it argued adversely affect its competitive position within the Australian grocery industry, including that:

- consumers may find it difficult to make comparisons between its exclusive, private label brands and proprietary branded products sold by other retailers
- there is a lack of access to suitable sites, particularly within existing shopping centres, hampering ALDI's expansion in Australia and forcing it to pursue 'out of centre' sites.<sup>8</sup>

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2 ALDI, submission no. 81, p. 7.

3 *ibid.*, p. 1.

4 *ibid.*, p. 2.

5 ACCC, Survey of grocery consumers.

6 Horticulture Australia Ltd, submission no. 91, p. 11.

7 ACCC public hearing transcript, Melbourne, 26 May 2008, p. 56.

8 ALDI, submission no. 81, p. 10.

## Recent changes in Woolworths pricing policy

During the ACCC's public hearings, Woolworths stated that it had changed its pricing practice over the preceding 12 months towards more uniform prices across a broad range of items.<sup>9</sup> Woolworths' pricing policy is discussed in more detail at section 5.3.1. Before this change in pricing practice, Woolworths set different prices for a range of (primarily private label) products in many stores with an ALDI store in the immediate vicinity. Woolworths has since extended the pricing strategy applying to its supermarkets operating in the vicinity of an ALDI store to apply to all of its supermarkets in the eastern states.<sup>10</sup>

## 8.2.2 Evidence of local price competition provided by ALDI

To assess the effects of local price competition, the ACCC conducted an extensive empirical study of the MSCs' local store pricing. The findings of this study regarding the impact of ALDI are discussed here. The full results of the study can be found at appendix D.

In this study, the ACCC separately measured differences in the prices consumers paid for the same products across individual Woolworths supermarkets and across individual Coles supermarkets. Once these price differences were measured, the ACCC analysed the factors causing the price differences across stores (including local competition).

It is important to note that the statistical analysis undertaken by the ACCC only detects the effects of price competition on differences in prices across stores. For example, the extent to which pricing by ALDI produces a pricing response from Coles or Woolworths across all stores, or all stores within a certain distribution area, will not show up in this analysis. Further, as noted below, Woolworths' move to more uniform pricing during 2007 and early 2008 means that this analysis will likely understate the effect of an ALDI on Woolworths local store pricing going forward.

ALDI can affect the MSCs local store pricing in two ways:

- Firstly, by influencing the standard shelf prices and promotional prices set by the MSCs. Information provided to the ACCC indicates that the MSCs set different shelf prices and promotional prices depending on the presence of local competitors.
- Secondly, the MSC store managers may match the prices of local ALDI stores.

The results from the ACCC study indicate that ALDI has a significant influence on the MSCs local store pricing. For example, over 2007 the presence of a closely located ALDI store had the following effects on Coles local store pricing:

- average prices that consumers paid at a Coles store with the closest ALDI within 1 km were on average around 0.8 per cent lower than the average prices consumer paid at Coles stores without an ALDI within 5 km.
- average prices that consumers paid at a Coles store with the closest ALDI between 1 to 5 km away were on average around 0.6 per cent lower than the average prices consumers paid at Coles stores without an ALDI within 5 km.

These effects are significant, noting that Coles EBIT margin in its food and liquor division was 3.39 per cent in 2006–07. As shown in chart 8.1, close to 50 per cent of Coles stores have an ALDI within 5 km.

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9 ACCC public hearing transcript, Melbourne, 19 May 2008 p. 53.

10 Except for a limited number of remote stores as described by Woolworths at the ACCC's public hearing.

This local pricing response by Coles to the presence of an ALDI store is particularly strong for a range of products (primarily private label products) that Coles consider are comparable to many of the products ALDI has on offer. For example, over 2007, for these products:

- average prices consumers paid at a Coles store with the closest ALDI within 1 km were on average around 5.1 per cent lower than the average prices consumer paid at Coles stores without an ALDI within 5 km
- average prices consumers paid at a Coles stores with the closest ALDI between 1 to 5 km away were on average between 3.4 and 4.2 per cent lower than the average prices consumers paid at Coles stores without an ALDI within 5 km.

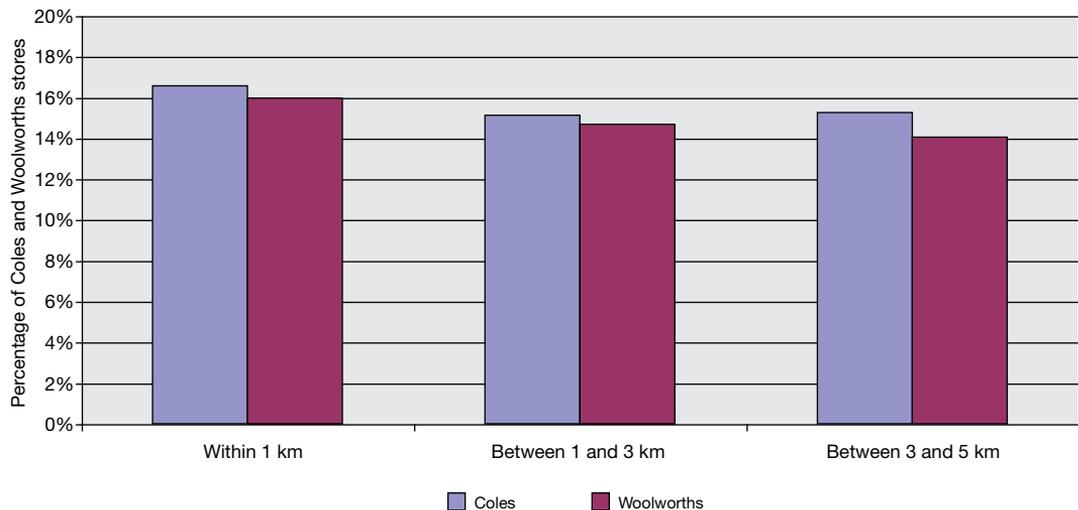
As noted above, Woolworths has recently changed its pricing practice in respect of ALDI. Before the change, ALDI had a significant effect on Woolworths pricing at the store level. For example, over 2007, the average prices consumers paid at a Woolworths store with the closest ALDI within 1 km, were on average around 0.7 per cent lower than the average prices consumer paid (for the same products) at Woolworths stores without an ALDI within 5 km.<sup>11</sup> As shown in chart 8.1, close to 16 per cent of Woolworths stores have an ALDI within 1 km.

As noted by Woolworths, it has extended the pricing strategy applying to its supermarkets in the vicinity of an ALDI store to apply to all its stores in the eastern states:

So in the case of the eastern states, you know, we had a price script that was competing against ALDI stores when they were in that area. All stores in the eastern states that have ALDIs somewhere in it, now have that same price script except for, as I said, you know, Mt Isa and stores like that that are way off the beaten track.<sup>12</sup>

As a result the effects of ALDI on Woolworths pricing at the store level now occur at the state level.

**Chart 8.1 Proximity of Coles and Woolworths stores to ALDI stores**



Source: MapInfo

11 Unlike Coles, if the closest ALDI store was more than 1 km from the Woolworths store it had little or no effect on the local Woolworths store pricing.

12 ACCC public hearing transcript, Melbourne, 19 May 2008, p. 53.

### 8.2.3 Conclusion—ALDI

ALDI competes effectively with the MSCs on price. ALDI's effect on the pricing of the MSCs is significant for the products that the MSCs consider are most comparable to those offered by ALDI. These are primarily private label products.

As part of a global retailer, ALDI has access to substantial amounts of capital. Given this situation, it was able to absorb losses until it established itself in the industry. Accordingly, its presence and growth should not be seen as evidence that barriers to entry are low, but perhaps as evidence that the Australian grocery industry is attractive for parties willing and able to risk the large amounts of capital necessary for large-scale entry.

## 8.3 Franklins

Franklins owns 74 stores and has six franchised stores, all of which are in New South Wales. It is a wholly owned subsidiary of Pick 'n Pay Stores Limited, a large grocery retailer in South Africa. As part of the 2001 divestment of Franklins Limited by Dairy Farm International, Pick n Pay acquired 50 stores in the greater Sydney area and the brand name 'Franklins'. At the same time, Pick 'n Pay acquired a further 20 Fresco-branded supermarkets.

Before 2001 Franklins was owned by Dairy Farm International and was a vertically integrated supermarket chain with distribution centres in all states in which it operated (Queensland, New South Wales and Victoria). In 2001 Franklins' mass expansion and reformatting ended in failure, with Dairy Farm International exiting Australia in May 2001 and its 287 stores being sold to a number of entities, including Woolworths (71 stores), Coles, Pick 'n Pay and IGA franchisees.

Between 2001 and 2005, Franklins was supplied with dry groceries by Metcash. In 2005 Franklins established its own distribution and logistics capabilities and buying team after terminating its supply arrangements with Metcash, claiming that it was unable to source products through Metcash at a price that allowed it to compete with Coles and Woolworths.<sup>13</sup> Franklins is now vertically integrated and all Franklins stores are supplied by its two distribution centres. Franklins does not supply unbranded independent retailers and, currently, for a grocery retailer to be serviced by Franklins, it must either be corporately owned by Franklins or under the Franklins banner.

Franklins is able to operate a vertically integrated operation with its own distribution centre because its stores are in close proximity, with nearly all stores located in the greater Sydney area. Such proximity provides Franklins with the benefits of lower costs through economies of density. Grocery retailers such as FoodWorks that operate on a national basis do not have this same degree of density and would presumably find it much harder to establish in-house distribution options. Franklins' ability to access capital through its established parent company may also have provided an advantage over other independent operators looking to expand or develop their own distribution facilities.

### 8.3.1 How does Franklins compete with MSCs?

Franklins predominately operates out of medium- or large-format stores with approximately one-third of Franklins stores being greater than 2000 m<sup>2</sup>.<sup>14</sup> Franklins sets its prices in a similar manner to the

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<sup>13</sup> ACCC, public hearing, Sydney, 1 April 2008, p. 48.

<sup>14</sup> MapInfo.

MSCs. It states that its policy is to 'establish pricing that allows it to actively compete with the MSCs'.<sup>15</sup> Franklins states that it will adopt zone or regional pricing when necessary to remain competitive with the MSCs.<sup>16</sup>

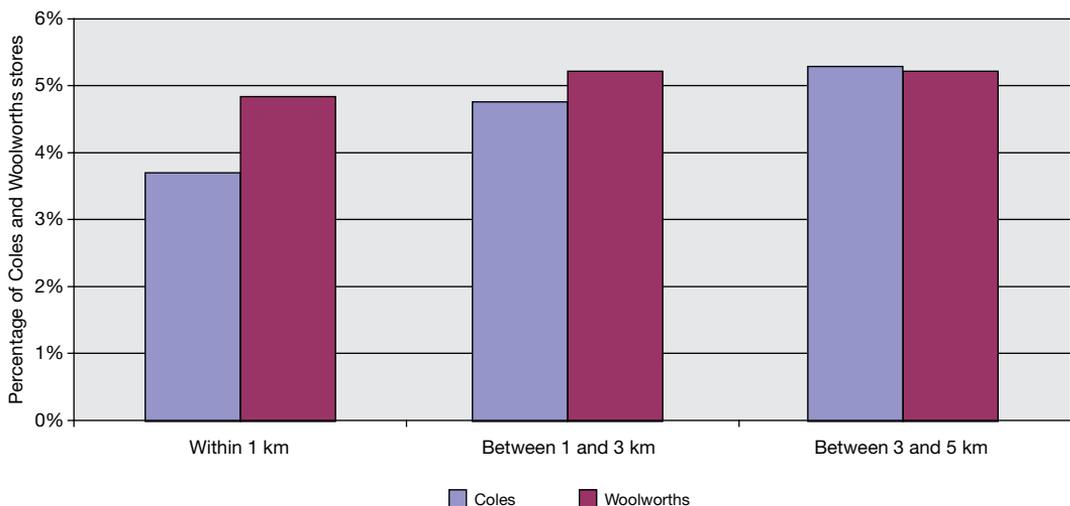
### 8.3.2 Evidence of local price competition provided by Franklins

The ACCC is aware that both MSCs price check Franklins stores as part of their regular price monitoring of other retailers. This suggests that the MSCs consider Franklins pricing to be relevant to their own pricing.

The ACCC's analysis of the MSCs' local store pricing indicates that the local presence of a Franklins stores appears to affect Coles local store pricing, particularly for dry groceries (see appendix D). For example, over 2007, consumers shopping at a Coles store with the nearest Franklins store within 3 km paid prices for dry groceries that were on average around 0.8 per cent lower than the prices paid by consumers at Coles stores without a Franklins store within 5 km. Nationally, around 8 per cent of Coles stores have a Franklins store within 3 km (see chart 8.2). Looking only at New South Wales, around 24 per cent of Coles stores have a Franklins store within 3 km. This effect on Coles' local pricing is similar to the local presence of a Woolworths store, and is a larger effect than the local presence of an ALDI store.

Franklins appears to have little effect on Woolworths' local store pricing in any trading department. This does not necessarily mean that Franklins has no impact on the prices Woolworths offers its customers. It is possible that the effect Franklins has on Woolworths pricing occurs across all its stores in New South Wales, rather than at the individual store level.

**Chart 8.2 Proximity of Coles and Woolworths stores to Franklins stores**



Source: MapInfo

<sup>15</sup> Franklins, submission no. 104, p. 9.

<sup>16</sup> *ibid.*

### 8.3.3 Conclusion—Franklins

The local presence of a Franklins store has a strong impact on the pricing of Coles, particularly for dry groceries. Franklins has only recently moved to a vertically integrated model of grocery wholesaling and retailing. It is possible that its competitive influence on the MSCs may increase as it fully establishes this model.

## 8.4 SPAR

SPAR commenced operations in Australia in 2002 by acquiring the Woolworths-owned Australia Independent Wholesalers distribution business located in Brisbane.<sup>17</sup> While SPAR operates independently in each country, it states that SPAR International is the world's largest food retailer, with approximately 15 000 stores in 35 countries.<sup>18</sup>

In Australia, SPAR is an independent grocery wholesaler that services 300 customers from a 40 000 m<sup>2</sup> distribution centre located in Brisbane, which stocks approximately 14 000 stock keeping units (SKUs). SPAR's customers are located in Queensland, New South Wales, the Australian Capital Territory, the Northern Territory and the Pacific Islands. SPAR also provides marketing and retail support to over 130 independently owned retail supermarkets and convenience stores under the SPAR and 5 Star banner groups.

### 8.4.1 Competition provided by SPAR

Most of the retail outlets supplied by SPAR are smaller format stores, servicing the convenience or 'express' market. Only 11 SPAR supplied stores are above 1000 m<sup>2</sup> in size.<sup>19</sup> Many of the SPAR supplied stores are located in regional or rural areas. Both SPAR and 5 Star-branded stores have their own private label products.

The extent to which SPAR provides a competitive constraint on Metcash (as an alternative wholesaler) in the regions it operates is unclear. Based on evidence provided by SPAR to the ACCC, over 30 stores have shifted from the Metcash supply network to become customers of SPAR, indicating a degree of churn between the two wholesalers.<sup>20</sup>

SPAR informed the ACCC that it is seeking to expand its wholesale operations and establish a second distribution centre. It considers the ability to obtain sites as one of the main hurdles to expansion. SPAR stated that it would be able to increase its SKUs if it were to gain customers who required a larger range of SKUs.

### 8.4.2 Conclusion—SPAR

From the evidence available, it appears that SPAR-supplied retail outlets do not provide a significant constraint on the pricing of the MSCs.

Given the evidence of customer churn between Metcash and SPAR, it would appear that some retailers consider the two wholesalers as substitutes. Given SPAR's stated aim to expand its wholesale operations, it remains to be seen what impact a second independent wholesaler will have on Metcash in the geographic regions in which SPAR operates.

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17 SPAR was then known as Australian Retail Logistix Limited. The current name emerged in October 2006.

18 See [www.spar.com.au/corporate.asp](http://www.spar.com.au/corporate.asp).

19 SPAR, submission no.195, p. 1.

20 Email from SPAR to ACCC, 25 June 2008.

## 8.5 Costco

Costco is one of the world's largest retailers and operates an international chain of over 500 membership warehouses in eight countries. It reported net sales of over US\$63 billion in the 2007 financial year.<sup>21</sup> Costco operates out of simple warehouses and stocks a large range of products. Costco also operates petrol stations at a number of its United States and Canadian locations. It stocks 3500 to 4000 SKUs across categories that include groceries, sporting goods, jewellery and office supplies. The company claims that size and efficiency of these warehouses allow for lower costs than traditional retailers. Costco is only open to members, offering business and individual memberships. Currently, the annual fee for membership in the US is US\$50.

Media reports indicate that Costco intends to open its first Australian store in Melbourne's Docklands precinct by mid-2009.<sup>22</sup> The reports state that Costco will occupy a 14 000 m<sup>2</sup> warehouse format store in the Docklands with construction to begin in September 2008. It is expected to stock about 4000 product lines of groceries, whitegoods, electronics, cosmetics, jewellery, hardware and furniture. Costco has not announced a membership structure for its Australian store.

### 8.5.1 What competition will Costco offer?

The arrival of Costco will introduce a new style of 'big box' retailing to Australia. Media reports state that, as Costco derives the majority of its revenue through annual membership fees, it is able to price goods at between 8 per cent and 15 per cent above cost.<sup>23</sup>

Given that Costco will initially only have one outlet, it is unlikely that Costco will provide much of a competitive constraint on the MSCs, other than perhaps in a localised area. Also, given its different format, the extent to which consumers view it as a substitute to a full service supermarket remains to be seen.

The reported introduction of Costco appears to have initiated a competitive response from Metcash, which is reported to have said it may look to set up a wholesale membership club similar to the Costco model operating in the US. Metcash stated that it has previously unsuccessfully applied to operate Campbells Cash and Carry in this manner in areas not zoned as retail.<sup>24</sup>

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21 Costco, *2007 annual report*, p. 2.

22 C. Vedelago, 'Costco warehouse retailer appeals to the big spenders', *The Age*, 23 June 2008.

23 *ibid.*

24 *Australian Financial Review*, 'Metcash tries to match Costco', 25 June 2008.

## 8.6 Competition between supermarkets and specialty stores

Supermarkets face competition from an array of specialty stores including butchers, fishmongers, bakeries, greengrocers, produce markets, pharmacies and Asian grocers. Australian Bureau of Statistics (ABS) data indicates that there are approximately 22 000 specialty stores in Australia.<sup>25</sup> The majority of specialty stores focus on fresh groceries and are a major reason the MSCs (and supermarkets overall) have a smaller percentage of retail sales of fresh groceries than packaged groceries. Specialty stores are diverse in nature, and source their products in a variety of ways. For example, bakeries often manufacture their own products, while greengrocers generally rely on local wholesale produce markets. Specialty stores may be stand alone stores owned on an individual basis, or part of a banner group, such as Harris Farm.

Because of the vast number of specialty stores, it is difficult to assess the impact specialty stores have on the pricing of the MSCs. The ACCC is not in a position to quantify the price effects specialty retailers may have on the MSCs. However, it is possible to make qualitative comments regarding the interaction between supermarkets and specialty grocery retailers. This section draws on several sources of information including ACNielsen, Roy Morgan, the ACCC's consumer survey and evidence given to the inquiry.

Competition between supermarkets and specialty retailers has evolved over time, as supermarkets have expanded their retail offer into areas that were traditionally the domain of specialty retailers. It is likely that deregulation of trading hours in many states and territories facilitated this move by supermarkets, enabling them to offer items that consumers would have otherwise purchased from specialty retailers. For example, in 1995 the Trade Practices Tribunal noted<sup>26</sup>:

The older classification of retail stores into supermarkets, top-up stores and convenience stores, with the chains dominating the first category, is becoming outmoded by reason of extended trading hours and increased customer mobility: a supermarket may be used for all categories of purchases.

Woolworths stated that there is vigorous competition between specialty stores and supermarkets as consumers 'cross-shop' between supermarkets and specialty stores. Woolworths submitted that this competition 'is evidenced through the reality that:

- consumers regularly compare the meat, seafood, delicatessen, bakery and fruit and vegetable departments in supermarkets with comparable offers of specialty retailers;
- Woolworths' fresh produce departments closely monitor development in the range and pricing of product ranges offered by specialty stores and
- specialty stores monitor the fresh produce on offer at supermarkets such as Woolworths.<sup>27</sup>

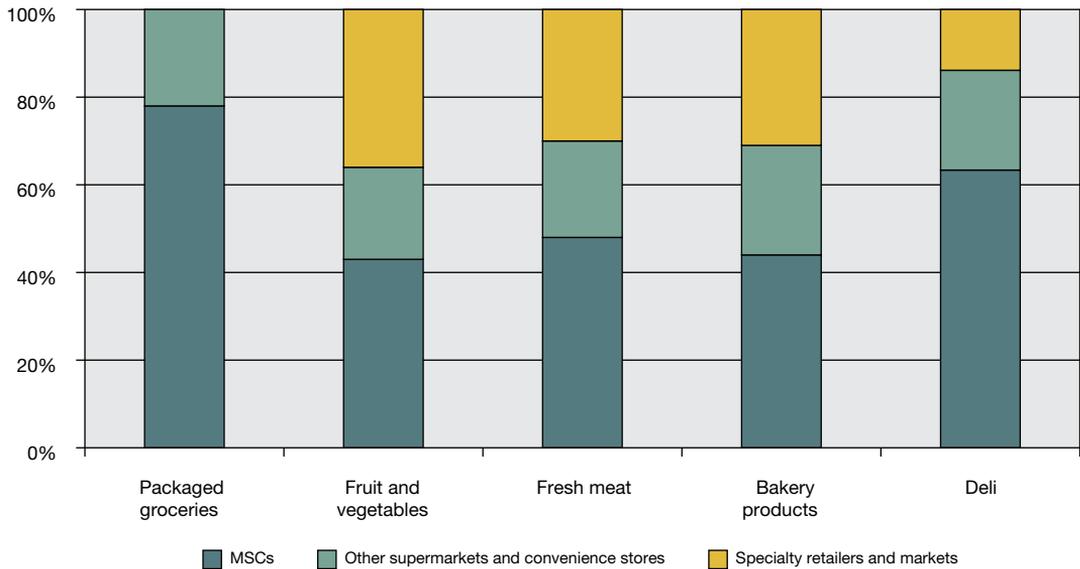
Chart 8.3 shows the relative sales of various product categories achieved by MSCs, other supermarkets and specialty stores. The MSCs have a much lower share of sales of fresh produce than packaged groceries. The category of fresh produce where the MSCs have the highest share is deli (60 per cent). Across the other three fresh categories, the MSCs share of sales is fairly even at approximately 45 per cent to 50 per cent.

<sup>25</sup> ABS, Counts of Australian businesses, including entries and exits, June 2003 to June 2007, cat. no. 8165.0.

<sup>26</sup> *Re Queensland Independent Wholesalers Ltd* (1995) ATPR 41-438.

<sup>27</sup> Woolworths, submission no. 134, p. 22.

**Chart 8.3 Sales of packaged and fresh groceries by retailer type**

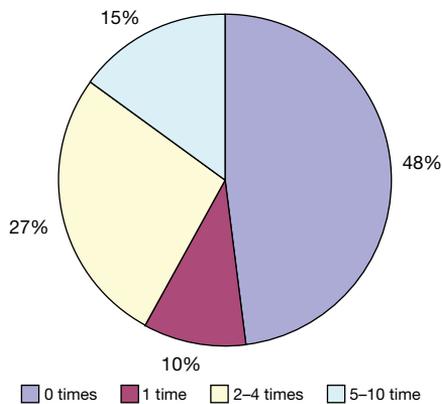


Source: AC Nielsen ScanTrack data and Roy Morgan survey data

The majority of respondents to the ACCC’s consumer survey shop at specialty stores as well as supermarkets. Chart 8.4 indicates that while 48 per cent of those surveyed had not been to a specialty store in their last 10 shopping trips, 27 per cent had visited between two and four times, and 15 per cent between five and 10 times. Woolworths’ submission to the inquiry appears consistent with these findings, stating:

Over a third of shoppers visit speciality fresh outlets most often to buy their fresh produce, illustrating the strength of non-supermarket stores in providing a competitive fresh produce offering.<sup>28</sup>

**Chart 8.4 Number of visits to specialty stores out of last 10 shopping trips**

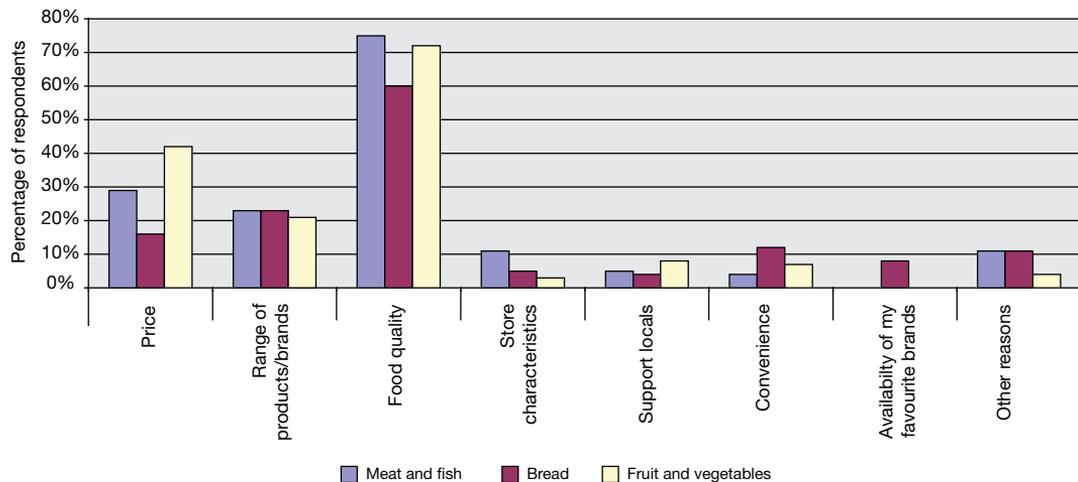


Source: respondents answers to the question, ‘How many of the last 10 household grocery shops were made at a supermarket, how many at specialty grocery stores such as bakers and butchers and how many were at convenience stores or service stations?’, ACCC Consumer survey, April 2008.

<sup>28</sup> Woolworths, submission no. 134, p. 1.

The ACCC's consumer survey found that overwhelmingly the most common reason given for shopping at specialty stores was the quality of the produce. This can be seen in chart 8.5, which illustrates that price was the second most important consideration when shopping at specialty stores, particularly in the fruit and vegetable category.

**Chart 8.5 Reasons for shopping at specialty stores by product category**



Source: respondents answers to the questions, 'Why do you make most of your meat and fish/bread/fruit and vegetables purchases at the speciality store?', ACCC Consumer survey, April 2008.

Specialty retailers provide a competitive constraint on supermarkets for the fresh groceries category and, while most of the competition appears to be based on quality, there also appears to be an element of price competition. The extent to which specialty retailers compete with full-service supermarkets for the weekly shop, as opposed to top-up shopping, is unclear. Full service supermarkets would appear to have the advantage over specialty stores of being able to offer a one-stop shopping experience.

Supermarkets offer consumers the convenience of purchasing packaged groceries and fresh produce in the one store. While this may provide supermarkets with an advantage over specialty stores, the popularity of specialty stores indicates that the convenience factor is not overwhelming. For supermarkets located in a shopping centre, the convenience factor is likely to be minimal. This is consistent with the preference of specialty retailers to be located close to supermarkets. Bakers Delight submitted that the optimal position for it to be located is within a shopping centre, around other fresh food retailers and near the exit of the major supermarket.<sup>29</sup>

Further, there is evidence that the MSCs do compete on prices with specialty retailers, particularly at stores with specialty retailers nearby. For instance, the ACCC is aware that the MSCs monitor prices of some specialty retailers, particularly at the local level.<sup>30</sup>

29 ACCC hearing, Melbourne, 30 May 2008, transcript in confidence, p. 84, cited with the consent of Bakers Delight.

30 Woolworths, submission no. 134, p. 22; Coles, submission no. 157, p. 4.

## 8.6.1 Conclusion—specialty stores

While supermarkets have a lower percentage of sales in fresh groceries than packaged groceries, they still command a substantial share of sales across the fresh categories. Sales of fresh groceries in Australia do not currently appear to be highly concentrated with sales spread between MSCs, other supermarkets and specialty stores.

Specialty stores exert competitive pressure on supermarkets in the fresh categories. Specialty retailers are frequented by consumers both as top-up shopping visits (e.g. purchasing fruit from the local high street) and in conjunction with a major supermarket shop (e.g. buying fresh bread from a bakery and meat from a butcher co-located in a shopping centre with a supermarket).

## 8.7 Conclusion

ALDI provides strong price competition to the MSCs, especially in private label products. ALDI's stores offer 900 products, have a limited range of brands for each product type, and stock products on shelves in pallets or boxes. Given the barriers to entry into grocery retailing (see chapter 9), grocery retailing models such as ALDI (or Costco) are the most likely source of greater price competition in grocery retailing in Australia.

At the wholesale level, currently SPAR appears to only provide a weak competitive constraint on Metcash due to its limited volumes and geographic reach. Given its expansion plans, it remains to be seen to what extent SPAR can further compete with Metcash in the future.

Specialty stores command a significant share of retail sales in fresh groceries, and the ACCC recognises that they represent an important part of the grocery industry. Specialty retailers provide consumers with a significant alternative to supermarkets in purchasing fresh products. The vast number of specialty retailers and the low barriers to setting up specialty grocery outlets mean specialty retailers provide a strong competitive force in retailing fresh products.

## 9 Barriers to entry and expansion in grocery retailing

### Key points

- Lack of access to suitable sites is a significant barrier to the entry or expansion of supermarkets.
- Developers and shopping centre managers prefer to lease space to the MSCs over other supermarkets. Having a Coles and/or Woolworths located in a shopping centre is almost essential for centre operators. While there are sound economic reasons for the MSCs being preferred, this significantly impedes the ability of competing supermarkets to access prime locations.
- The MSCs also engage in deliberate strategies designed to ensure they maintain exclusive access to prime sites. In particular, the MSCs include terms in their leases that effectively prevent centre managers leasing space in centres to competing supermarkets. These lease agreements can be considered under Part IV of the *Trade Practices Act 1974*. The ACCC is considering the application of Part IV of the Act to a number of these arrangements.
- Supermarket operators also use planning laws on occasion to frustrate competitive entry, sometimes in circumstances where they have no legitimate planning concerns.
- More generally, state planning regimes, while designed to preserve public amenity, also act as a barrier to new supermarkets being established in local areas. The ACCC recommends that consideration of planning decision should have specific regard to competition issues, particularly where the application contemplated would facilitate the entry into an area of a supermarket operator not currently trading in the area.
- The MSCs have broadened their retail offer in recent years into areas such as petrol, liquor and banking. While such expansion is often pro-competitive, it can potentially make it more difficult for new supermarkets to establish themselves if they have to match this broader retail offer to attract customers.
- The most significant link between grocery retailing and other industries is petrol shopper docket programs. While these programs may have increased barriers to entry, particularly for smaller retailers, they are only one part of the retail offer on which grocery retailers compete. Further, evidence suggests that these schemes have delivered benefits to consumers and promoted competition from other retailers.

### 9.1 Introduction

The ACCC considers that there are several barriers to entry that potential new entrants to grocery retailing face, as well as barriers to expansion for smaller players wanting to compete in supermarket retailing. Issues include the need to obtain the necessary scale to be competitive, natural barriers to entry (which may mean there is limited room for more major grocery retailers) and the need to obtain wholesale groceries at a price that enables other retailers to compete with the MSCs. These issues are discussed in detail in chapter 7 and are only briefly noted again in this chapter.

Other important potential barriers to entry and expansion in grocery retailing are:

- access to suitable sites for supermarkets
- the possible need to establish links with other forms of retailing (e.g. petrol).

These potential barriers to entry and expansion are discussed in this chapter.

## 9.2 Examples of entry

ALDI is the best example of a recent new entry to grocery retailing in Australia. ALDI is located across the eastern seaboard and has grown to have around 170 stores since opening its first Australian store in 2001. Many ALDI stores were developed on vacant or 'greenfield' sites, but more recently stores have been established in developed areas. ALDI stores are located primarily in metropolitan and urban areas, but there are also in excess of 20 stores in rural areas. ALDI states that an attractive prospective location should have an immediate catchment population in excess of 20 000 people.

ALDI has raised concerns in relation to the barriers to entry it has faced. These predominantly relate to site access and are analysed in detail in section 9.4.2.

Despite this evidence of rapid and extensive entry, ALDI's entry into grocery retailing in Australia should be considered in the context of its grocery offering. The sites it utilises are typically significantly smaller than the sites of major supermarkets. As was discussed in the previous chapter, ALDI only offers 900 products, compared to a typical MSC, which will generally offer over 20 000 product lines in a store.

This is not to suggest that ALDI does not provide a competitive tension in respect of the MSCs' grocery offer. However, in the context of the issues being considered in this chapter—in particular, access to suitable sites—the fact that ALDI cannot meet the needs of a one-stop grocery shopper means that it does not face the same difficulties in accessing suitable sites as other potential entrants. Rather, as discussed further in section 9.4.1, after an initial reluctance, the MSCs have become more accommodating of ALDI in recent years in relation to site access.

Other evidence of entry includes Costco, which has recently announced its intention to open its first Australian store in the Docklands, Victoria, in 2009.

Costco is a no-frills discount retailer that operates out of large warehouses and attempts to attract bulk shoppers. Costco Wholesale is one of the world's largest retailers and operates an international chain of over 500 membership warehouses in eight countries. It reported net sales of over US\$63 billion in the 2007 financial year.<sup>1</sup> Costco stocks 3500 to 4000 stock keeping units (SKUs) across categories such as groceries, sporting goods, jewellery and office supplies, to name a few. This range includes a number of exclusive brands like the private label Kirkland Signature.

Costco claims that the size and efficiency of these warehouses allow for lower costs than traditional retailers. Costco is open to members only, offering business and individual memberships. Currently, its annual fee for membership in the United States is US\$50. Costco has not announced a membership structure for its Australian stores.

Other full-line, large-format retailers are also attempting to expand, the largest being Franklins in New South Wales. Others include Foodland in South Australia, FoodWorks, Supabarn in New South Wales and the Australian Capital Territory and Supa IGAs.

Expansion of large full-line supermarkets is, however, slow. The main reason for this, according to those who gave evidence to the inquiry, is access to suitable sites.

<sup>1</sup> Costco, 2007 annual report, p. 2.

## 9.3 Barriers to entry and expansion due to economies of scale and scope

Chapter 7 considered cost savings that can be achieved by expanding the operations of a wholesaling business. Utilisation of economies of scale provides a business with a competitive advantage over smaller competitors and can act as a barrier to entry into the relevant market. The conclusions reached in chapter 7 with regard to economies of scale in grocery wholesaling are briefly restated here. Economies of scale in grocery retailing are also briefly considered in this section.

Economies of scale exist in the grocery industry as a high proportion of costs are either fixed or vary only marginally with product volume. Accordingly, at least up to a certain scale, businesses can lower the cost of their operations (per unit of output) through expansion.

Economies of scale may be available to grocery retailers at the store level and organisation level, as well as at the wholesaler level.

### 9.3.1 Retail store level

Economies of scale at the retail store level are obtained by increasing the volume of goods sold in the store. Economies are generated as operating and capital costs do not increase in proportion to product volumes or store size (e.g. administration and management costs, distribution costs, labour, rent and advertising).

The cost structure of retail stores means that economies of scope—where the cost of supplying each product is reduced by increasing the range of products available—may also be available. A greater product range may also generate larger customer volumes as the trend towards ‘one-stop-shopping’ continues.

### 9.3.2 Retail organisation level

Increasing the number of retail stores in a chain may lower the cost of operating each store. Savings are likely to come from four main sources:

- Joint brand and product marketing. Product marketing will be more cost effective if all stores offer a standard range of products and prices.
- An allocation of administration, management and business support costs over a larger base.
- Potential for greater investment in operating systems and processes which allow for enhanced information and data management capability.
- Savings generated by buying larger volumes from suppliers.
- Independent supermarkets typically attempt to take advantage of some of the saving potential available to the larger chains by operating under a banner group (e.g. IGA or Foodland).

### 9.3.3 Wholesale level

Economies of scale in grocery wholesaling come from a range of sources. Larger wholesaling operations can spread the costs of distribution centres over greater volumes and can often better manage their working capital. Economies of density refer to reduction in unit costs in serving more stores within a given area. For example, increasing the number of stores serviced within a given area can reduce transport costs through better route planning and reduce working capital.

Whether or not a company needs to be national or just regional to take advantage of these scale economies depends on the typical supply chain for different product lines (i.e. whether the products are sourced nationally or regionally). Although purchasing for some product lines may occur on a national level, most distribution occurs on a state, regional or store level—indicating that a new entrant may not necessarily need to operate nationally to be cost competitive. This is demonstrated in the industry presently, with Franklins operating in New South Wales only and ALDI operating only on the east coast.

The availability of scale opportunities in the supply chain may differ between product categories. Factors such as the ability to centralise product distribution, product shelf life and concentration of retailers will all affect the level of economies that can be achieved.

The ACCC believes that the difficulty for vertically integrated players such as Franklins and ALDI to build a ‘critical mass’ of stores within new regions—to gain access to these economies of scale and density—has hampered their ability to expand in Australia.

The ACCC considers that there are substantial barriers to entry to setting up a new wholesale operation on either a national or state-wide basis. It is not conceivable that a new wholesaler will be immediately profitable. For a new wholesaler to be profitable, based on evidence received during the inquiry, the ACCC considers that it would be necessary to attract a significant number of retailers to ensure that significant volumes are passing through the wholesaling operation.

The ACCC also considers that the wholesaler would need to not only attract individual retailers, but also larger chains of retailers, such as FoodWorks or Ritchies. As noted in chapter 7, this may be difficult for a new wholesaler to do, as Metcash has recently taken minority shares in some of the larger independent chains. Another alternative may be for an independent chain to break away from Metcash and set up their own wholesaling operation (as done by Franklins.)

Further, the ACCC considers that a wholesaling operation run on a state-wide basis rather than a national operation may more easily achieve the economies of scale needed. This is particularly true in some of the heavily populated east coast states. That said, it is impossible to comment definitively on the exact conditions needed in the wholesale grocery market to allow a second large wholesaler to compete against Metcash. As noted in chapter 7, Franklins, which has 80 stores, has publicly stated that it has reached the critical mass required to run a profitable, vertically integrated chain in New South Wales.<sup>2</sup> As such, the ACCC considers that on a state basis, a wholesaler would need to have guaranteed sales of between \$800 million and \$1 billion to remain viable.

## 9.4 Access to suitable sites

Submissions to the inquiry raised concerns that access to suitable sites was a significant barrier to the establishment of independent supermarkets in local areas.

Concerns related to the MSCs’ acquisition of vacant land suitable for development, duplication of sites by MSCs to exclude competitors and the MSCs developing shopping centres themselves or taking over existing centres. These issues are considered in detail in chapter 19, which examines acquisitions by the MSCs.

While all these issues were of concern, the most significant concerns raised by independent supermarket operators with relation to access to sites were:

- shopping centre landlords’ preference to lease sites to MSCs over independent supermarkets

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<sup>2</sup> ACCC, public hearing transcript, Sydney, 1 April 2008, p. 54.

- favourable lease arrangements for the MSCs
- restrictive provisions in the MSC leases that prevent landlords offering space in centres to other supermarkets
- planning laws restricting the development of new supermarkets.

### 9.4.1 Access to sites—negotiations with landlords

As noted, a number of parties raised concerns regarding shopping centre landlords' preference to lease sites to MSCs over independent supermarkets and favourable lease arrangements for the MSCs.

#### Evidence provided at hearings and in submissions to the inquiry

##### *Access to sites within shopping centres*

Metcash submitted that, as most customers undertake shopping activities in either shopping centres or retail activity centres, retailers must be able to secure sites in these locations to be competitive.<sup>3</sup>

Independent supermarkets gave evidence that developers prefer MSCs to anchor their centres, reflecting the MSCs' proven track record and ability to drive foot traffic. The National Association of Retail Grocers of Australia (NARGA) also stated that independent supermarkets have trouble getting access to shopping centres because of landlords' preferences to lease sites to the MSCs.<sup>4</sup>

Colonial First State (CFS) and Westfield expressed the view that anchor tenants are very important to shopping centres because the strength of the anchor tenant is crucial to the viability of the centre. They stated that they choose anchor tenants based on research and knowledge regarding which anchor tenant would be likely to generate the largest sales, and typically that is Woolworths and Coles. CFS and Westfield further stated that if other proven operators capable of driving sales existed, they would also be considered as anchor tenants but that typically this is not the case.<sup>5</sup>

Stockland indicated that supermarkets it would consider as anchor tenants in its developments were Woolworths, Coles, ALDI and, in some cases, IGA. Stockland indicated that, depending on the size of the development, smaller operators—for example, Harris Farm in New South Wales—could also be considered.<sup>6</sup>

Westfield submitted that the consequence of an anchor tenant refusing to come into a development would be that less retail space would be built than otherwise, including less space for specialty stores, as there would be less customer traffic to sustain specialty stores.<sup>7</sup>

A specialist fresh food retailer also provided confidential evidence that its sales would be significantly affected if it was trading in a centre where it was located close to an independent supermarket instead of one of the MSCs.

##### *Tenant mix and number of supermarkets in centres*

With respect to the number of supermarkets within centres, landlords generally indicated that the tenant mix depends on the size of the centre and getting the right mix of large anchor tenants and

<sup>3</sup> Metcash, submission no. 181, p. 33.

<sup>4</sup> ACCC, public hearing transcript, Canberra, 9 April 2008, p. 20.

<sup>5</sup> ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 72; ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 128; ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 61.

<sup>6</sup> ACCC, public hearing transcript, Sydney, 2 April 2008, p. 44.

<sup>7</sup> ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 68.

smaller specialty shops.<sup>8</sup> Landlords indicated that there are no major disincentives to offering more than one supermarket site within a centre if the centre is of sufficient size to accommodate more than one supermarket.<sup>9</sup>

CFS stated that it is not in their interest to have a third full-line supermarket that undertrades in their centres. CFS submitted that there are not many centres in Australia with three full-line supermarkets all trading well. While some centres include three full-line supermarkets, CFS contended that one is usually making a very poor consumer offer.<sup>10</sup> CFS argued that, in these circumstances, they would be better off bringing in a different type of retailer that does trade well and adds value to the centre.<sup>11</sup>

Coles also stated that there would be very few shopping centres in Australia able to accommodate three successful full-line supermarkets.<sup>12</sup>

Westfield stated that, where a centre can clearly only accommodate one supermarket, one of the factors it looks at is competition within the area with a view to creating a point of difference within the centre that is likely to make it more attractive to customers.<sup>13</sup> Specifically, Westfield stated that if one of the MSCs was dominant in the area they would generally seek to get the other chain into their centre.<sup>14</sup>

### *Lease terms*

Master Grocers Australia (MGA) submitted that the MSCs' market dominance affords them an unfair bargaining position in negotiating access to high-quality retail sites. The MGA stated that while this is a measure of the success of the MSCs, it compounds the difficulties independent retailers have in obtaining quality retail sites.<sup>15</sup> The MGA stated that one consequence of this is higher rents charged to independents, which discourages them from expanding their businesses.<sup>16</sup>

Landlords submitted that anchor tenants are charged lower comparative rents for a number of reasons, including that they lease greater areas of space, enter into substantially longer leases (up to 25 years versus five years), and drive foot traffic for the centre and drive the success or otherwise of the centre.<sup>17</sup>

NARGA and Metcash stated that the long-term leases entered into by MSCs require a substantial financial commitment which independents would not be able to match.<sup>18</sup>

### *Competition test for lease arrangements*

In response to a question regarding the possibility of any new lease arrangement or developments being subject to a competition test, Woolworths stated that this would add a considerable cost to applications, which would eventually be reflected in grocery prices.

In response to the same question, CFS stated that, if, for example, such a requirement resulted in CFS having to lease space to an independent instead of an MSC, this may jeopardise the viability of a development. CFS stated that strong anchor tenants are important to developments and, if forced

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8 ACCC, public hearing transcript, Sydney, 2 April 2008, p. 46.

9 ACCC, public hearing transcript, Sydney, 2 April 2008, p. 47; ACCC public hearing transcript, Melbourne, 15 May 2008, p. 127.

10 ACCC, public hearing transcript, Melbourne, 15 May 2008, p.137.

11 *ibid.*, p.138.

12 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 90.

13 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 62.

14 *ibid.*, p. 64.

15 Master Grocers Australia, submission no. 96, p. 10.

16 *ibid.*, p. 11.

17 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 68; ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 136.

18 ACCC, public hearing transcript, Canberra, 9 April 2008, p. 21.

to lease to an independent instead of an MSC, there was a risk the independent would not generate sufficient sales to sustain the centre.<sup>19</sup>

Westfield stated that the impact of such a test would depend on the circumstances. If, for example, such a test could be used to exclude Coles or Woolworths from a centre, or require that ALDI or FoodWorks be granted access as an alternative to an MSC, this could change the viability of the development and potentially result in it not proceeding. Westfield considered that the impact of exclusion of an MSC from a centre could depend on whether they were replaced with a true 'like for like' operator.

### *ALDI's access to sites*

Evidence was provided to the inquiry that ALDI has been successful in obtaining leases in a number of shopping centres.

Generally speaking, landlords considered ALDI to be a beneficial addition to their tenant mix as they generate additional sales. Westfield and CFS stated that initially there was a level of concern by the MSCs regarding the introduction of ALDI to centres. However, that has now dissipated to the point where, if an ALDI is to be introduced to the centre, the MSCs would rather have the ALDI located nearby rather than in another part of the centre.<sup>20</sup>

Similarly, Coles stated that ALDI is a complementary retailer and that in terms of foot traffic Coles would rather have ALDI located nearby in competition than away from a Coles supermarket.<sup>21</sup>

NARGA contended that ALDI has been successful in obtaining sites because the MSCs do not consider ALDI to be a serious competitor across the full grocery range that the MSCs offer.<sup>22</sup>

### **Assessment**

As noted in evidence to the inquiry, faced with a choice, shopping centre owners have a strong preference for Woolworths and/or Coles as supermarket tenants in their centres compared with other supermarket operators.

Anchor tenants, such as supermarkets, generate sales and foot traffic, which benefit all tenants and drive the success or otherwise of the centre. Woolworths and Coles have a proven track record of driving sales and are considered by many developers to be the only supermarkets that can successfully anchor a shopping centre development. Therefore, Coles and/or Woolworths are essentially considered almost 'must have' tenants for any successful, large-scale shopping centre. Almost inevitably, where there are two large supermarket sites available within a centre and Coles and Woolworths both wish to be present in the centre, they will be offered the sites.

While the preference of centre owners to have Coles and/or Woolworths as tenants is a reflection of their importance to the success or otherwise of centres, it does create a significant barrier to entry for other supermarket operators, particularly given consumer preferences to undertake grocery shopping activities in these centres.

The extent to which the dominant presence of the MSCs in centres inhibits the ability for other supermarkets to successfully enter local markets is exacerbated by the fact that very few shopping centres in Australia are able to successfully maintain three full-line supermarkets. This, combined with

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19 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 144.

20 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 69; ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 137.

21 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 84.

22 ACCC, public hearing transcript, Canberra, 9 April 2008, p. 20.

the 'must have' status of Coles and/or Woolworths for centre owners, all but forecloses access to major shopping centres for independent retailers in most instances.

In short, developers are reluctant to offer prime sites to independent operators as they are unlikely to trade as successfully as the MSCs. Conversely, one reason, among others, that independent operators are unable to trade as successfully as the MSCs is an inability to access prime sites.

As discussed in chapter 4, given that much of the competition that takes place between grocery retailers necessarily occurs at a local level, such barriers have the potential to impact significantly on local competition among grocery retailers.

As well as affecting competition at the local level, the dominance of the MSCs in obtaining prime supermarket sites has broader network effects as it affects the ability of independents to establish a successful chain of stores necessary to compete with the MSCs at a regional, state or national level.

Generally speaking, new supermarket developments will be pro-competitive. While it is clearly the case that alternative large-format supermarkets' lack of access to prime sites creates a significant barrier to entry into local areas, forcing landlords to deal with alternative operators may not improve competition. Because the foot traffic driven by anchor tenants is a major consideration for both landlords and tenants in considering sites, removing one or both of the MSCs as a possible tenant may have the consequence of undermining the viability of a development.

In relation to ALDI, as noted above evidence was provided to the inquiry that ALDI has been successful in obtaining leases in a number of shopping centres and that the MSCs' initial reluctance to have ALDI in centres in competition with them has dissipated over time.

This is not to suggest that ALDI does not compete with the MSCs. Rather, it suggests that, given that ALDI is not a full-line supermarket the MSCs view ALDI customers as likely to make purchases from an additional grocery retailer. This means that *if* ALDI is going to enter a local area, the MSCs would rather have ALDI located nearby to them where they will be able to capture the additional customer spend.

Further, ALDI's business model, which concentrates on limited lines in stores of around 1000 m<sup>2</sup>, also makes it less difficult for ALDI to obtain sites than larger full service supermarkets.

In these circumstances, given the differences in the ALDI business model, the ACCC considers that ALDI's ability to obtain leases in major shopping centres is not indicative of the significant difficulties that other supermarkets encounter.

As with the acquisition of land or a business, the ACCC is able to consider the acquisition of leases, by supermarkets or any other business, under the substantial lessening of competition test in s. 50 of the Act and other sections of Part IV of the Act. The ACCC will actively investigate lease arrangements or other acquisitions where there is evidence put before it that indicates that there is a likely breach of the substantially lessening of competition test.

### 9.4.2 Restrictive provisions in leases

A number of parties raised concerns regarding restrictive provisions in leases between shopping centre owners and MSCs. Broadly, these concerns related to clauses which:

- prohibit the landlords from introducing a second, or third, supermarket over a certain size to the centre for a specific period of time, or
- provide for a significant reduction in the rent payable by the MSC if a second, or third, supermarket over a certain size is introduced to the centre within a specified timeframe.

Evidence was also provided of clauses in leases that give existing tenants first or last right of refusal over access to additional space in centres, such as for a discount department store or petrol site, and of clauses in deeds of surrender for leases which provide that the relevant site cannot be re-let to another supermarket operator.

### Investigation of claims

Using its information gathering powers under s. 95ZK of the Act, the ACCC required Coles and Woolworths to provide copies of all leases between them and landlords which prohibit the landlord from granting a lease to a competitor or which contained any penalty, rent reduction or change in lease terms if the landlord grants a lease to a competitor. The ACCC also used its information gathering powers to obtain copies of leases and other information from shopping centre landlords and developers.

Information provided by the MSCs and developers in response to the ACCC's information requests confirmed that many leases entered into by the MSCs do contain restrictive provisions. These provisions most commonly take the form of a prohibition on the introduction of an additional supermarket, or provision of a sufficient reduction in an MSC's rent if an additional supermarket is introduced so as to make it financially unviable for the centre to do so. These provisions generally have effect for a stipulated period of time, commonly around 10 years, although periods ranged from five years to the duration of the lease.

Relevant clauses in leases for smaller centres often prohibit the introduction of a second supermarket. In larger centres the prohibition is generally in relation to the introduction of a third supermarket.

The restriction on new supermarkets entering a centre does not generally apply to grocery retailers below a size specified in the lease—generally somewhere between 500 m<sup>2</sup> and 2000 m<sup>2</sup> but most commonly around 1000 m<sup>2</sup> or 1500 m<sup>2</sup>.

### Submissions

A number of submissions identified clauses in specific leases which, they contended, had the effect of preventing them from establishing supermarkets in the centres in question. These submissions were generally made on a confidential basis.

It was submitted that these clauses restrict the ability of competitors of the MSCs to access sites in prime locations, often forcing them to pursue opportunities in less desirable locations or preventing them entering the relevant area altogether. In a public submission, Metcash argued that such clauses in leases entrench the position of MSCs.<sup>23</sup>

ALDI submitted that these clauses are used by the MSCs to reduce competition. ALDI stated that the MSCs have hundreds of such provisions in place in centres around Australia which restrict ALDI's access to shopping centres that they would otherwise be interested in moving into.<sup>24</sup>

#### *How are such restrictions justified?*

Coles stated that its standard leases generally have a restrictive provision in them; however, these standard documents form the basis of negotiations such that the clause may or may not be included in executed lease depending on the specific circumstances and negotiations between Coles and the developer.<sup>25</sup>

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<sup>23</sup> Metcash, submission no. 181, p. 33.

<sup>24</sup> ALDI, submission no. 241, p. 2.

<sup>25</sup> ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 81.

Woolworths stated that it generally enters leases for periods of around 20 years. In agreeing on applicable rent or other terms and conditions, consideration is given to a whole range of issues that creates the environment in which Woolworths can operate in that particular area, including tenant mix.<sup>26</sup>

Based on representations from the landlord about what the makeup of the centre will be, Woolworths makes an assessment of sales potential. Such assessments are influenced by issues such as how many other supermarkets will be in the centre. Leases and base rent negotiated with the landlord are determined on the basis of potential sales.<sup>27</sup>

Woolworths stated that restrictive provisions in leases are a mechanism by which the environment promised by the landlord, on which rent is based, is protected.<sup>28</sup>

Woolworths also provided a submission, supported by econometric analysis from Concept Economics, which argued that restrictive provisions:

- have no adverse effect on the likelihood of a competitor being located within 3 to 5 km of a Woolworths supermarket (or in the same centre in the case of independents)
- are not associated with a statistically significant impact on average store level prices and in fact are associated with somewhat lower store level prices, although the effect is not statistically significant.<sup>29</sup>

CFS stated that restrictive provisions are sometimes included in leases but, when agreeing to these provisions, CFS will look at the potential sales opportunity for the site and will generally time limit restrictive provisions to the point in time when the centre could successfully sustain another supermarket.<sup>30</sup>

CFS also noted that the other way in which restrictive provisions are limited to the point in time when the centre could successfully sustain another supermarket is by a provision that they expire when a certain level of turnover is reached.<sup>31</sup>

CFS stated that they would not be concerned if restrictive provisions in their leases were banned.<sup>32</sup> Westfield also stated that such a ban would not be a bad thing and would be unlikely to have any substantial ramifications on its business.<sup>33</sup>

Woolworths stated that, in relation to such a prohibition, rents paid by supermarkets reflect the environment that has been agreed with the landlord at the commencement of the lease and involve a significant capital commitment from Woolworths.<sup>34</sup>

## Assessment

### *Application of the Act to restrictive provisions*

A number of supermarket operators provided the ACCC with specific examples of leases between the MSCs and shopping centres which, they contend, have prevented or delayed their entry into a centre. This evidence was credible and specific.

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26 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 75.

27 *ibid.*, p. 76.

28 *ibid.*, p. 75.

29 Woolworths, submission no. 237, p. 5.

30 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 132.

31 *ibid.*, p. 132.

32 *ibid.*, p. 143.

33 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 81.

34 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 91.

Given that the ACCC is satisfied that most competition between grocery retailers occurs at the local level, any agreement which has the effect of blocking competitive entry has the potential to limit competition and potentially raises concerns under the Act.

Section 47(4) of the Act regulates the acquisition of goods or services, which includes leases. It covers any acquisition made on condition that the supplier will not supply, or will limit the extent to which they will supply, goods or services to another person. Acquisition on such a condition is prohibited where the purpose or likely effect of the acquisition is a substantial lessening of competition.

Section 46 of the Act may also be applicable in circumstances where a party with a substantial degree of market power has taken advantage of that market power to prevent entry.

### *ACCC's approach to restrictions*

The ACCC accepts that there are some circumstances, particularly in areas of projected future population growth where centre developments are occurring, where a guarantee of a period of exclusivity may encourage a supermarket operator to enter a centre that they may not otherwise enter. Accordingly, these provisions play a role in attracting an anchor tenant to a complex which may not be built without that tenant. In these circumstances, provided there is no evidence of an anti-competitive purpose and good evidence that there would be no competitive entry even if the clause were removed, the ACCC may not have significant concerns.

However, in the vast majority of leases in larger metropolitan centres, there appears to be little justification for these clauses other than to prevent competitive entry. While such clauses guarantee a return on a supermarket's investment by creating certainty as to the competitive environment, at least within the centre, it does not appear that the commercial risk undertaken by the supermarket in entering the centre in these instances justifies such exclusivity.

Rather, it would appear that in these cases restrictive provisions are sought so as to maximise the profitability of the supermarket by restricting its exposure to competing grocery offerings.

Such clauses, by their nature, restrict the ability of other supermarkets to compete with the operator entering into the restrictive provision as they create a significant barrier to entry to competing supermarket proprietors. While potential competitors are only excluded from the particular centre by any individual arrangement, as discussed above in section 9.4.1, many consumers have a strong preference for conducting grocery shopping in major centres. Indeed, such exclusivity would not be so valued if tenants considered that supermarkets outside of the centre were likely to be as strong a competitive constraint as those within the centre.

The ACCC is satisfied that landlords already have a strong incentive to ensure that the tenant mix in a centre is such to ensure tenants trade profitably, and there are few incentives for competitors to enter a centre if the potential turnover does not justify it. These market factors should be enough to ensure that investments are appropriately protected.<sup>35</sup>

Further, while potential competitors are only excluded from the particular development where the restrictive provision is in place, the prevalence of such provisions, along with the scarcity of suitable large sites, particularly in built-up metropolitan areas, means that the effect of restrictive provisions can be far broader than simply excluding potential entrants from the particular development.

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<sup>35</sup> The ACCC is aware of a number of instances where landlords have refused a request by one of the MSCs for an exclusivity clause in a lease but none where the MSC has chosen not to enter the centre as a consequence of the refusal.

As well as acting as an impediment to entry into local areas, restrictive provisions in leases also act as a broader barrier to entry, particularly for independent chains, as access to prime sites across a range of locations is restricted, which serves to entrench the dominance of the MSCs both in localised areas and more broadly.

The barriers to competitive entry created by restrictive provisions are further entrenched given the preference Australia's retail planning laws give to existing centre developments over new developments, as discussed in section 9.4.3.

Developers questioned by the ACCC in relation to inclusion of restrictive provisions in leases stated that they would not be concerned if such provisions were prohibited. This tends to indicate that landlords do not consider such clauses necessary in order to attract supermarket tenants to developments.

#### *Time limits on restrictive provisions*

Some landlords stated that they will generally time limit restrictive provisions to the point in time when the centre could successfully sustain another supermarket; therefore, absent the restrictive provision, it would be unlikely that they would add a new supermarket prior to the provision expiring.

While this may be true in many cases, the ACCC also heard evidence from landlords that, in some instances, inclusion of these clauses in leases is a result of the bargaining power of the MSC, based on specific circumstances in the local area and/or circumstances surrounding the negotiation of the particular lease.

The ACCC considers that landlords having the freedom to add new supermarkets to centres as consumer demand dictates will be of far greater benefit to the competitiveness of the grocery industry than MSCs enjoying the benefits of restrictive provisions insulating them from the competitive tension that competing supermarkets provide.

#### *Deeds of surrender*

The ACCC also received evidence during the inquiry of deeds of surrender for supermarket sites, including a clause preventing the landlord re-letting the site to another supermarket operator.<sup>36</sup> This was done in centres where both MSCs were represented and a third alternative supermarket was a possible new tenant on the site.

The ACCC sees no reasonable basis on which such clauses would be entered into other than to prevent a competing supermarket establishing itself in the local area, and no evidence was provided in response to questions posed by the ACCC to suggest a contrary intention.

The ACCC considers that such clauses serve to restrict competition between grocery retailers, particularly in the context of Australia's planning and zoning laws, which, as discussed in section 9.4.3, place strict limits on the availability of new sites for retail developments.

## Conclusion

The ACCC acknowledges that there are some circumstances where the guarantee of a period of exclusivity to a supermarket may assist in encouraging a development or may assist the entry by a supermarket into the relevant centre. This is likely to result in greater competition in the local area and in these circumstances the lease arrangements will be unlikely to raise concerns under the Act.

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<sup>36</sup> ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 79.

However, in many cases, restrictive provisions in supermarket leases appear to be employed simply to maximise the profitability of a supermarket by restricting its exposure to competition.

As noted, restrictive provisions in supermarket leases are prohibited under Part IV of the Act in circumstances where they have the purpose or effect of substantially lessening competition. However, prior to this inquiry, very few concerns had been raised with the ACCC regarding these lease arrangements and the arrangements have not, to date, been a focus of the ACCC's enforcement activities.

During this inquiry, however, significant concerns have been raised with the ACCC in relation to the impact of some of these arrangements on competition in local areas, and considerable information regarding the operation of these clauses has been collected. Flowing from this, the ACCC is considering the application of Part IV of the Act to a number of these arrangements. The ACCC encourages independent retailers who have evidence that existing arrangements affect their ability to establish new sites to contact the ACCC. The ACCC's assessment as to the competitive effect of any particular arrangement will depend on the specific nature of the restriction and the characteristics of the market in which the restriction applies.

Some parties suggested to the inquiry an outright ban on restrictive provisions in leases, or restrictions on their enforceability beyond a certain point—for example, five years after the lease is entered into. However, the ACCC does not propose to recommend an industry specific legislative amendment in circumstances where the application of the existing provisions of the Act to restrictive provisions in leases is yet to be fully explored.

The ACCC's consideration of a number of relevant lease arrangements flowing from information obtained during the inquiry will provide an opportunity for the application of Part IV of the Act to these arrangements to be considered. If, following this assessment, the ACCC is not satisfied that the existing provisions of Part IV provide an effective mechanism for dealing with restrictive provisions in supermarket leases, consideration should be given to whether legislative amendment to address these concerns is appropriate.

### 9.4.3 Planning and zoning laws

Many interested parties raised concerns during the course of the inquiry that state planning and zoning laws act as a barrier to entry to the establishment of new supermarkets in local areas.

#### The Productivity Commission's consideration of planning issues

On 13 December 2007 the Productivity Commission released its draft report into the market for retail tenancy leases in Australia.<sup>37</sup> Among other issues, the report considered the extent to which planning laws affect competition between retailers. The draft report recommended the following:

While recognising the merits of planning and zoning controls in preserving public amenity, States and Territories should examine the potential to relax those controls that limit competition and restrict retail space and its utilisation.

The Productivity Commission's considerations and findings in respect of this draft recommendation are summarised below.

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<sup>37</sup> The information in this section is taken from: Productivity Commission, *The Market for Retail Tenancy Leases in Australia*, draft report, November 2007, pp. 58–60, 191–96, 215.

State and territory governments have formed planning policies around the ‘centres policy’. Centres policy seeks to set in place systems that exploit the benefits of concentrating activities in one location. This is based on the notion of combining major trip-generating activities in the one location to reduce car usage and traffic congestion and make better use of public road and transport infrastructure.

Other benefits, it is argued, of centres policy include:

- improved access to retail, commercial, health, education, leisure, entertainment and cultural facilities, along with cultural and personal services
- increased competition, collaboration and innovation among businesses from clustering.

In terms of retail zoning, the centres policy has concentrated retail activity into specific locations. A key determinant in this respect has been access to public transport and other infrastructure. These policies are aimed at reducing or eliminating the emergence of new retail concentrations outside identified centres. Instead, planning policies aim to induce new retail investments in underdeveloped or poorly maintained existing developments—particularly strip shopping centres in main transport corridors.

Limiting ‘non-centre’ developments has also been prompted by concerns over congestion and availability of infrastructure. Creation of trip-generating activities outside of centres for which infrastructure has been developed (and for which continued development is planned) has the potential to put strain on existing infrastructure and create externalities such as congestion.

Submissions to the inquiry contended that these restrictions could limit the supply of supermarket space, particularly at the shopping centre level, create barriers to new retail concentrations and increase ownership concentration of retail space.

The Productivity Commission’s draft report concluded that the extent that planning laws and zoning regulations have altered market provision of retail space is unclear and needs further consideration. However, while important for urban development, planning and zoning restrictions restrict competition in the supply and use of retail space.

The Productivity Commission concluded that there is scope to increase retailing opportunities and competition in the retail tenancy market for the benefit of new entrants to the sector and consumers more generally. While recognising the merits of zoning and planning controls in preserving public amenity, the Productivity Commission’s draft report concluded that the application of such controls restricts the availability and use of retail space and in some circumstances could reduce competition in this market. The Productivity Commission considered that it would be appropriate for state and territory governments to examine the potential impacts that zoning and planning controls might have on competition in the market for retail space.

## Evidence provided at hearings and in submissions to the grocery inquiry

### *Impact on competition of existing planning and zoning laws*

The MGA, the Koundouris Group, Franklins and Urban Taskforce Australia argued that by making it difficult to obtain sites, local planning laws act as a barrier to expansion of independent supermarkets.<sup>38</sup>

Metcash and Franklins also submitted that delays in planning application processes are a significant impediment to new developments. Franklins cited an example where, they claimed, it had taken them six years to negotiate and build due to the planning process.<sup>39</sup>

<sup>38</sup> Master Grocers Australia, submission no. 96, p. 11; Koundouris Group, submission no. 35, p. 4; Urban Taskforce Australia, submission no. 62, p. 3.

<sup>39</sup> ACCC, public hearing transcript, Sydney, 1 April 2007, p. 56.

Franklins stated that planning laws are not attuned to commercial reality and areas zoned as retail are not necessarily in appropriate locations. Further, Franklins submitted that government initiatives to increase population density have created demands for retail space that cannot be met by existing planning criteria.<sup>40</sup>

Submissions also raised concerns that planning laws favour the expansion of existing centres over new developments so as to concentrate retail developments in established centres.

The Shopping Centre Council of Australia (SCCA) stated that Australian planning laws have not resulted in a shortage of retail space.<sup>41</sup>

The SCCA submitted that, while planning laws control and restrict the location and usage of retail space, they do not impose any greater constraint on the retail property market than they do on other property markets. The SCCA submitted that government intervention in this respect is designed to minimise environmental and economic costs to the community of dispersed retail and commercial development, and maximise public benefits.<sup>42</sup>

Urban Taskforce Australia argued that new supermarkets and larger food stores are being denied the opportunity to compete with existing shopping centres, resulting in less choice and higher prices for groceries and everyday household goods.<sup>43</sup>

The Koundouris Group, NARGA and Urban Taskforce Australia each argued that local government and planning bodies should be more attuned to competition issues.<sup>44</sup>

Stockland stated that, although there are exceptions, as a general rule competition issues are not considered by councils in considering development proposals.<sup>45</sup>

NARGA submitted that planning issues need to be addressed to prevent further consolidation of local markets. NARGA noted that competition issues are not generally considered by state or local government planning authorities. NARGA cited an example in Hurstville where, it states, Coles was allowed to open a new supermarket within 100 metres of an existing Coles store. NARGA argued that in an ideal world Coles would have been required to divest its existing store before opening the new store so as to allow another competitor into the area.<sup>46</sup>

Urban Taskforce Australia argued that planning systems should be about protecting the community from congestion, noise and the loss of cultural and environmental assets but, instead, planning laws are protecting existing retail landlords from the threat of competition. Urban Taskforce Australia argued that the centres policy also gives landlords the opportunity to charge higher rents.<sup>47</sup>

Franklins stated that rezoning applications are a long and slow process and local council development approval processes are too complicated.<sup>48</sup> The MGA contended that, while the MSCs are well resourced to fight public protests and engage in public relations campaigns highlighting the benefits of developments, the independent sector is not.<sup>49</sup>

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40 Franklins, submission no. 104, p. 10.

41 Shopping Centre Council of Australia, submission no. 203, cover letter.

42 *ibid.*, p. 29.

43 Urban Taskforce Australia, submission no. 213, cover letter.

44 Koundouris Group, submission no. 35, p 4; NARGA, submission no. 129, p. 33; Urban Taskforce Australia, submission no. 213, cover letter.

45 ACCC, public hearing transcript, Sydney, 2 April 2007, p. 49.

46 *National Association of Retail Grocers of Australia*, submission no. 129, p. 33.

47 Urban Taskforce Australia, submission no. 213, cover letter.

48 Franklins, submission no. 104, p. 10.

49 Master Grocers Australia, submission no. 96, p. 11.

### *Use of planning laws by the MSCs to deter new entry*

In response to questions asked by the ACCC in a public hearing, Woolworths stated that planning objections lodged by it, while lodged under the grounds allowable under the relevant legislation, are generally lodged to protect Woolworths' commercial interests.<sup>50</sup>

In response to questioning by the ACCC regarding Woolworths' use of planning objections to prevent competitive entry to a market, Woolworths' CEO, Michael Luscombe, stated:

We're a public company that is in retailing and the way we grow our company is by growing our sales and one of the ways we grow our sales is to both have our opportunity for new stores protected and secondly, to try to protect existing business.<sup>51</sup>

Woolworths stated that lodging planning objections to prevent competitive entry was engaged in fairly regularly by other retailers and was a practice adopted by Woolworths where Woolworths had a commercial interest, be it an existing or planned future interest, to protect.<sup>52</sup>

Woolworths stated that it was more common for its competitors to lodge planning objections in respect of its developments than vice versa and that Woolworths had only objected to 22 developments since 2005.<sup>53</sup>

Coles stated that they do, on occasion, lodge planning objections to protect their own commercial interests but that it is not standard practice.<sup>54</sup>

Submissions to the inquiry stated that leases between shopping centre landlords and MSCs sometimes require the landlord to object, as a matter of course, to competing developments.

Woolworths confirmed that their leases with shopping centre landlords sometimes do contain such clauses. Woolworths noted that such appeals will not be successful if the development application conforms with the law.<sup>55</sup> Coles stated that such provisions are rare in its leases.<sup>56</sup>

Urban Taskforce Australia submitted that objections to proposed developments are also routinely lodged by shopping centre owners to protect their existing business.<sup>57</sup>

Independent supermarket operators also gave confidential evidence at the hearings that MSCs have objected to their liquor licence applications in order to protect their own commercial interests. In this respect, independent supermarkets contended that attaching a liquor arm to their grocery business would add value to the business and allow them to compete more effectively with the MSCs. The Koundouris Group submitted that opposition from MSCs to it obtaining liquor licences has been an impediment to expansion of its chain of Supabarn stores.<sup>58</sup>

Woolworths stated that, similar to planning objections, it will on occasion object to applications by competing grocery retailers for licences to establish liquor stores. As with planning objections, Woolworths stated that such objections are lodged to protect Woolworths' existing business.<sup>59</sup>

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50 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 64.

51 *ibid.*

52 *ibid.*, p. 65.

53 *ibid.*, p. 66.

54 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 73.

55 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 80.

56 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 74.

57 Urban Taskforce Australia, submission no. 240, p. 1.

58 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 31.

59 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 66.

### *Amendments to planning laws to take account of competition issues*

The MGA submitted that local governments should be able to take into account the long-term benefits of independent supermarkets and in particular their strong community ties when assessing planning applications.<sup>60</sup>

NARGA suggested that competition issues should be required to be taken account of in local planning decisions. In particular, NARGA suggests that any development in the grocery retailing sector should be subject to a competition or public interest test specified or approved by the ACCC.<sup>61</sup>

Urban Taskforce Australia stated that an overhaul of state governments' centres policies would mean greater competition and would give people more choice. Urban Taskforce Australia submitted that planning laws should encourage retail developments that would take pressure off these highly congested areas and promote more pedestrian friendly communities while still facilitating transport use.<sup>62</sup>

Westfield stated that amending planning laws to take account of competition issues would add another layer of complexity to the process and may result in developments happening more slowly, developments not getting built and, in fact, less competition. Westfield considered that the merits of such a proposal would depend on how it operated and the number of players that were in the market overall.<sup>63</sup>

Metcash contended that simply reducing the level of planning regulation risks further restricting competition as it may result in the MSCs, which have significant capital reserves, securing large masses of sites, locking out independents.<sup>64</sup>

Urban Taskforce Australia recommended that planning authorities should not be able to consider the impact on other retail businesses, such as loss of trade by incumbents to potential new entrants, when making zoning decisions or assessing individual developments.<sup>65</sup>

### **ACCC assessment**

State and territory planning laws which limit the availability of retail space by definition restrict opportunities for new supermarkets to establish within areas.

The majority of new retail developments are required to be supported by an economic impact assessment that concludes there is a community need for a new retail development. This conclusion is reached having regard to the provisions of the relevant planning scheme and the impact of the new retail development on existing retail developments. However, broadly speaking, little regard is had to competition issues in considering zoning or planning proposals.

Restrictions created by planning laws, and in particular the adoption of centres policies, are particularly acute for independent supermarkets who, for the reasons outlined in sections 9.4.1 and 9.4.2, find it comparatively more difficult to obtain access to sites within existing shopping centres and therefore rely more heavily on the availability of new sites in an area to establish themselves.

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60 Master Grocers Australia, submission no. 96, p. 11.

61 National Association of Retail Grocers of Australia, submission no. 129, p. 34.

62 Urban Taskforce Australia, submission no. 213, p. 10.

63 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 81.

64 Metcash, submission no. 217, p. 4.

65 Urban Taskforce Australia, submission no. 222, p. 4.

Further, the complexities of planning applications, and in particular the public consultation and objections processes, while soundly based, provide the opportunity for incumbents to ‘game’ the planning system to frustrate or prevent potential competitors entering local markets.

In evidence provided to the inquiry, Woolworths stated that they lodge planning objections where it is in their general interest to do so. When questioned about a specific planning objection lodged by Woolworths in respect of a proposal to upgrade an independent supermarket in Appin, New South Wales, Woolworths acknowledged that the grounds on which it had lodged the appeal—traffic and access, heritage, noise impact and overshadowing—had no impact on Woolworths. Rather, Woolworths acknowledged, the objection was lodged for the purpose of pursuing a commercial opportunity.<sup>66</sup>

Woolworths stated that lodging planning objections to prevent competitive entry was engaged in fairly regularly by other retailers and was a practice adopted by Woolworths where Woolworths had a commercial interest, be it an existing or planned future interest, to protect.<sup>67</sup>

It is clear that in these instances the commercial interest at stake is the ability to continue to trade in the area, or move into the area in the future, free of the competitive tension that the competing retailer lodging the planning application would otherwise provide.

Further, the ACCC has previously considered instances where the MSCs have entered into anti-competitive agreements by which they objected to liquor licence applications by other parties and then proposed restrictive agreements with those parties aimed at limiting the extent to which the parties would compete with Woolworths and Liquorland (a wholly owned subsidiary of the Coles Group) in return for withdrawing their objections.

In May 2005 Liquorland admitted that it had entered into illegal agreements with five applicants for liquor licences and was subsequently penalised \$4.75 million by the Federal Court. On 30 June 2006 the Federal Court found that four agreements entered into by Woolworths with liquor licence applicants contravened s. 45 of the Act. On 22 December 2006, the Federal Court imposed pecuniary penalties totalling \$7 million on Woolworths.<sup>68</sup>

As discussed in greater detail in section 9.5.2, attaching a liquor arm to a grocery business adds value to the business and allows other grocery retailers to compete more effectively with the MSCs. Any impediment to liquor retailing that the MSCs seek to impose on other grocery retailers therefore not only restricts competition in liquor retailing but also has the potential to insulate the MSCs’ grocery businesses from a greater level of competition as they would otherwise be subjected to.

The ACCC also heard evidence during the inquiry that leases between MSCs and landlords sometimes contain clauses requiring the landlord to object if a competing development is proposed in an area. The ACCC obtained copies of leases between shopping centres and MSCs that confirmed the existence of these clauses.

The ACCC considers there is no justification for provisions in leases that require landlords to object if competing developments are proposed in an area. Where a landlord has legitimate concerns about a development, they would be likely to object regardless of any obligation placed on them through their lease with an MSC to do so. Where such objections are lodged solely to protect the interests of the MSC, transparency would dictate that such objections should be lodged directly by the MSC.

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66 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 64.

67 *ibid.*, p. 65.

68 ACCC, *Woolworths penalised \$7 million for anticompetitive liquor deals*, media release, 22 December 2006.

Woolworths argued that its planning objections will only be successful if the proposed development does not conform to relevant planning legislation. However, unsuccessful objections lodged purely to protect the appellant's commercial interest still drain significant resources from the party proposing the development and can be used to delay and frustrate entry as well as creating disincentives to explore development opportunities in the first instance.

In response to a question regarding the possible consequences of its lease arrangement or developments being subject to tighter regulatory scrutiny, Woolworths stated that this would add a considerable cost to applications, which would eventually be reflected in grocery prices. This argument is equally applicable to unsuccessful planning objections by MSCs, lodged purely to protect their own commercial interest.

### *Conclusion*

Zoning and planning regimes act as an artificial barrier to new supermarkets establishing in areas with a, likely unintended, consequence of thereby potentially impacting on competition between supermarkets to supply consumers. As noted, the barriers to entry created by planning laws are particularly pronounced for independent supermarkets.

In particular, the centre's policy, combined with the strong preference of existing centre owners to lease space to the MSCs rather than independent supermarkets or new entrants, is likely to lead to a greater concentration of supermarket sites in the hands of the MSCs.

The ACCC recognises that zoning and planning policies are designed to preserve public amenity. In particular, zoning and planning laws are designed to encourage:

- the proper management, development and conservation of land for the purpose of promoting the social and economic welfare of the community and a better environment
- the promotion and coordination of the orderly and economic use and development of land
- the provision and coordination of community services and facilities
- the protection of the environment.<sup>69</sup>

The ACCC is not in a position to assess the merits of these objectives or the effectiveness of state and territory zoning and planning laws in achieving these outcomes, nor is it the ACCC's role to do so.

However, as noted, zoning and planning regimes, including existing centres policies, act as an artificial barrier to new supermarkets establishing in areas, thereby potentially impacting on competition between supermarkets to supply consumers. In particular, such policies, by limiting opportunities for new developments, contribute to increasing the level of concentration in the retail grocery sector.

The ACCC considers that zoning and planning policies, and, in particular, consideration of individual planning applications, should have specific regard to competition issues—specifically, whether proposed developments would assist in facilitating the entry into an area of a supermarket operator that is not presently operating in the area.

### **Recommendation**

The ACCC recommends that all appropriate levels of government consider ways in which zoning and planning laws and decisions in respect of individual planning applications where additional retail space for the purpose of operating a supermarket is contemplated should have specific regard to the likely

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69 Section 7 of the *Environmental Planning and Assessment Act 1979* (NSW).

impact of the proposal on competition between supermarkets in the area. Particular regard should be had to whether the proposal will facilitate the entry of a supermarket operator not currently trading in the area.

#### 9.4.4 Foreign investment rules

Existing rules regarding investments in Australia by foreign companies, in effect, require that any vacant land acquired by foreign companies be developed within 12 months of acquisition. ALDI submitted that these rules inhibit their ability to expand their networks of stores.

The entry into contracts for the purchase of real estate in Australia by foreign persons is governed by the *Foreign Acquisitions and Takeovers Act 1975* (FATA) and the *Foreign Acquisitions and Takeovers Regulations 1989* (FATR).

Unless specifically exempted by the FATR, approval from the Treasurer is required when a foreign person or company wishes to:

- acquire vacant land, regardless of value
- develop commercial property valued at \$50 million or more
- enter into commercial leases where the likely term of the lease is more than five years.

Acquisitions of vacant land for development by foreign interests are normally approved subject to continuous substantial construction on the vacant land commencing within 12 months of acquisition.

ALDI submitted that the stringency of this requirement represents a significant regulatory barrier to the timely and efficient expansion of ALDI's commercial operations in Australia. Further, ALDI contended that this regulation also puts it at a significant competitive disadvantage to the MSCs and other domestically owned supermarkets that are able to acquire land on the basis of long-term business planning without these constraints.<sup>70</sup>

On 23 April 2008 the Hon. Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, announced changes to foreign investment rules. Specifically, he announced that the timeframe for the development of vacant commercial land by foreign companies would be extended to five years.<sup>71</sup>

The Minister stated that the current time limit discourages new competitors from entering markets and prevents some existing competitors from expanding because they cannot secure forward purchases of land in growth areas and greenfield sites.<sup>72</sup>

The Minister cited the grocery sector as a particular area of the economy that may benefit from increased competition as a result of the proposed change.<sup>73</sup>

The ability to landbank is particularly important to vertically integrated retailers such as ALDI and Franklins as profitable expansion of their wholesale distribution networks requires a critical mass of stores in a given area. Conversely, it is difficult to develop a critical mass of stores without first having a viable distribution network.

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<sup>70</sup> Aldi, submission no 81, p. 11.

<sup>71</sup> The Hon. Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, *Government looks to increase competition across the economy with changes to foreign investment rules*, media release, Treasury, 23 April 2008.

<sup>72</sup> *ibid.*

<sup>73</sup> *ibid.*

Landbanking allows a number of sites to be identified and acquired and then developed simultaneously once a critical mass of suitable sites is reached.

This proposed change to foreign investment rules to allow foreign companies five years to develop acquired vacant land appears to address the concerns raised by ALDI.

## 9.5 Links to other industries

In recent years the MSCs have expanded their consumer offer beyond their traditional domain of grocery items into areas such as petrol, liquor, banking, pharmacy and general merchandise. The MSCs have also expanded into new categories that would have been typically sold only in pharmacies or general merchandise stores.

The broadening of the retail offer in supermarkets and connections with other business operations is not in itself a prima facie competition concern. In fact, often such changes are pro-competitive as they introduce a new strong competitive dynamic. However, the expansion into other business areas can raise barriers to entry to supermarket retailing. If consumer preferences change to the extent that it becomes necessary to offer these additional goods and services in order to compete effectively as a supermarket, this may make it harder for new entrants or smaller players to expand.

### 9.5.1 Petrol retailing (shopper docket)

One possible barrier to entry could be the need to establish links with petrol retailing as the MSCs have done with their shopper docket arrangements.

Shopper docket arrangements providing discounts on petrol upon purchasing a minimum amount of groceries and other items have aided the establishment and expansion of supermarkets in petrol retailing. The ACCC considered shopper docket arrangements in its December 2007 report on its inquiry into the price of unleaded petrol (referred to as the ACCC's petrol inquiry).<sup>74</sup> The focus of that report was on the impact of shopper docket arrangements on competition in the retail market for petrol. As discussed below, the ACCC analysis of price data suggests that petrol prices were lower after the introduction of the MSCs' shopper docket schemes.

The focus of the consideration of shopper docket arrangements in this inquiry is on the impact of these arrangements on grocery prices and competition between grocery retailers.

#### *Woolworths shopper docket scheme*

Woolworths routinely offers a 4 cents per litre (cpl) discount on the price of fuel to customers who present a voucher obtained upon purchasing \$30 or more from a Woolworths or Safeway supermarket, a Big W store or another Woolworths subsidiary. From time to time, Woolworths offers a greater discount on petrol to customers who have purchased a minimum value of goods from a particular retailer in the Woolworths' group.

Woolworths commenced its shopper docket scheme in 1996 when it became the first Australian supermarket to enter petrol retailing. In August 2003 Woolworths and Caltex announced a joint venture arrangement for the retailing of motor fuel through up to 450 petrol retail sites. Longer term arrangements (involving up to 500 sites) were announced in March 2004. As at 30 March 2008, Woolworths operates from 515 petrol outlets across Australia. Of these, 381 outlets are owned and

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<sup>74</sup> ACCC, *Petrol prices and Australian consumers: report of the ACCC inquiry into the price of unleaded petrol*, December 2007.

operated directly by Woolworths and the remaining 134 are owned by Caltex and operated by them directly or through their franchisees under an alliance arrangement in which Caltex supplies petrol to Woolworths for retail sale.

Estimates provided to the ACCC's petrol inquiry suggest that transactions for around 60 per cent of fuel sold at Woolworths service stations involve a shopper docket.

Woolworths advised the ACCC as part of this inquiry that the shopper docket fuel reward has no impact on the pricing of Woolworths supermarkets at a local, regional or national level. Woolworths indicated that the 'cost' of the fuel discount is small, amounting to less than 0.5 per cent of grocery sales. Woolworths stated that it treats the fuel discount as a loyalty program for its customers and that, if this loyalty program did not exist, it would need to implement some other marketing program which, Woolworths argued, it is likely would not be as effective or as directly rewarding to its customers.

Recently, Woolworths has begun replacing its petrol shopper dockets paper vouchers with a swipe card that stores rewards electronically. Known as Everyday Rewards, the scheme comprises fuel e-vouchers and extra rewards or prizes offered from time to time.<sup>75</sup> Customers who spend the qualifying amount in a single transaction at participating Woolworths or Safeway supermarkets or participating Big W stores can accrue fuel saving offers on the Everyday Rewards card. As with petrol shopper dockets, the rewards accrued on the card expire 28 days after the date of issue.

### *Coles shopper docket scheme*

In July 2003 Coles and Shell entered into an alliance under which Coles took over the management of Shell's core franchise network across Australia. The roll out of the Coles Express network was completed in March 2004 and there are currently just over 600 Coles Express service station sites.<sup>76</sup>

Coles Express routinely offers a 4 cpl discount on petrol to customers who purchase \$30 or more from Coles Supermarkets and liquor outlets, or other retailers in the Coles Group. From time to time, Coles Express offers discounts above the standard 4 cpl. Coles submit that millions of customers choose to redeem their fuel discount offer every month.<sup>77</sup>

Coles advised the ACCC's petrol inquiry that Coles Express funds 1 cent of the 4 cpl discount on petrol while the remaining 3 cents are funded by the business area which elects to offer a shopper docket promotion. Any additional discounts offered above 4 cpl are funded by the business area. Coles advised that the cost of its shopper docket scheme is not a factor in determining the price of individual grocery items. It is treated as a promotional option in the same category as a catalogue or television advertising, and the cost is treated as a marketing expense. Coles advised that the objective of offering a shopper docket promotion is to drive additional sales volumes.

### *Other shopper docket schemes*

Some grocery retailers have introduced their own shopper docket schemes. For example, IGA has introduced a scheme in New South Wales, Queensland, Victoria and South Australia where customers who spend over \$30 in-store and present a petrol docket from any petrol retailer receive a 4 cpl discount off their groceries. In Western Australia, consumers who spend at least \$25 in an IGA supermarket are eligible for a 4 cpl discount off fuel at participating United Petroleum, Peak or BP service stations.<sup>78</sup>

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<sup>75</sup> Woolworths Ltd, viewed 1 July 2008, [www.everydayrewards.com.au](http://www.everydayrewards.com.au).

<sup>76</sup> Coles Group Limited, *Annual Report 2007*, p. 8.

<sup>77</sup> Coles, submission no. 157, p. 3.

<sup>78</sup> IGA Distribution Pty Ltd 2001, viewed 19 June 2008, [www.iga.net.au/igafresh/index.cfm?page\\_id=2296&breadcrumb=About%20IGA%20<%20Search%20Fuel%20Deal&branch\\_ID=2298](http://www.iga.net.au/igafresh/index.cfm?page_id=2296&breadcrumb=About%20IGA%20<%20Search%20Fuel%20Deal&branch_ID=2298).

Additionally, information presented to the ACCC's petrol inquiry suggests that a number of petrol retailers, including Neumann Petroleum and APCO Service Stations, have introduced their own shopper docket arrangements, while Mobil and Matilda Fuel Supplies offer fuel discounts based on convenience store purchases, and BP has introduced a credit card discount scheme which applies to purchases of both fuel and goods from its convenience stores.

The Servo Savers arrangement is a widely established shopper docket scheme not affiliated with the MSCs. Under this scheme, consumers may receive a discount of 6 cpl off the cost of the first 30 litres of fuel by presenting a docket from participating businesses. As many as five dockets from participating businesses may be presented at once to receive a cumulative discount of 30 cpl off the cost of the first 30 litres of fuel purchased.<sup>79</sup>

## Shopper docket notifications

### *Exclusive dealing and third line forcing notifications*

Shopper docket arrangements may raise issues under the exclusive dealing provisions of the Act. One form of exclusive dealing, third line forcing, involves the supply of goods or services on condition that the purchaser acquires goods or services from a particular third party, or a refusal to supply because the purchaser will not agree to that condition—for example, the provision of discounted fuel on condition that the purchaser has acquired groceries from a third party. Such conduct is prohibited under ss. 47(6) and 47(7) of the Act.

While third line forcing is prohibited under the Act, parties are able to obtain immunity for third line forcing conduct by 'notifying' the ACCC of the arrangement. Immunity from legal action begins 14 days after notification, provided the ACCC does not object in that period by issuing a draft notice. The ACCC may at any stage remove the immunity provided by a third line forcing notification if it is satisfied that the likely benefit to the public from the notified conduct would not outweigh the likely detriment to the public resulting from the conduct.

Under amendments to the Act that came into effect on 1 January 2007, shopper docket arrangements between related companies (including many of the supermarket arrangements) will no longer constitute a contravention of ss. 47(6) or 47(7).

### *ACCC consideration of shopper docket notifications*

In 2004 following a period of change in the grocery and petrol sectors, including the commencement of Coles' arrangements and the announcement of the Woolworths and Caltex joint venture, the ACCC conducted a public review of shopper docket arrangements. The ACCC report, released in February 2004, found that there were significant benefits to consumers from shopper docket petrol discount schemes and that the schemes had not had an anti-competitive effect on independent petrol retailers.

Most recently, the ACCC considered shopper docket arrangements as part of its inquiry into the price of unleaded petrol in 2007. The ACCC concluded that the general emergence of supermarket shopper docket arrangements has not had an anti-competitive effect but has delivered discounts that are to the benefit of consumers and has promoted competition from other retailers.

The ACCC noted that shopper docket arrangements have aided the establishment and expansion of supermarkets in petrol retailing and have created significant challenges for those retailers not aligned with the supermarkets. It also noted that retailers have responded to shopper docket arrangements in a

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<sup>79</sup> Servo Savers (Aust) Pty Ltd, viewed 1 July 2008, [www.servosavers.com.au](http://www.servosavers.com.au).

variety of ways, including competitive promotions and a renewed focus on delivering consumer choice and convenience. Some independent retailers have introduced their own shopper docket discounts and loyalty schemes. However, the ACCC acknowledged that no competing scheme can have the pulling power of those offered by the two main supermarkets.

## Submissions to the inquiry

The issue of shopper dockets was raised in a number of submissions and during hearings. Several parties raised concerns about the impact of the MSCs' shopper docket arrangements on competition in grocery retailing and questioned whether consumers are paying more for their groceries in order to obtain 'cheaper' petrol.

A number of parties raised concerns about the impact of shopper dockets on consumer behaviour and consumer choice. The Consumer Action Law Centre (CALC) submitted that petrol shopper docket arrangements create a barrier to switching by tying consumers to particular retailers.<sup>80</sup> In CALC's view, the recent introduction by Woolworths of a card to replace shopper dockets aligns customers more tightly to the retailer.<sup>81</sup> Choice advised that its Choice survey indicates that shopper dockets are influencing the purchasing decisions of a sizeable minority of consumers.<sup>82</sup> NARGA referred to a 2003 survey conducted by Roy Morgan which indicated that around 50 per cent of shoppers viewed discount petrol as a significant incentive to shop at the associated MSC; however, NARGA also noted that shopper dockets no longer have a large effect on consumers' buying habits.<sup>83</sup> Metcash considered that petrol shopper docket schemes are widely used by consumers and have influenced consumer choice in petrol retailers.<sup>84</sup>

Many parties consider that shopper docket arrangements have had an adverse effect on competition. CALC, Choice and the Public Transport Users Association (PTUA) raised concerns that the shopper docket arrangements result in market distortions associated with bundling and cross-subsidisations.<sup>85</sup> The PTUA considers that the cross-subsidisation of petrol consumption resulting from shopper dockets should be discouraged.<sup>86</sup>

Several parties, including Choice and the Australian Manufacturing Workers Union, seek greater transparency around the financial arrangements and costs associated with shopper docket schemes.<sup>87</sup>

Other parties, including French's Youngtown Supermarket, raised concerns about the impact of the MSCs' shopper docket arrangements on other grocery retailers.<sup>88</sup>

SPAR considered that it is not able to effectively compete with the incentives offered by petrol shopper docket arrangements.<sup>89</sup> Franklins considered that the MSCs' presence as petrol retailers and their shopper docket schemes provided them with a substantial advantage that is not available to other market participants.<sup>90</sup>

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80 Consumer Action Law Centre, submission no. 124, p. 10.

81 *ibid.*

82 CHOICE, submission no. 143, p. 4.

83 *National Association of Retail Grocers of Australia*, submission no. 129, p. 60.

84 Metcash, submission no. 181, p.17.

85 Consumer Action Law Centre, submission no. 124, p. 10; CHOICE, submission no. 143, p. 2; Public Transport Users Association, submission no. 76, p. 4.

86 Public Transport Users Association, submission no. 76, p. 4.

87 CHOICE, submission no. 143, p. 3; Australian Manufacturing Workers Union, submission no. 123, p. 10.

88 ACCC, public hearing transcript, Launceston, 14 April 2008, p. 40.

89 SPAR Australia, submission no. 195, p. 8.

90 Franklins, submission no. 104, p. 8.

Metcash submitted that shopper docket arrangements create barriers to entry for grocery retailers as any new entrant into grocery retailing must not only provide competitive grocery prices but also provide customers a discount for their petrol purchases.<sup>91</sup> Metcash noted that the limited availability of petrol partners would add to the difficulty of a new entrant setting up a shopper docket scheme.<sup>92</sup>

Franklins submitted that shopper docket schemes have had a dramatic effect on the ability of smaller retailers to compete with Coles and Woolworths.<sup>93</sup> Franklins advised that it experienced a 13.5 per cent drop in its sales in New South Wales following the introduction of the MSCs' shopper docket schemes.<sup>94</sup> In a limited number of rural locations in New South Wales, Franklins has established localised petrol shopper docket programs but these have had limited and varied success.<sup>95</sup>

Against this, FoodWorks submitted that shopper docket schemes do not really impact on the ability of the smaller grocery retailers to compete because the smaller retailers' offering is focused on non-price factors such as convenience.<sup>96</sup> FoodWorks submitted that the new Woolworths petrol card may build increased loyalty with existing customers but it is unlikely to further impact smaller grocery retailers.<sup>97</sup> FoodWorks also considered that the initial advantage provided to the MSCs by their shopper docket schemes has been negated because many retailers now offer similar schemes.<sup>98</sup>

Some parties, including Mr Brian Barlin, Mr John Gallo and the Sydney Food Fairness Alliance, submitted that the entry of the MSCs into the fuel sector has resulted in higher grocery prices.<sup>99</sup> Metcash submitted that shopper docket schemes enable retailers to raise their 'headline' prices while still retaining customers through the scheme, which offers a lower 'bundled' price overall.<sup>100</sup>

Against this, Mr Bernie Kingston argued that, given the maximum discount is 4 cpl, it would have little impact on the overall bottom line of the supermarkets after allowing for the profit on the sale of the groceries and the fuel.<sup>101</sup>

Several parties noted the impact of shopper docket arrangements in the context of the operation of convenience stores. Mr Bob Katter MP and NARGA considered that the MSCs' move into petrol retailing provided them with the opportunity to open and operate a significant number of convenience stores, to the detriment of independent retailers.<sup>102</sup>

Several parties, including ALDI, SPAR, Franklins and FoodWorks, described their responses to MSCs' shopper docket arrangement.

ALDI advised that it does not provide shopper dockets or fuel vouchers because it considers that the costs of running these schemes are inconsistent with its strategy of transparency and everyday low prices as ultimately the cost of any discount must be recouped through higher prices elsewhere.<sup>103</sup> ALDI considered that its customers recognise that the savings they achieve from shopping at ALDI outweigh any perceived savings from shopper dockets or fuel vouchers.<sup>104</sup>

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91 Metcash, submission no. 181, p. 11.

92 *ibid.*

93 Franklins, submission no. 104, p. 8.

94 *ibid.*, p. 7.

95 *ibid.*

96 FoodWorks, submission no. 90, p. 38.

97 *ibid.*

98 *ibid.*

99 Brian Barlin, submission no. 1, p. 7; John Gallo, submission no. 182, p. 1; Sydney Food Fairness Alliance, submission no. 52, p. 9.

100 Metcash, submission no. 181, p.18.

101 Bernie Kingston, submission no. 12, p. 5.

102 Bob Katter MP, submission no. 180, p.19; NARGA, submission no. 129, p. 60.

103 ALDI, submission no. 81, p. 10.

104 *ibid.*, p. 14.

SPAR noted that it does not own petrol outlets and it is only able to provide a fragmented petrol shopper docket system by partnering with other small suppliers.<sup>105</sup>

Franklins advised that it established a customer loyalty program in 2007 to counter the effect of the shopper docket schemes by Coles and Woolworths.<sup>106</sup> Under the program, customers earn loyalty points for every dollar spent at Franklins.<sup>107</sup> Once 2000 points have been accrued, customers can redeem the points for payment of grocery purchases or for Franklins vouchers. Bonus points offers and other special offers are available exclusively to loyalty program members.<sup>108</sup> While Franklins is pleased with the early impacts, it is difficult to gauge the full effect of the program given the relatively short time that the program has been in operation.<sup>109</sup>

FoodWorks has introduced a reverse docket system where customers who spend over \$30 in-store and present a petrol docket from any petrol retailer receive a 4 cpl discount off their groceries.<sup>110</sup> FoodWorks notes that, under this type of scheme, every petrol station remains available to its customer base.<sup>111</sup> FoodWorks advised that, to date, the amount of redemption has been limited and it is not considered an important driver of customer traffic unless the offer is at a higher discount level or tied to other promotions.<sup>112</sup>

Metcash noted the benefits of a 'reverse scheme' in preserving competition in the petrol retailing market as it does not require an alliance with a specific petrol retailer.<sup>113</sup> Further, Metcash noted that reverse docket schemes do not create artificial price dependencies between grocery retailing and petrol retailing.<sup>114</sup>

The Motor Trades Association of Australia submitted that the entry of the supermarket chains into the retail petroleum industry has seen the development of market circumstances that place independent fuel retailers at a competitive disadvantage.<sup>115</sup>

## ACCC analysis

### *Impact of shopper docket arrangements on grocery retailing*

A central concern expressed by submissions is that the introduction of shopper docket arrangements has had an adverse impact on competition in the grocery retailing sector.

In particular, concerns have been raised that shopper docket arrangements influence the purchasing decisions of consumers and create a barrier to switching by tying consumers to particular grocery retailers. Concerns have also been raised that shopper docket arrangements create barriers to entry for grocery retailers and the presence of the MSCs in the operation of service station convenience stores is having a detrimental impact on grocery retailers. Submissions suggest that, when introduced, the MSCs' shopper docket arrangements provided a significant competitive advantage, and some grocery retailers continue to find it difficult to effectively compete with the incentives offered by petrol shopper docket arrangements.

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<sup>105</sup> SPAR Australia, submission no. 195, p. 8.

<sup>106</sup> Franklins, submission no. 104, p. 12.

<sup>107</sup> Franklins, viewed 19 June 2008, [www.franklins.com.au](http://www.franklins.com.au).

<sup>108</sup> *ibid.*

<sup>109</sup> Franklins, submission no. 104, p. 12.

<sup>110</sup> FoodWorks, submission no. 90, p. 38.

<sup>111</sup> FoodWorks, submission no. 90, p. 38.

<sup>112</sup> *ibid.*, p. 38.

<sup>113</sup> Metcash, submission no. 181, p.18.

<sup>114</sup> *ibid.*, p.18.

<sup>115</sup> Motor Trades Association of Australia, submission no. 79, p. 2.

It appears that the initial impact of the MSCs' shopper docket arrangements on their grocery competitors was significant, with Franklins submitting that it experienced a 13.5 per cent drop in its sales in New South Wales following the introduction of petrol shopper docket arrangements by the MSCs.<sup>116</sup>

However, over time, grocery retailers appear to have responded to the MSCs' shopper docket arrangements in a variety of ways, including by:

- establishing their own shopper docket arrangements
- establishing 'reverse' shopper docket arrangements whereby customers who purchase a certain amount of groceries and present a petrol receipt (from any petrol retailer) receive a 4 cpl discount off their grocery purchase
- introducing customer loyalty programs.

The ACCC understands that the success of some of these initiatives has been varied while others have only been operating for a relatively short period of time.

As acknowledged in the ACCC's 2007 report about the price of unleaded petrol, no competing shopper docket scheme can have the pulling power of those offered by the MSCs. In the context of the grocery industry, this pulling power, all else being equal, is likely to result in some consumers exhibiting a preference for purchasing groceries at the MSCs in order to obtain access to a petrol discount through a shopper docket. As noted, several parties submitted that shopper docket arrangements affect consumers' choice of grocery retailers.

However, as discussed in chapter 4, while 32 per cent of consumers questioned in the ACCC's Millward Brown survey indicated that they considered fuel discount schemes to be an important factor when choosing where to shop for groceries, of the 12 factors which consumers were asked to rate, fuel discount schemes were considered to be the third least important factor.

More generally, as discussed in chapter 4, supermarkets compete across their entire retail offering including price, quality, range, convenience, service and in-store amenities. The offering of loyalty programs, such as shopper docket arrangements, is only one element of this retail offer.

With respect to convenience stores, the ACCC notes Coles' submission to the ACCC's petrol inquiry that convenience stores provide an important source of income to petrol retailers. In its petrol report, the ACCC noted that the potential for growth in convenience store sales has become the focus of many petrol retailers competing against Coles Express and Woolworths shopper docket arrangements. Any increased competition with respect to convenience store offerings by petrol retailers will have an impact on the grocery sector, and some grocery retailers are likely to find the changing environment extremely challenging. However, while market evolution as a result of competition may present difficulties for some, it is generally to the benefit of consumers.

### *Impact on grocery prices*

In addition to examining whether shopper docket arrangements are a barrier to entry, the ACCC has also considered the direct impact of these arrangements on grocery prices.

A concern raised by many is that shopper docket arrangements have not been beneficial to consumers because they have resulted in increased grocery prices. It is alleged that the supermarkets have increased the price of grocery items to recoup the discount provided on petrol under their shopper docket arrangements.

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<sup>116</sup> Franklins, submission no. 104, p. 7.

As grocery pricing is complex it is not possible to accurately gauge the effect that petrol discount vouchers may have on grocery prices. For this reason, it is not possible to accurately measure any impact on grocery prices as a result of shopper docket.

However, it is possible to measure the cost of shopper docket schemes in terms of the total value of the discounts offered and to gain some understanding of the relative size and importance of these costs in the context of the broader businesses of Woolworths and Coles.

Woolworths and Coles offer similar discount schemes, with a standard discount of 4 cpl and greater discounts periodically associated with the purchase of a minimum value of groceries or other items.

Both advise that the cost of their respective shopper docket schemes is not taken into account in setting prices for individual grocery items but rather is treated as a marketing expense.

This practice is mirrored by members of FoodWorks, which advises that the discount is funded from their store margin or marketing expense and submits it is not aware of any grocery price increases by its members to fund the cost of shopper docket.

Based upon information provided to the ACCC, it is difficult to conclude this expense in isolation could have a significant effect on grocery prices. No evidence has been put forward to support a view that the supermarkets recoup the cost of their shopper docket schemes via higher grocery prices. Furthermore, in the context of business groups which annually generate billions of dollars in sales and hundreds of millions of dollars in profit, the cost of the shopper docket scheme is unlikely to be significant.<sup>117</sup> Woolworths has indicated that the cost of the shopper docket schemes is in the order of half of one per cent of the total annual sales. Both Woolworths and Coles also stated that their shopper docket programs are loyalty programs for customers, which, Woolworths stated, would need to be replaced with some other form of market program if they did not exist. This suggests, at worst, any effect on grocery prices of the shopper docket schemes is likely to be insignificant.

### *Impact of shopper docket arrangements on petrol prices*

While not directly relevant to this inquiry, a related issue is the potential impact of shopper docket arrangements on petrol prices.

The ACCC recently considered whether shopper docket arrangements inflated retail petrol prices as part of its petrol inquiry.

ACCC analysis of petrol price data suggests that retail petrol prices were lower following the entry of Coles Express and Woolworths into petrol retailing. The petrol prices of the MSCs have also generally been lower than market average prices. However, consumers should not automatically rely on shopper docket vouchers to necessarily deliver the lowest price.

There are often a range of retail prices charged by service stations and on any given day the range from the lowest available retail price to the highest is usually between 15 and 20 cpl.

The ACCC recently highlighted the need for consumers to look at petrol price boards to check the competition in their area before filling up their tanks.<sup>118</sup> Analysis of petrol pricing in a 9.00 am 'snapshot' on 7 May 2008 showed that Coles Express sites set the highest prices in all four eastern capital cities. It was found that Coles Express was setting the highest prices at a significant number of its sites, which is consistent with a recent trend identified by the ACCC. Therefore, loyal shoppers redeeming their

<sup>117</sup> In its *2007 Annual Report*, Coles reported sales of \$34.7 billion, an underlying net profit after tax of \$792 million and advertising expenses of \$341 million. In its *2007 Annual Report*, Woolworths reported total sales of \$42 477 million, and a net operating profit after tax of \$1294 million across all its businesses.

<sup>118</sup> P Walker (ACCC Commissioner), *Coles Express leads petrol prices up in four capitals*, media release 120/08, ACCC, 7 May 2008.

shopper docket vouchers at the highest priced sites are paying more than they need to.

## Conclusion

The introduction of shopper docket arrangements is likely to have had an impact on other grocery retailers. In particular, the offer of discount petrol schemes may have increased barriers to entry and expansion, particularly for smaller retailers. However, evidence also suggests that the schemes have delivered discounts to the benefit of consumers and promoted competition from other retailers.

More generally, evidence indicates that some retailers have responded with alternative arrangements. Further, shopper docket arrangements are only one part of the total retail offer on which supermarkets compete. More generally, there is no evidence to suggest grocery retailers as a whole are in jeopardy as a result of the MSCs' shopper docket schemes.

Further, shopper docket arrangements do not appear to have resulted in a noticeable increase in grocery prices.

### 9.5.2 MSCs' involvement in other business areas

As noted, along with the expansion into petrol, the MSCs are following a general pattern of expanding the range of their business operations into areas such as liquor, banking, pharmacy and general merchandise.

As with petrol retailing, the more general broadening of the MSCs' retail offer has the potential to raise barriers to entry if consumer expectations of the types of goods and services provided by supermarkets changes to such an extent that other supermarket operators would be required to offer these goods and services in order to compete effectively.

#### Liquor

Evidence provided to the inquiry suggested that liquor retailing is an important complement to a supermarket's retail grocery offer as the added convenience of being able to make grocery and liquor purchases in the one location is valued by consumers.<sup>119</sup>

Against this, as discussed in chapter 4, only 12 per cent of consumers questioned in the ACCC's Millward Brown survey indicated that they considered that having a liquor store attached to a supermarket was an important factor when choosing where to shop for groceries. Of the 12 factors which consumers were asked to rate, having a liquor store attached to a supermarket was considered to be the least important factor.

Another reason grocery retailers may be interested in expanding into liquor retailing is the profitability of liquor retailing in its own right coupled with the potential synergies, in distribution and retail operations, of having the liquor and grocery retailing operations co-located. However, these benefits of grocery retailers expanding into liquor are unlikely to create a barrier to other grocery retailers unless liquor operations were being used to cross-subsidise groceries. In this respect, FoodWorks submitted that liquor is highly competitive with the MSCs trying to build market share<sup>120</sup>, and any cross-subsidy is likely to be taken from groceries and used in liquor operations.

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119 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 31.

120 FoodWorks, submission no. 90, p. 26.

More generally, while it appears that expansion into liquor retailing could provide some competitive advantage to grocery retailers by expanding the range of their consumer offer, it does not appear that this expansion creates any significant barriers to entry in itself. To the extent that other grocery retailers are unable to match this expanded offer, this is primarily a function of liquor licensing laws and, on occasions, associated licence objections lodged by incumbent grocery and liquor retailers to prevent competitors similarly expanding their consumer offer.

As such, the ACCC does not consider that the MSCs' expansion into liquor significantly raises barriers to entry. Issues such as site access would seem to be much more significant barriers. However, to the extent that selling liquor does create a competitive advantage for a grocery retailer, the need to obtain a liquor licence (which provides for more opportunity for incumbents to object) does create additional costs and potentially some barriers to entry.

This is not to suggest that the ACCC considers that a relaxation of liquor licensing laws would be appropriate, given the stated aims of such legislation, including the regulation of alcohol sales, having regard to the welfare and needs of the community and the minimisation of any harm arising from misuse of alcohol.<sup>121</sup>

## Banking

The introduction of EFTPOS in the 1980s paved the way for the introduction of supermarket banking in Australia. Offering banking and other financial services is now seen as a good way for supermarkets to capitalise on their strong brands and customer base. Woolworths stores, for example, process 114 million transactions or 11 per cent of all credit card transactions in Australia each year.

Supermarket banking services are commonplace in the United Kingdom, with retailers such as Sainsbury's, Tesco, and Marks & Spencer among those with dedicated financial services departments offering personal loans, insurance, credit cards and other banking products. Australian supermarkets are currently predicted to increase their offering in these areas.

In 2007 following a global tender process, Woolworths negotiated a deal with HSBC to release a Woolworths credit card. It has previously offered a Mastercard through their Ezy Banking joint venture with the Commonwealth Bank. In 2006 Woolworths also signed a deal with ANZ for the placement of co-branded ATMs in their stores. Coles also offers a Mastercard; however, their card is owned and controlled by GE.

The potential risk that access to banks in Australia for independent retailers could be foreclosed by the current links with the MSCs does not appear to be of concern at the current scale as these products are available from a wide variety of sources. Although small independent retailers are less likely to have an incentive to establish links with the banking sector because the establishment costs will not justify the investment, there would appear to be few barriers to larger players establishing such links.

## Discount department stores

Woolworths Ltd is involved in general merchandise department stores through the Big W brand. Coles is affiliated with discount department stores Target and Kmart as they are both owned by the Coles parent company, Wesfarmers Ltd. In relation to the grocery products sold by these stores, there is some overlap in the products sold, which may result in increased buyer power for the MSCs. This is because, for those products that are sold in both the supermarket division and in the general merchandise store, they will sell an even larger proportion of the product sold in Australia.

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<sup>121</sup> *Liquor Act 1992* (Qld), s. 3.

Currently, the different product offerings of the MSCs and the general merchandise department stores mean that they only overlap in relation to a relatively limited number of grocery products (generally in the dry groceries range, particularly confectionary) and, as a result, the relationship between these stores is not in and of itself typically seen as a competition concern. There is also overlap in the sense that the MSCs sell many products (particularly basic stationery, hardware, kitchen, underwear and linen ranges) that are also sold in the general merchandise stores. However, there are many other retailers that also compete in this area. Furthermore, the focus of this inquiry is on groceries, rather than general merchandise.

In the United States, discount department stores such as Costco and Wal-Mart stock a significant range of both grocery and non-grocery items. Such developments have generally been viewed as an extension of the one-stop shopping concept, which is regarded as potentially appealing to shoppers interested in saving time and travel costs.

The common ownership between general merchandise stores and MSCs may raise additional buyer power issues for some product ranges but it is not generally considered a competition concern in and of itself. However, this is not to suggest that the ACCC would not closely analyse any mergers or acquisitions in this area in order to identify possible competition effects.

### Convenience store retailing

Woolworths and Coles are both involved in convenience store retailing and Metcash is involved in wholesale supply to convenience outlets. The ACCC does not consider that expansion into convenience store retailing is an area of competition concern. The scale of the MSCs and Metcash may enable them to access lower prices for their convenience outlets. However, this does not inhibit competition between the MSCs and other supermarkets.

### Pharmacy sales and other new categories

The MSCs currently stock a limited range of non-prescription pharmaceutical products and have expressed an interest in expanding into a full range of products if the state and territory laws throughout Australia would permit them. The ACCC considers that the extension by the MSCs into the sale of a limited number of pharmacy products and the possibility that they may expand into a full range of products is unlikely to significantly further raise barriers to entry into grocery retailing in Australia. The ACCC considers that the broadening of the MSCs' offering into pharmacy products may have consumer appeal due to the ability to one-stop shop but it is unlikely to be something that on its own delivers a sustained competitive advantage to the MSC retailers.

In noting this, the ACCC is not commenting on the merits, or otherwise, of pharmaceutical products being made available to consumers in supermarkets. The ACCC's consideration of this issue in the context of this inquiry has been limited to consideration of whether expanding supermarkets retail offer may raise barriers to entry. Consideration of issues related to the appropriateness of a full range of pharmaceutical products being made available for sale in supermarkets is beyond the scope of this inquiry.

### ACCC's view

The retail offer provided by supermarkets continues to evolve over time. From their traditional base of dry groceries, supermarkets have, over time, expanded their offer to include bakery products, fresh

fruit and vegetables, deli meat and fish products. In more recent times the retail offering of the MSCs has expanded further still, away from food items into other categories of products such as those noted above.

The expansion of supermarkets into these areas has brought a new competitive dynamic, both to grocery retailing and to retail sectors that have traditionally sold these products, which is likely to be of benefit to consumers.

As noted in relation to shopper dockets, supermarkets compete across their entire retail offering including price, quality, range, convenience, service and in-store amenities. Expanding into any particular new retail area is unlikely, in itself, to significantly impact consumers' choices of store in the long run given the range of factors weighed up in choosing where to shop. However, the broadening of the range of the supermarkets' retail offer is likely to provide a competitive advantage to the extent that this broader range is valued by some customers. To the extent that expansion into a broad range of areas does influence consumers' choices about where to shop, this reflects the value consumers place on this broader retail offer.

The expansion of the MSCs into these areas could potentially raise barriers to entry or expansion for competitors seeking to develop full-line supermarkets to meet the needs of one-stop grocery shoppers. While there is nothing to stop a potential rival matching the expanded retail offer of the MSCs, the broader the range of goods and services consumers come to expect their local supermarket to offer, the more difficult and costly it becomes for new supermarkets to establish themselves.

## 10 Conclusions on competition at retail level

### Key points

Based on the analysis in the previous chapters, the following are the key features relevant to a consideration of retail competition in the Australian grocery industry.

- Australian food prices have been increasing at a rate greater than the CPI since 1990. Among a number of comparable OECD countries, Australia's is the only economy that exhibits that feature.<sup>1</sup> While much of that inflation can be attributed to domestic factors such as floods, cyclones and droughts, and international factors including economic growth in Asia, it is impossible to rule out factors relating to domestic competition as contributing in some way to the gap between CPI and food price inflation.
- Any contribution from increased retailer margins to food inflation is, however, small. Less than one-twentieth of all food inflation in the past five years could potentially be attributed to increased gross margins achieved by the major supermarket chains (MSCs) and Metcash. Accordingly, retail level competition issues do not lie at the heart of Australia's food price inflation. Competition issues may, however, still be significant.
- Supermarkets compete on both price and non-price components of the retail offer (such as convenience). The structure of local markets is strongly influential on the competitiveness of prices in each local area. The presence of the MSCs and ALDI has a positive influence on the competitiveness of pricing in individual regions. The presence of a Metcash-supplied independent or Franklins has a less significant influence.
- Competition in grocery retailing appears to be stronger on non-price elements of the retail offer than on price. Non-price elements of the retail offer, such as convenience and product range, are significant determinants of where consumers choose to shop.
- Price competition does exist, despite not being a strong feature of the market. Price competition primarily takes two forms. The first is promotional pricing, which the MSCs, Franklins and the Metcash-supplied independents engage in. Promotional pricing is, however, often a reflection of inter-brand competition rather than supermarket competition, as the promotional program is most often funded by the manufacturer or supplier. This is discussed in greater detail in chapter 15.

The second form of price competition between the MSCs occurs on what are called known value items, which are about 300 or so items for which consumers commonly remember the price and which are used to assess the value of a supermarket's offering. ALDI, as a low-cost retailer with a limited number of product lines, provides effective price competition on many known value items.

The evidence before the inquiry did not suggest that there is strong broad price competition, either in the form of sustained supermarket investment in promotional pricing or broad price discounting across the entire range stocked by the MSCs.

## Key points

The stability of the market, high concentration and transparency of pricing limit the benefit to an MSC of pursuing a heavy discounting strategy. The fact that most independents receive a substantial proportion of their packaged grocery stock from Metcash, on terms that make direct price competition difficult, limits the competitive effectiveness of many independents. Only ALDI has the incentive to engage in sustained price competition, which it has done since its arrival in Australia, albeit on a more limited range of products than are stocked by the MSCs.

- The earnings of the two MSCs are in the average to high range by international standards. Woolworths is currently more profitable than Coles and has increased its EBIT margin consistently over the period from 2001–02 to 2006–07. The data is consistent with a relatively stronger position for Woolworths compared to Coles. There is evidence that Coles and Woolworths have experienced larger increases in categories where the MSCs have a relatively larger share of national sales. In wholesaling, Metcash, the only significant supplier of wholesale groceries to the independent sector, achieves healthy margins having regard to its role in the supply chain.
- Barriers to entry to the Australian grocery market in the area of packaged groceries and large format supermarkets are very high. Access to sites and the need to generate large volumes of sales to access products on competitive terms are the two main barriers. The ALDI experience shows that large capital reserves are essential for entry on a significant scale. The fact that Metcash is essentially the only source of packaged groceries for non-vertically integrated supermarkets makes organic, competitive market entry difficult. Further, access to suitable sites makes it difficult for existing independent chains capable of operating large format supermarkets to grow organically. Suitable sites are difficult to obtain because of the MSCs' customer pulling power as anchor tenants and their greater ability to pay premiums for the most attractive sites. Difficulties in accessing sites are exacerbated by the deliberate strategies employed by the MSCs to ensure they maintain exclusive access to prime sites. In particular, these strategies include terms in leases that effectively prevent centre managers leasing space in centres to competing supermarkets and the use of the planning appeals process to frustrate new developments.

The features of the market summarised in the key points above suggest the retail competition is workably competitive, but that a number of factors currently weaken price competition in grocery retailing in Australia. Why this is so can be understood in part by examining the behaviour of participants in the market.

## 10.1 Behaviour of market participants

### 10.1.1 Woolworths

Woolworths does not have a policy of undercutting on standard shelf pricing. It monitors pricing of Coles and nearby competitors and will match cent for cent. It will not, however, lead standard prices down.<sup>1</sup> Confidential information provided to the ACCC during the inquiry suggests that Woolworths is

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<sup>1</sup> ACCC, public hearing transcript, 19 May 2008, pp. 52–55.

able to keep its prices very close to those set by Coles, thus limiting opportunities for market share to be taken from Woolworths. Confidential documentation received also indicates that market conditions allow Woolworths to raise its standard shelf pricing in some circumstances.

Woolworths does, however, invest heavily in promotional pricing. Evidence obtained confidentially from suppliers indicates that Woolworths will provide price subsidies for some key products in addition to promotional funding provided by the manufacturer. The consumer consequently pays very competitive prices for these items during promotions.

### 10.1.2 Coles

Coles has stated that it still has a lot of work to do to get back into the sort of shape it needs to be in to be able to compete strongly in the Australian retail arena. Despite this, Coles remains strongly profitable.

Internal Coles' documents and public reports show that when Coles attempts to engage in heavy promotional pricing, Woolworths matches it. Accordingly, a strategy of heavy promotional pricing is unlikely to be adopted in the medium term.

As discussed in chapter 5, a price war between Coles and Woolworths became apparent during the latter half of 2007. It appears that this was instigated by Coles in an attempt to regain some market share. Woolworths then matched Coles' significantly discounted pricing. As discussed in chapter 5, it appears that Coles, as a result of Woolworths' response to Coles pricing, did not obtain any significant benefit from the aggressive price reductions. Woolworths stated in the media that its overall margins had not been affected. In the ACCC's view such an outcome indicates that heavy promotional discounting, at least on Coles' current cost base, could not be maintained for any significant length of time, nor is it likely to produce any significant benefit to Coles. Accordingly, the ACCC considers that it is unlikely Coles will engage in such behaviour in the future. Material accessed by the inquiry on a confidential basis reaffirms the ACCC's view.

Although Coles invests in promotions, much of the promotional activity engaged in by supermarkets is funded by the suppliers according to a schedule negotiated between retailers and suppliers that ensures suppliers do not have the same product on promotion in numerous retailers at the same time. Much of the promotional activity may well be a reflection of competition between brands at the manufacturing level rather than vigorous competition at the retail level.<sup>2</sup>

### 10.1.4 ALDI

ALDI is the only hard discounter operating in the grocery category on a significant scale. Its competitive effect is significant, but it is not and does not set out to be a full service supermarket. In order to compete strongly on price, Aldi cuts its costs by selling a limited range of products. Consequently a large range of items stocked by the MSCs do not come under price pressure from ALDI. The items on which Woolworths and Coles price-match ALDI are primarily the private label products that the MSCs consider to be directly comparable to ALDI's products.<sup>3</sup> ALDI does not appear to have had a broader effect on standard shelf pricing. Further analysis regarding ALDI's position in the grocery retail sector is provided in chapter 8.

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<sup>2</sup> See chapter 5 of this report for further detail on the manner in which retailers source their promotions.

<sup>3</sup> See ACCC, public hearing transcript, 19 May 2008, pp. 16–18; ACCC, public hearing transcript, 26 May 2008, pp. 8–9.

### 10.1.5 Metcash-supplied independents

Metcash-supplied independents, for the most part, do not offer direct price competition to the MSCs across the range. They tend to compete on convenience, a tailored product range and service. However, Metcash-supplied independents do have access to promotions negotiated by Metcash and so may offer price competition in that area. Some large-format independents such as Supa IGA, Foodland and Supabarn do offer direct price and range competition to the MSCs. However, their ability to place downward pressure on the MSCs' pricing is limited because of the terms on which they acquire packaged groceries from Metcash.

While part of the problem may be that Metcash is not given competitive supply terms by producers and suppliers, it is not clear that this is the case. The ACCC notes that Metcash takes a substantial wholesale margin. At present it takes a net margin of 3.59 per cent of the final retail price of goods sold by IGAs.<sup>4</sup> This net margin is slightly above the net margin that Coles takes, notwithstanding that Coles performs the retail function as well as conducting its own wholesaling.

The Metcash margin means that a Metcash-supplied supermarket cannot as a general rule aggressively compete with the MSCs on price.<sup>5</sup> The large format independent supermarkets appear to be able to match Coles and Woolworths on products supplied by Metcash but only by accepting margins that either do not, or barely, cover the cost of doing business.<sup>6</sup> Where independent supermarkets can compete is on goods supplied from sources other than Metcash. These include fruit and vegetables, meat, deli, bakery and products sourced directly from manufacturers. Price competition can occur in these categories, but is limited by the need to obtain gross margins sufficient to make up for the poor margins on packaged groceries supplied through Metcash. The position of Metcash-supplied independents is discussed in detail in chapter 7 of the report.

### 10.1.6 Franklins

Franklins is independently owned, operates large format stores in New South Wales, and is vertically integrated. However, in recent years it has been significantly handicapped by its wholesaling arrangements. Initially, problems arose because it was not being provided with groceries from Metcash on what Franklins considered to be competitive terms. When Franklins terminated that arrangement, its transition to its own warehousing arrangements did not go smoothly. Consequently it has been in a period of consolidation in recent years and to date has not provided significant price competition to the MSCs; notwithstanding that, it may have the potential to do so.

## 10.2 How competitive is the market?

Based on the matters outlined above and the evidence before the inquiry, the ACCC considers that:

- Competition in retailing groceries in Australia is workably competitive; however, a number of factors currently limit the effectiveness of price competition. Both the MSCs and the major wholesaler, Metcash, make average to above average returns by world standards. In particular these three players have very dominant positions in the supply of packaged groceries. There is competition in the form of promotions and on known value items, but there are weak incentives for any participant to intensify competition in this area. Price-matching practices between the MSCs and the weakness

<sup>4</sup> Metcash company results presentations, annual reports 2007–08.

<sup>5</sup> An analysis of the terms provided to Metcash, and the terms upon which they on-supply products to independent retailers is contained in chapter 7 of this report.

<sup>6</sup> This is discussed in more detail in chapter 7 of this report.

of the independents because of the high Metcash supply prices for packaged groceries mean there is little incentive for a market participant to lead prices down across the broader range of products.

- The major source of greater competition in recent times has been the introduction and likely continuing expansion of ALDI. Further improvements in the competitive dynamic are most likely to be by the potential entry of new grocery retailers. However, the ACCC has seen no significant evidence to suggest that such a competitor will enter in the near future.
- The level of price and non-price competition in the market might be enhanced if there were expansion in the number of large format independent supermarkets. However, not every independent supermarket has the ability or incentive to engage in price competition and the barriers to organic growth of even the most efficient independent operators are considerable. First, it is difficult to obtain suitable sites in areas that will generate the cash flow necessary to sustain a competitive supermarket. Second, there is difficulty obtaining packaged groceries on competitive terms while Metcash remains the only viable wholesale supplier for the independent supermarket sector.

### 10.3 Will new entry occur?

It would be a mistake to see the grocery market in Australia as static, with Metcash's and the MSCs' powerful positions permanently entrenched.

In recent years the market has seen the introduction of ALDI, which has been a very significant development, especially for price-conscious shoppers. Costco's announced entry into Australia suggests that the returns available in the Australian retail grocery market are attractive to foreign companies.<sup>7</sup>

In the fresh category, specialist retailers like Harris Farm have been able to expand in New South Wales, and there are strong chains in specialty categories such as bread, deli and fresh chicken. In addition, shopping centre developers have suggested that by grouping specialty shops offering a range of fresh items, consumers can be attracted away from an MSC for a large proportion of their grocery needs.<sup>8</sup>

Large format independent supermarkets do exist and in some cases offer serious competition to the MSCs in particular local areas.<sup>9</sup> However, the barriers to entry are substantial and any change in the current structure of the packaged grocery large-format supermarket shopping environment is likely to be slow.

While the ACCC recognises this, it does not consider that the competition issues are so serious that structural market intervention is required. As pointed out earlier, any possible lack of retail competition is not by any means the most significant contributor to food price inflation in Australia. Accordingly, significant restructuring of the market is not justified by the ACCC's observations on the level of competition. Further, many food categories remain strongly competitive and it is not clear that any improvement will be made by attempts to structurally interfere with the market.

However, there are steps the ACCC can take using its existing powers under the *Trade Practices Act 1974* (the Act) which have good prospects of promoting new entry at the wholesale level and have the potential to increase the range of competitors in local markets accessing appropriate and attractive retail sites.

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7 See 'US Firm Costco to open Melbourne store', *Sydney Morning Herald*, viewed 20 June 2008, available at <http://news.smh.com.au/business/us-firm-costco-to-open-melbourne-store-20080620-2u15.html>.

8 See, for example, ACCC, public hearing transcript, 12 May 2008, p. 65.

9 For example, Supabarn supermarkets, which are located in the Australian Capital Territory—and, more recently, expanding into New South Wales.

## 10.4 What interventions will improve competitiveness?

While it is a relatively simple matter to note that a market will be improved by the presence of more competitors, it is more difficult to identify appropriate interventions to produce such a result.

### 10.4.1 Retail market

Before advocating any particular approach to improving the retail market, it is important to note that a competitive process largely produced the current market structure. Woolworths' and Coles' market shares are the product of millions of consumers preferring the MSCs' offerings over a host of other independent and chain stores. When it was owned by Dairy Farm International in the late 1990s and early 2000s, Franklins was the victim of vigorous competition, notwithstanding that it had sites and a brand that provided a strong foundation to be competitive.

In addition, greenfield expansion by the MSCs exceeds acquisition as a method of growth. It would accordingly be wrong to suggest that the MSCs have succeeded by buying out the competition.

Now that Coles and Woolworths are the dominant brands in large format supermarkets, they have key market advantages which a new entrant will find difficult to overcome. The key advantage is that shopping centre developers are dependent on anchor tenants to bring in customers. It is accepted by developers that having the MSCs as anchor tenants drives more traffic than any other supermarket brand.<sup>10</sup> For sensible economic reasons, all other things being equal, a developer of a site in a premium location will almost always choose to base a centre around an MSC rather than an independent or lesser known supermarket. By including terms in leases that restrict the introduction of competing supermarkets to developments, the MSCs are able to further entrench their dominance of prime retail sites.

This creates a significant market impediment to competitor growth.

### 10.4.2 Wholesale market

The history of Australian wholesaling to the independent sector has been one of steady consolidation. This consolidation has been permitted on the basis that vertically integrated retailers such as the MSCs provided sufficient constraint on a monopoly wholesaler, and that the efficiencies available to a single wholesaler from the increased scale would deliver greater competition from the independent sector at the retail level.

With the benefit of the material available to the ACCC as a result of this inquiry, it would appear that, at least in the last few years, the level of constraint on Metcash has been weaker than anticipated. Consolidation of grocery wholesalers has improved the returns available at the wholesale level, but it has also produced imperfect incentives for the wholesaler to encourage competition at the retail level. Consequently, the returns earned by Metcash are almost certainly higher than they would be if it faced a competitor at the wholesale level, and there are large categories of products in which the MSCs face little price competition because of the buying advantage they have over the independent retailers that buy through Metcash.

These high returns earned by Metcash have prompted market reactions, such as one of its largest customers, Franklins (now owned by Pick 'n Pay, South Africa), discontinuing the relationship. Franklins instead brought its warehousing and supply function in-house, despite the high costs of doing so.

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<sup>10</sup> See ACCC, public hearing transcript, 12 May 2008, p. 68.

The ACCC expects that if sufficient volumes can be aggregated to justify the establishment of alternative wholesaling arrangements, others in the independent sector may also make alternative wholesaling arrangements. However, Metcash has put in place a number of measures that make it difficult for any new entrant to the wholesale market to attract sufficient volumes to be viable. These include taking equity stakes in the larger independent supermarket groups and using agreements with clauses in them that make it difficult for independent supermarkets and franchisees to leave Metcash or obtain products elsewhere.

Consequently, it may be difficult for new entry to occur.

## 10.5 ACCC's approach

The key impediments to increased intensity in retail competition are:

- access to suitable sites for alternative retail offerings
- access to competitive wholesale supply in packaged groceries for the independent supermarkets.

The ACCC believes that its existing powers can be used to encourage competition and enhance dynamic change in grocery retailing.

In particular, the ACCC will closely scrutinise supermarket site leases. Arrangements whereby the MSCs include terms in their leases that effectively prevent centre managers leasing space in centres to competing supermarkets can be considered under Part IV of the Act. Before the inquiry, few concerns had been raised with the ACCC about these lease arrangements and the arrangements have not, to date, been a focus of the ACCC's enforcement activities. During this inquiry, significant concerns have been raised about the impact of some of these arrangements on competition in local areas, and considerable information regarding the operation of these clauses has been collected by the ACCC. The ACCC will actively pursue such arrangements where it considers that there is a likely breach of the substantial lessening of competition test contained in the Act.

During the inquiry it has also become apparent that state planning regimes, while designed to preserve public amenity, also act as a barrier to new supermarkets being established in local areas. The ACCC has recommended that consideration of planning decisions at all levels of government should have specific regard to competition issues, particularly where the application contemplated would facilitate the entry of a supermarket operator not currently trading in the area.

The ACCC will also continue to scrutinise acquisitions of supermarket sites and leases that give rise to competition concerns under s. 50 of the Act, which relates to mergers and acquisitions. The ACCC will pay particular attention to sites in built-up areas where the site is likely to be utilised by a competitor if the MSC acquisition does not proceed. In many cases, an MSC opening will be the most competitive outcome, but there may be sites where a competitive alternative exists which would permit action under s. 50. This issue is considered further in chapter 19.

In relation to the wholesale supply of packaged groceries to the independent sector, the ACCC will pay closer attention to certain conduct by Metcash. In particular, the ACCC will examine:

- any agreements or acquisition of further equity in downstream retailers that inhibit the aggregation of sufficient volume to enable an alternative wholesaler to enter the market on an appropriate scale
- any agreements with suppliers or retailers that prevent direct dealings between suppliers and independent retailers

- any use of Metcash's market power in the supply of packaged groceries to induce independent retailers to shift to IGA Fresh for the supply of fresh produce.

The ACCC considers that efforts in these areas can bring about improvements to the competitiveness of the grocery sector in Australia. If, following the taking of these steps, it transpires that the ACCC's powers are inadequate to address these concerns, the ACCC may take steps to identify any legislative changes which may be necessary.

# 11 Supply chain and vertical issues

## 11.1 Introduction

The first 10 chapters of this report focused on horizontal competition at the retail level. The remainder of the report focuses on supply chain issues and their impact on retail prices.

Supply chain issues are relevant to the inquiry for three reasons:

- if there is a lack of horizontal competition at any level of the supply chain, this weakness will flow through to consumers in the form of higher prices
- if changes in prices at one level of the supply chain, are not reflective of higher costs, this could reflect market power at that level of the supply chain
- buyer power in the supply chain can damage efficiency, by eroding investment and innovation in the upstream markets, resulting in a less competitive supply chain overall.

To explore the first issue, it is necessary to examine some features of the various supply chains through which groceries pass. Issues such as the number of participants, the market share of those participants, how prices are set and the outside options available to participants are all relevant when considering whether there is effective competition throughout the supply chain. However, in the timeframe available the ACCC has not been able to investigate the potential market power of every manufacturer, processor and wholesaler for the many thousands of standard groceries. Accordingly, only a selection has been examined in detail in the next chapter.

To explore the second issue, it is necessary to consider the relationship between prices in the supply chain, particularly the gap between wholesale and retail prices. The key question to be answered is: When retailers increase retail prices, is it because they are facing higher wholesale prices (which, assuming effective competition elsewhere in the supply chain, reflect higher commodity prices, climate shocks and increased production costs), or are they raising prices even in the absence of such changes to their costs?<sup>1</sup>

To explore the third issue, it is necessary to consider whether any party in the supply chain has buyer power and, if so, whether they are exercising it in such a way that it damages the long term efficiency of the supply chain. In particular, the focus in this inquiry report is on the buyer power of the MSCs and Metcash.

The brief general introduction to the supply chain contained in this chapter is followed in chapter 12 by eight case studies, which provide a detailed analysis of the competitiveness of the supply chains for a selection of standard grocery items. A broader discussion of the gap between farm gate and retail prices occurs in chapter 13. The report then considers issues concerning buyer and bargaining power. Chapter 14 provides a theoretical framework for considering buyer and bargaining power and chapter 15 considers evidence provided to the inquiry about buyer and bargaining power, including an analysis of trading terms. The issue of private label products, which is also related to buyer power, is specifically considered in chapter 16. Chapter 17 outlines the main conclusions on supply chain issues. Finally, chapter 18 considers whether changes to the Horticulture Code are necessary to improve vertical relationships in the horticulture supply chain.

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<sup>1</sup> Assuming no change in the retailers' costs of doing business.

### 11.1.1 Assessment of the efficiency of the supply chain

The efficiency of a particular supply chain depends on the nature and extent of horizontal competition at each functional level of the supply chain as well as the vertical relationships between different levels in the supply chain. Those vertical relationships may, in turn, impact on horizontal competition throughout the supply chain. In assessing the efficiency of the supply chain, the ACCC has therefore examined the horizontal competition at the various functional levels as well as the vertical relationships between parties in different functional levels. This assessment has been facilitated by information obtained by the ACCC using its information gathering powers. Much of this information was provided in confidence.

The ACCC considers that concerns about potential impediments to the efficient supply of groceries to consumers are only likely to be realised if market power exists in any of the functional levels of the supply chain. Market power is more likely to exist where there are high barriers to entry, high levels of concentration and limited import competition. In the absence of market power, the ACCC is confident that the supply chain would deliver groceries to consumers in an efficient manner, which would result in greater choice and lower prices for consumers.

This assessment also applies to the potential effect of vertical relationships on the efficiency of grocery supply chains. Generally, vertical relationships or vertical integration helps to coordinate interdependent stages in the supply chain and minimise the transaction costs of doing so, to the benefit of efficiency and consumers. However, where there is market power, some vertical arrangements, typically known as vertical restraints, can have anti-competitive effects by raising barriers to entry or by foreclosing actual and potential competitors.

In examining the nature of relationships between the various vertical layers of the supply chain, the ACCC has considered the extent to which any aspects of those relationships unnecessarily constrain each party involved in a way that may be anti-competitive.

The next section of this chapter looks briefly at some of the major supply chains for standard groceries. Due to the vast range of supply chains, this section necessarily provides a broad introduction only. More detailed analysis of individual supply chains is undertaken in the case studies presented in chapter 12.

## 11.2 Introduction to the supply chain

During this inquiry it has become evident that the supply chains for each grocery category vary considerably. For fresh produce there is typically a short supply chain, that mostly comprises three functional levels— produce is purchased at the farm gate by a wholesaler and is then on-sold to retailers. For some fresh produce, such as dairy and meat, more complex processing occurs after the farm gate and before wholesaling, resulting in a four-level supply chain.

For the MSCs, ALDI and Franklins, the wholesale function is primarily performed in-house by the retailer. For most other grocery retailers and specialty stores, the wholesale function is performed by wholesalers and consolidators for fresh produce and by Metcash for packaged groceries.

### Fruit and vegetables

The supply chain for fruit and vegetables is varied.

It is estimated that there are more than 2800 commercial vegetable production enterprises around

Australia.<sup>2</sup> The majority of vegetable growers are small in terms of the area they crop and most focus only on a single vegetable crop.<sup>3</sup> Similarly, fruit production also involves large numbers of small-sized participants spread throughout Australia.

Australia's varying climate and soil conditions mean that different regions are amenable to producing different ranges of fruits and vegetables. Given the geographical size of the country, this creates a need for significant transportation of fresh produce to ensure continuous fresh supply. Similarly, Australia's varied climate means fruit and vegetable produce grown in different regions will become available at different times of year. To counteract deterioration of fresh produce, farmers, and in some cases processors, may chill the produce immediately after harvest or use controlled atmosphere storage (with lower levels of oxygen and higher levels of carbon dioxide than normal air) to further slow deterioration.<sup>4</sup> This enables crops that would otherwise be more susceptible to seasonal fluctuations in supply to be released over a longer period.

Increasingly, fruit and vegetable growers are by-passing wholesalers and entering into direct supply arrangements with the major supermarket chains (MSCs) and other retail outlets. The ACCC understands that the majority of fruit and vegetables sold in the MSCs and ALDI do not pass through a wholesaler. It is estimated that only 20 to 30 per cent of MSC produce is now purchased from wholesalers.

The ACCC understands that most fruit and vegetables sold in independent stores are supplied by wholesalers (typically this is not Metcash, although, as discussed in chapter 7, Metcash has commenced wholesaling fresh produce through IGA Fresh.<sup>5</sup>)

Restaurants also usually obtain their fresh produce through wholesalers or providores. Wholesalers and providores may also be used to source product to some extent by some processors and exporters.

The majority of wholesalers operate from the central wholesale markets located in Melbourne, Sydney, Brisbane, Adelaide and Perth.

Not all farm produce consumed as food goes through wholesale markets or is sold to MSCs. Large quantities are sold directly to manufacturers and processors of various kinds. Processing of fruit and vegetables predominantly consists of manufacturing fruit and vegetable juices, or canning, preserving, freezing or drying produce. Fruit and vegetables are also key inputs into many products such as sauces, jams, prepared meals and snacks. Certain products, such as potatoes, often tend to be used in processing. For example in 2004, 56 per cent of the domestic potato crop was sold as processed potatoes<sup>6</sup>. Domestic processors, particularly in the case of processed potato products, generally compete for sales with imported processed products. Processors are also able to export some of their products.

In addition to imported and exported processed produce, there are also significant quantities of fresh fruit and vegetables being imported and exported. The main export products include fresh carrots, asparagus, onions, cauliflower, potatoes, oranges, grapes and apples.<sup>7</sup> Exporters either contract directly with farmers or purchase from wholesalers in wholesale markets. Imports of fresh product are typically most significant during domestic off-seasons or periods of domestic shortage. Although levels of imports have increased recently, a wide range of fresh produce is prohibited from entering Australia

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2 Australian Bureau of Agricultural and Resource Economics (ABARE) research report, *Australian Vegetable Growing*, October 2007, p. 1.

3 *ibid.*, p. 7.

4 Coles, 'Public submission to the grocery inquiry', 28 March 2008, p. 67.

5 ACCC, public hearing, Melbourne, 2 June 2008, p. 66.

6 AusVeg, *Australian Processing Potato Industry Strategic Plan 2006-2011*, November 2006, 9

7 Austrade, *Fruit and Vegetable overview*, accessed on 23 April 2008 at [www.austrade.gov.au/Fruit-and-vegetables/default.aspx](http://www.austrade.gov.au/Fruit-and-vegetables/default.aspx).

because of strict quarantine restrictions. Fresh imports are typically sold directly to the MSCs or to independent retailers through the wholesale markets. Oranges and pineapples are two of the fruits most commonly imported into Australia.<sup>8</sup>

There were no concerns raised by wholesalers or retailers about producers overpricing their fresh fruit and vegetable produce at the farm gate. The markets in every commodity appear to be characterised by a large number of producers and low barriers to entry. Farming and agricultural groups accepted that farmers, growers and graziers were essentially price takers. Prices are dictated by supply-and-demand conditions in the marketplace at the time the growers' products are ready for market. The ACCC has no concerns about the competitiveness of any market at this level.

At the wholesale level the market narrowed considerably. For some commodities, such as potatoes, there were significantly fewer packers and wholesalers than growers. However, notwithstanding that the markets were more concentrated at the wholesale level in most commodities, there were a number of different routes to market that a grower could access and a number of market alternatives for a person looking to acquire product.

For a grower, selling produce through one of the wholesale markets in a capital city represents a relatively straightforward route to market. The ACCC understands that for a supplier to sell produce through some markets, they require a relationship with a wholesaler, but in other markets, such as Adelaide, a growers' shed is available that allows growers to deal directly with wholesale customers.

The wholesale market appears to operate efficiently. Prices in the wholesale market appear to be set by supply and demand. Complaints about the operation of these markets were primarily directed at their perceived lack of transparency when a grower dealt with a wholesaler. These issues are examined more closely in chapter 18, which deals with the Horticulture Code.

In addition to selling through the wholesale markets, growers can also:

- sell direct to an MSC
- establish a direct relationship with a larger group of independent stores
- supply processors
- export
- develop their own direct retailing arrangements
- vertically integrate to further process their own product.

While the availability of these options will vary with the growers' particular circumstances, in the course of the inquiry the ACCC has seen examples of all of these kinds of arrangements.

As noted in chapter 3, the ACCC has found that up to 50 per cent of fruit and vegetables at the retail level are sold through an MSC. While the ACCC notes that this is a relatively large percentage of the fruit and vegetables sold at retail level, in terms of the wider market for farm produce (when food service, processors and export are considered) the MSCs represent a much smaller proportion of the potential buyers of farm produce.

Accordingly, the ACCC is satisfied that, broadly speaking, the wholesale level of the market for produce was efficient and competitive with a depth and variety of market participants to allow prices to be set by market forces.

In chapter 12, the apples case study provides more detail for a single product.

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8 IBISWorld, *Fruit growing in Australia*, A0119, 29 June 2007, p. 14.

## Milk and dairy<sup>9</sup>

The typical supermarket dairy cabinet holds a range of standard groceries. It is estimated that of the raw milk supplied by farms in Australia:

- 35 per cent is used in cheese production
- 23 per cent is used for drinking milk
- 23 per cent is made into skim milk powder and/or butter
- 11 per cent becomes white milk powder
- 3 per cent becomes casein and/or butter
- 5 per cent is used for other purposes.

There are approximately 8000 dairy farms in Australia, most located in Victoria.

The supply chain is generally relatively simple, with the dairy farmer supplying raw milk to dairy manufacturers, who, after processing, supply the MSCs, Metcash, other retail stores and export markets. Approximately 50 per cent of milk produced domestically is converted into products that are exported (constituting around 12 per cent of world dairy trade). Around 68 per cent of manufactured dairy product produced in Australia is exported, compared to only 4 per cent of drinking milk. Small quantities of dairy products are also imported, primarily from New Zealand.

When supplying Australian retail stores, dairy manufacturers generally use a mix of delivery direct to store and delivery to wholesale distribution centres, depending on the product (largely upon its shelf life).

No concerns were raised during the inquiry that the farm gate market is not competitive. The large number of milk producers across diverse geographical regions means that the milk processors have a large number of potential suppliers and the market appears to respond to price signals, with milk production falling in response to low farm gate pricing.

Concerns were, however, raised that the market for the acquisition of milk from farmers by processors was not always so competitive. For example, allegations of 'no poach' agreements were made in respect of processors in north-west New South Wales.

The ACCC is satisfied that the market for the acquisition of milk from the farm gate is competitive and price is set by market forces of supply and demand. As discussed later in chapter 12, because milk products are internationally traded, the prices domestic milk processors offer are primarily set by international factors. The best evidence of this was the recent surge in farm gate price in response to rising international demand. Accordingly the ACCC considers that the market for fresh milk at the farm gate is competitive.

The other level of the dairy supply chain is the supply of dairy products by the processors to retailers. As a number of processors can supply milk, cheese, cream, yoghurt and other dairy products, and there is strong competition for access to retail shelf space, the ACCC is satisfied that the market at this level is broadly competitive.

## Meat and poultry

The supply chains for red meat and poultry are varied and often complex. Rather than explore all of the specifics in this chapter, much of the detail is covered in the context of two case studies, beef and chicken, in chapter 12.

<sup>9</sup> The information in this section is sourced from Dairy Australia, *Australian dairy industry in focus 2007*.

## Red meat

The supply chains for red meat including beef and lamb are broadly similar. Farmers rear animals until they reach the preferred specifications of the relevant market.

Like other primary producers, there are a large number of sellers at this level but significantly fewer participants at the wholesale level. Accordingly, the market for wholesale supply is considered to be highly competitive, with graziers being price takers. The inquiry was presented with good evidence that prevailing beef prices in the Western Australian domestic market were not sufficient to cover the costs of raising animals.

Compared to producers of fresh produce, meat producers have relatively few alternatives available to them to sell their product onto the domestic market. Although several avenues for sale of livestock are available, sales occur primarily through saleyards or directly to feedlots, processors or retailers. The methods used to calculate payment vary and are detailed further in chapter 12.

The supply chain for meat sold domestically by retailers may include some or all of the following steps:

- purchase of animal → finishing on feedlots → transportation → slaughter and boning → further processing and packing → transportation to distribution centres/stores → in-store butchery preparation → packaging → shelves.

Issues explored in detail in the chapter 12 beef case study include the ability for grazier's to export as an alternative to dealing with domestic purchasers, and the explanations for poor beef prices.

## Pork

There are approximately 1900 pork producers in Australia.<sup>10</sup> The pork supply chain is not examined in detail in a case study in chapter 12, so supply chain issues are considered in some detail below.

Locally produced pigmeat is either sold in the fresh pork market or used in the manufacture of bacon, ham and smallgoods. Porker pigs typically supply fresh pork and larger, baconer pigs supply the processed pork market; however, subject to size constraints<sup>11</sup>, cuts from either type of pig can be sold to both markets. The market to which the meat is sold generally depends on the relative prices for pigmeat in the fresh and processed markets.

The route the pigmeat follows through the supply chain depends on whether it is intended for the fresh or processed market. Porker pigs are typically sold under contract to big retailers or wholesalers through longstanding arrangements; however, around 5 per cent of pigs are also sold through the saleyard.<sup>12</sup> Abattoirs perform 'service kills' for the purchaser of the pig. Retailers then sell the meat under private brands and wholesalers will then prepare the meat for sale in supermarkets and butcheries or for export or the food service industry.

Baconer pigs follow a similar process. However, retailers, wholesalers and small good manufacturers can obtain imported pigmeat in addition to or instead of acquiring Australian carcasses from abattoirs.

More than half of the pork produced in Australia is part of an 'integrated supply chain which includes primary processing and production'.<sup>13</sup> Australian Pork Limited (APL) submitted that

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10 IBIS World, *Pig Farming in Australia*, 11 September 2007, p. 36.

11 Productivity Commission, *Pig and pigmeat industries: safeguard action against imports*, 1999, p. 55 available at [www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0006/41595/pigs.pdf](http://www.pc.gov.au/__data/assets/pdf_file/0006/41595/pigs.pdf).

12 APL, submission no. 147, p. 6.

13 APL, submission no. 147, p. 6.

... of the 5 million pigs slaughtered (each year) some 3 million are part of an integrated enterprise including production and primary processing, the remaining pigs sold for slaughter are sourced either through saleyards, spot-market or forward and general contracts.<sup>14</sup>

Australia is a net importer of pigmeat.<sup>15</sup> Since 1990, imports of boned, frozen cuts of pigmeat have been allowed into Australia from certain countries (including Canada and New Zealand). As a result of the fact that pigmeat is an internationally traded commodity, domestic prices have largely been linked to world prices for both the fresh and processed pork markets. The link between the world price and domestic prices for both fresh and processed pork has strengthened as the range of imported cuts has expanded.<sup>16</sup>

As stated by the Productivity Commission:

The opening of the market to imported cuts has essentially capped prices for equivalent locally-produced cuts at world prices.<sup>17</sup>

Even though the fresh pork and bone-in processed market is not subject to direct import competition, the availability of imported cuts (or a decrease in the import price) encourages domestic producers to switch supply from the processing market to the fresh meat or bone-in processed markets, depressing prices in those markets to the point that producer returns are eventually equalised across baconer and porker markets.<sup>18</sup>

Submissions from pig producers and industry bodies suggest that producers are not able to achieve prices that cover their production costs.

Given the number of producers and the level of import competition, the ACCC is satisfied that this level of the supply chain is highly competitive.

At the wholesale level, wholesalers and processors are subject to direct competition from vertically integrated MSCs. Accordingly, the ability of wholesalers and processors to raise prices is constrained by the MSC's ability to increase supply from their own supply chains. While prices achieved by producers may be below their costs of production, the ACCC is satisfied that this has not been caused by any buyer power at the wholesale level. Rather, this has occurred as a result of international supply and demand factors together with the rising Australian dollar.

At the retail level, bacon and ham prices have declined in real terms since 1992, which probably reflects the exposure to imports from overseas. Pork prices have been above the CPI since 1992 but in the last two years price increases have been well below the CPI. Given this movement in retail prices, the ACCC is satisfied that pork and processed pork supply chains are competitive.

## Chicken

The chicken meat supply chain differs slightly from that for red meat because the industry operates largely through vertical integration with company ownership of breeding farms, multiplication farms, hatcheries, feed mills, some broiler<sup>19</sup> growing farms and processing plants. Integrated processors supply day-old chicks and feed to contract growers or company-owned farms. They then collect the

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14 APL, submission no. 1 to Productivity Commission, *Safeguards inquiry into the import of pigmeat*, 23 November 2007, p. 34.

15 Productivity Commission, *Safeguards inquiry into the import of pigmeat—Productivity Commission inquiry report*, 2008, p. 17 available at [www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0004/78457/pigmeatsafeguards.pdf](http://www.pc.gov.au/__data/assets/pdf_file/0004/78457/pigmeatsafeguards.pdf).

16 Productivity Commission, *Safeguards inquiry into the import of pigmeat—Productivity Commission inquiry report*, 2008, p. 16 available at [www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0004/78457/pigmeatsafeguards.pdf](http://www.pc.gov.au/__data/assets/pdf_file/0004/78457/pigmeatsafeguards.pdf).

17 Productivity Commission, *Safeguards inquiry into the import of pigmeat—Productivity Commission inquiry report*, 2008, p. 17 available at [www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0004/78457/pigmeatsafeguards.pdf](http://www.pc.gov.au/__data/assets/pdf_file/0004/78457/pigmeatsafeguards.pdf).

18 *ibid.*, p. 32.

19 'Broiler' is the industry term for a chicken reared for meat production.

grown chicks, perform the necessary processing and then distribute and market the meat primarily to the retailing sector and the fast food industry.

As discussed in the chicken case study in chapter 12, some growers have been able to obtain a degree of countervailing power in negotiations with processors through collective bargaining. However, not all growers have been successful in engaging in collective negotiations. An industry participant confidentially submitted that fees paid to growers have not kept pace with the increase in growers' costs. Such an outcome is consistent with the assertion that growers are often in a weak bargaining position in their negotiations with processors. Overall, given that the cost of chicken has declined in real terms over the last 15 years, the ACCC is satisfied that the supply chain is generally efficient and competitive.

## Dry groceries

The supply chain for dry groceries is largely a supply chain for manufactured products. Dry groceries are produced by manufacturers who then generally negotiate directly with the MSCs or Metcash to have their product ranged.

Inputs for manufactured products depend largely upon the product examined. Many manufacturers have in recent times had to contend with large cost increases in their inputs, including rising costs of flour (associated with the rise in wheat) and skim milk powder. The ACCC is satisfied such input prices are generally driven by international commodity prices rather than any exercise of market power at that level of the supply chain. Accordingly, it is unlikely there is a competition issue at that level of supply, although in the context of this inquiry it is impossible to analyse the market for every input into the many thousands of products that are standard groceries.

For a food or non-food manufacturer to get broad distribution of its product through retail supermarkets in Australia, it is necessary to persuade the MSCs or Metcash to range the product or obtain a direct supply contract with ALDI. Ranging decisions for the MSCs are generally made as part of category reviews. These reviews essentially facilitate competition between the suppliers of dry groceries. The MSCs are looking for products that deliver margins and volumes which are attractive to them, while still providing a full range of products that consumers look for in a supermarket. In seeking to obtain access to scarce retail shelf space, it is necessary for manufacturers to consider competition from other manufacturers of products within the category (including private label products), the returns its product is likely to generate for the MSC and whether the product is sufficiently well known with sufficient brand loyalty to require the MSC to stock the product. Details regarding negotiations for shelf space are discussed in chapter 15. Some direct supply arrangements with independents are possible, but for the most common dry groceries, that is not the usual means of distribution.

The ACCC considers that the retail level of the supply chain for dry groceries is more likely to suffer from a lack of competition than other levels of the supply chain. The ACCC is unable to rule out that some products may be insulated from strong competition at various points in the supply chain because of high barriers to entry, the strength of branding and/or high market concentration. However, the vast bulk of grocery products are exposed to a number of competitive pressures, including inter-brand competition and competition for limited shelf space, which generally constrain the price at which manufacturers are able to sell their product.

## Other products

A huge range of foods available in supermarkets have not been discussed above. Typically, most fresh foods have a fairly similar supply chain, with the farmer supplying either directly, or indirectly via

a wholesaler or a processor, to a manufacturer. The manufacturer will then deliver the product to the retailers' or Metcash's distribution centres, from where it is transported to the individual retail stores.

There are many exceptions—for example, bread is generally supplied directly by wholesale bakeries to the stores (rather than via the retailers' distribution centres) or, alternatively, bread may be baked and prepared in-store by in-store bakeries. The bread supply chain is discussed in greater detail in the relevant case study in chapter 12.

### Non-food items

For non-food standard grocery items—such as oral and personal care items, hair products, baby needs, cleaning and pest control products, foils and wraps and pet foods<sup>20</sup>—the supply chain is generally relatively simple and almost identical to that for dry grocery items.

Non-food items are often high-value non-perishable items, which are capable of being transported greater distances than many food items. Accordingly, imported non-food items compete with domestically produced non-food items in many categories. Some of the larger suppliers of non-food items to Australian supermarkets include Unilever, Kimberly-Clark and Colgate Palmolive.<sup>21</sup>

Similarly to dry grocery products, inter-brand competition as well as competition for access to retail space exists. This assists in putting downward pressure on the prices that can be set by manufacturers, as are the introduction of greater numbers of private label products.

## 11.3 Conclusions

This chapter has introduced some key issues that will be the focus of much of the remainder of the report, and briefly described several key supply chains and factors that influence market power in the supply chain.

During the inquiry the ACCC obtained information about the workings of supply chains, which provide indicators on the efficiency and competitiveness of those supply chains. Generally speaking, on the information available to the ACCC, the supply chains have characteristics consistent with them being efficient and competitive markets.

The ACCC considers that competition and efficiency concerns are only likely if horizontal competition is weak at any of the vertical stages, resulting in sellers having market power at that stage. The ACCC has received little firm evidence of such a situation prevailing at any level below the retail level, but has not been able to investigate all market participants involved with the supply chains for the thousands of standard grocery products.

Competition concerns may also arise if buyers have power on the demand side of the market. Thus, the ACCC's assessment of the supply chain involves an examination of the vertical relationships that exist between buyers and sellers, particularly between growers/suppliers and retailers/wholesalers (see chapters 14 and 15).

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20 Although the precise definition of standard groceries is not critical, for the purposes of this inquiry, as discussed earlier, the ACCC has excluded items such as cigarettes, kitchenware, hardware and stationery (even though many of these products can be purchased in supermarkets).

21 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2007*, Retail Media, Sydney, 2007, pp. 17–18.



## 12 Cost contributors in the supply chain

The ACCC has been asked to consider all aspects of supply chains in the grocery industry in this inquiry, including the nature of competition at the supply, wholesale and retail levels.

The ACCC could not investigate in detail supply chains for all relevant grocery items in preparing this report. Accordingly, the ACCC has undertaken case studies of cost contributors in the supply chain for a number of standard grocery items:

- white full-cream drinking milk
- chicken
- apples
- bread
- eggs
- nappies
- biscuits
- beef.

The case studies are based on information available in public reports, information about each of the supply chains provided in the course of the inquiry through submissions, at hearings and in response to s. 95ZK notices and the ACCC's own inquiries.

Some of the information provided in submissions and at hearings, and much of the information provided in response to s. 95ZK notices, was commercially sensitive and has not been publicly disclosed by the ACCC. Such information included details of cost structures, contract negotiations, contract terms and conditions and supply costs and prices at various stages of supply chains. While the ACCC has relied on this information in preparing these cases studies, commercially sensitive information is only referred to in general terms and reported in broad aggregates in this report.

The case studies include analysis of farm gate, wholesale and retail prices as well as examination of input costs and gross returns to each level of the supply chain. Information used to conduct this analysis was sourced from a number of retailers and numerous suppliers. Accordingly, except where specific reference is made to an individual company, no conclusions should be drawn from these case studies about any individual companies prices, costs or gross returns over the periods reported.

## 12.1 Drinking milk

### Key points

- The retail price of milk has increased at a significantly faster rate than CPI over the last five years. However, the rate of increase in the price of private label milk sold through supermarkets, which makes up 55 per cent of all supermarket milk sales, has been significantly below CPI.
- The farm gate price of raw milk, which makes up between 25 per cent and 44 per cent of the end retail price, has increased by upwards of 40 per cent in the last 12 months. The farm gate prices as a proportion of the retail price of milk has also increased.
- There is strong competition at the processor level for the supply of both branded and private label milk.
- Increases in production costs are generally reflected in the retail price of branded milk.
- The bargaining power of the major supermarket chains (MSCs) means that increases in production costs are not being fully reflected in the wholesale or retail price of private label milk.
- The dairy milk supply chain has three distinct levels:
  - the dairy farm
  - the dairy processor
  - the retailer.
- This case study examines cost, price and margin in the supply chain for drinking milk with a particular focus on white, full-cream drinking milk.

### 12.1.1 Dairy farming and farm gate prices

The farm gate price of raw milk is a key determinant of the retail price for white drinking milk paid by consumers at the checkout. While the farm gate price as a proportion of the end retail price for white milk varies by product, processor and across time, currently the farm gate price as a percentage of the retail price of white full-cream drinking milk sold through the MSCs generally ranges from around 25 per cent to 44 per cent.<sup>1</sup>

#### Dairy farming<sup>2</sup>

Milk production in Australia is typically seasonal, peaking at around 1200 million litres in October with a low of 600 million litres produced in May and June. Seasonality of milk production is greatest in south-eastern Australia, where a greater proportion of milk produced is used for manufactured dairy products. Production is less cyclical in other states where more milk production is directed towards fresh drinking milk for consumption in the local area.

Approximately 50 per cent of Australia's 2006–07 milk production was exported, after processing, at an estimated value of \$2.5 billion, accounting for around 12 per cent of world dairy trade.

Domestically, per capita consumption of drinking milk in 2006–07 was 104 litres and approximately 2 billion litres in total was consumed. This represents around 20 per cent of annual domestic production. A further 30 per cent of domestic production was consumed domestically through products such as cheese, dairy spreads and yogurt, taking total per capita milk equivalent consumption to approximately 295 litres.

<sup>1</sup> Based on a farm gate price of 48.5 cents per litre and a retail price for a two litre carton, ranging from \$2.20 to \$3.80.

<sup>2</sup> Unless otherwise noted the information in this section is taken from Dairy Australia, *Australian dairy industry in focus 2007*, 2007.

Total domestic raw milk production in 2006–07 declined 5 per cent from 2005–06, attributed primarily to the effects of drought. Dairy Australia forecasts suggest a further 5 per cent drop in production in 2007–08.<sup>3</sup> Dairy Australia forecasts production to remain steady or increase slightly in 2008–09.<sup>4</sup>

### *Dairy farming—trends in key input costs*

Costs for a number of key farm inputs in the production of raw milk have increased significantly in recent years. National Foods submitted that domestic drought conditions have had the dual effect of increasing the cost of raw milk production for dairy processors and reducing milk supply to processors. Specifically, National Foods noted that scarcity of water, particularly in irrigation-dependent areas, has resulted in substantially higher input costs for farmers, who have needed to either pay higher prices for water or feed their herds on higher cost grain and hay.<sup>5</sup>

Fonterra noted in its submission that this has occurred at a time when other key costs, such as fuel, feed, fertiliser and labour have also risen dramatically.<sup>6</sup>

In evidence given at a hearing Parmalat stated that internal analysis it had undertaken examining feed costs and variable production costs for dairy farmers indicated that, from a base cost index of 1 in 2000, costs had risen to 1.53 in 2006–07 and 1.77 in 2007–08.<sup>7</sup>

### *The role of international dairy prices in setting domestic farm gate prices*

Australian dairy farmers operate in a deregulated and open market. Consequently, international prices are a major factor determining the price received by farmers for their milk.<sup>8</sup> In particular, farm gate prices paid to farmers in the south-east of Australia are heavily influenced by world dairy commodity prices.

With around 50 per cent of domestic raw milk production being exported (after processing), primarily in the form of milk powders and cheese, processors of dairy products to satisfy domestic demand compete directly for raw milk with production aimed at export markets. Accordingly, processors of product for domestic markets are required to match world dairy prices to ensure supply.

Fonterra's submission to the inquiry noted that:

While domestic demand for dairy products has shown solid growth in Australia, international demand has reached unprecedented levels. This accelerating international demand has been driven by a range of cultural and economic factors, including the significant economic growth and cultural change of a number of evolving markets such as China and other Asian countries. In addition the global stockpiles of the key dairy commodities traditionally held by the European Union and the United States have been eroded to the extent that in May 2007 they had been effectively emptied.

As demand for dairy products has accelerated many of the traditional exporters of dairy products have been unable to grow their supply to meet this increasing demand. Fuel and grain prices have reached record levels and there is increasing pressure on land use as other land use opportunities, such as bio fuels production, compete for lands traditionally used for dairy production.<sup>9</sup>

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3 Dairy Australia, *Dairy 2008: situation and outlook*, 2008, p. 49.

4 *ibid*, p. 55.

5 National Foods, submission 133, p. 2.

6 Fonterra, submission 85, p. 4.

7 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 49.

8 Dairy Australia, *Australian dairy industry in focus 2007, 2007*, p. 10.

9 Fonterra, submission 85, p. 4.

The Australian Bureau of Agricultural and Resource Economics (ABARE) reports that this resulted in sharp rises in world prices for major dairy products in 2007–08.<sup>10</sup> This growth was on the back of steady growth in world prices over the recent past.

ABARE estimates that global demand for dairy products is expected to grow steadily over the next five years, but that from around 2010–11 growth in production in major exporting countries is forecast to exceed growth in world import demand, which is expected to put downward pressure on prices.<sup>11</sup>

### *Influences on farm gate prices outside of south—eastern Australia*

Farm gate prices are generally higher outside of the export region of south-eastern Australia. Prices in these other regions are influenced primarily by local supply and demand conditions.

For example, Parmalat noted in evidence provided at a hearing that while production in regions other than south-eastern Australia is more costly, primarily because of the need for a flat pattern of milk flow to satisfy year round demand,<sup>12</sup> higher prices are paid to keep production in local areas. This is because the alternative would be to source milk from other areas at a cost of the farm gate price plus transport. Parmalat noted the Victorian region farm gate price plus freight costs to Queensland sets a maximum price above which it would not be economical for it to source raw milk locally.

Notwithstanding the premium paid by processors to source raw milk locally, Parmalat noted that seasonality of production in Queensland does lead to raw milk shortages at some times of year, necessitating raw milk being transported from other regions by some processors, although not Parmalat, to satisfy local demand.<sup>13</sup>

More generally, as noted, farm gate prices in regions outside of south-eastern Australia will be set by local supply and demand conditions.

### *Trends in farm gate prices*

As noted, the key determinants of farm gate prices paid to Australian dairy farmers for raw milk are:

- world dairy prices, which have increased significantly in recent years
- domestic supply conditions—domestic supply has fallen by about 10 per cent in the last two years
- dairy farmer production costs, which have also increased significantly in recent years.

As noted, farm gate prices can vary significantly by state. National average farm gate prices fell from 33 cents per litre in 2001–02 to 27.12 cents per litre in 2002–03 before gradually recovering to be approximately 33 cents per litre in 2006–07.<sup>14</sup>

Farm gate prices increased by upwards of 40 per cent in 2007–08 on the back of strong growth in world demand for dairy products and reduced domestic supply. Farm gate prices in 2007–08 ranged from 42 cents per litre up to 53 cents per litre and across the major production regions averaged in the range of 48 to 50 cents per litre.<sup>15</sup>

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<sup>10</sup> ABARE, *Australian Commodities*, March quarter, vol. 15, no. 1, 2008.

<sup>11</sup> *ibid.*

<sup>12</sup> While sufficient production to satisfy local demand is also required in south-eastern Australia even in low production months, supply far exceeds local demand.

<sup>13</sup> ACCC public hearing transcript, Brisbane, 3 April 2008, pp. 51–52.

<sup>14</sup> The 2001–02 to 2006–07 figures are Dairy Australia figures based on information provided by dairy manufacturers.

<sup>15</sup> Dairy Australia, *Dairy 2008: situation and outlook*, 2008, p. 54.

Weakening export returns may lead to a fall in farm gate prices paid in south-eastern Australia of up to 10 per cent in 2008–09, which would equate to a farm gate price of 43 to 44 cents per litre. Farm gate prices in Queensland and northern New South Wales are expected to continue to rise, into the 54 to 57 cents per litre range, and prices in central New South Wales are expected to remain steady at around 46 to 49 cents per litre. Western Australian farm gate prices are expected to continue to rise from their current level of 42 to 44 cents per litre but at a slower rate than in 2007–08.<sup>16</sup>

While farmers in all regions have enjoyed substantial increases in farm gate prices in the last 12 to 18 months—and many are expected to receive further increases, or at least a sustained period of prices above the averages of the last few years—such increases in prices received by farmers need to be considered in the context of the significantly increased costs of production noted above.

### *The farmer/processor relationship*

Processors source raw milk from dairy farmers for processing into drinking milk as well as for processing into other dairy products and milk powders. Processors source raw milk from dairy farmers under a variety of contractual arrangements, including through dairy cooperatives, collective negotiation with dairy farmers organised into bargaining groups<sup>17</sup> and individual negotiations.

Contracts are often negotiated annually, although, particularly those negotiated with cooperatives or collective bargaining groups, can range up to two to three years in duration.

Contracts generally set the fixed price, or range of prices, farmers will receive for their raw milk, subject to quality and technical specifications, such as for butter fat and protein levels. Some contracts provide for farm gate prices to be increased during the term of the agreement in line with movements in market prices. The ACCC also heard evidence at hearings that processors will on occasion, particularly in response to strong increases in market prices for raw milk, increase farm gate prices paid to farmers outside of any contractual obligation to do so. Processors indicated that they do this to ensure strong relationships with their farmers, which are necessary to remain competitive in the market for sourcing raw milk.

In most regions of Australia there are a number of processors to which farmers can supply their raw milk.

In evidence, National Foods stated:

If you look at Northern Victoria it is probably one of the most competitive milk regions in Australia if not the world in a sense that there are a lot of processors that could pick up—and pick up farmer's milk. In New South Wales you have got National Foods, Dairy Farmers, Bega, Milk Co, Fonterra as options. In south east Queensland, National Foods, Dairy Farmers, Parmalat, Milk Co as options as in northern New South Wales. Victoria; those names, so we have got Parmalat, National Foods, Murray Goulburn, Warrnambool Cheese & Butter, Fonterra, United Dairy Power and then a range of, probably, other smaller companies as well.

In Tasmania there is National Foods, Fonterra, Murray Goulburn. In South Australia you have got Warrnambool Cheese & Butter, Murray Goulburn, National Foods, Dairy Farmers, Seko, UDP. In Western Australia you have got Challenge Dairies, National Foods, Fonterra and Harvey Fresh. So in most regions there is more multiple processors to—for farmers to choose whom to supply.<sup>18</sup>

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<sup>16</sup> *ibid.*

<sup>17</sup> See, for example, authorisations granted by the ACCC for Premium Milk Supply Pty Ltd (Premium) to collectively bargain farm gate prices and milk standards in negotiations with Pauls (A90745) and for Australian Dairy Farmers members to collectively bargain with processors (A90966). These authorisations are available from the ACCC website, [www.accc.gov.au](http://www.accc.gov.au).

<sup>18</sup> ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 13.

The ACCC heard evidence at hearings that, while the incidents of dairy farmers switching between processors is not high, the capacity to do so does exist, particularly in the current climate where demand for raw milk among processors is strong. Regarding farmers switching between processors, National Foods provided evidence at a hearing that:

You will find that you could have, in some seasons, little change and then in some other seasons, quite a lot. It's a hard percentage to put in. We do find that there is strong—strong tension processes each—annually to ensure you can secure your supply. So, it's a very competitive market out there.<sup>19</sup>

In contrast the Kiama Shellharbour Albion Park Milk Suppliers Collective Bargaining group contended in evidence provided at a hearing that, at least in their area, there is anecdotal evidence of an agreement between processors not to 'poach' each others farmers.<sup>20</sup>

To the extent that it does happen, switching generally occurs at the expiration of existing contractual arrangements. In particular, the industry generally operates on a financial year season and renegotiation of annual contracts will occur in June or July.

The ACCC has previously recognised the comparatively weak bargaining position of individual dairy farmers as compared to dairy processors.<sup>21</sup>

It appears, however, that more recently reduced supply of raw milk, both domestically and internationally, coupled with increasing world demand for dairy products, has resulted in increased competition among domestic dairy processors for the supply of raw milk which in turn has strengthened the bargaining position of dairy farmers.

The ACCC is satisfied that in most regions of Australia there is at present strong competition between processors for farmer's milk, as reflected in current farm gate prices. While complaints from farmers about the farm gate price they receive do persist, it is difficult to conclude on the evidence available to the inquiry that the market for the supply of raw milk for processors is not competitive.

As chart 12.1 demonstrates, the farm gate price of raw milk dropped significantly in 2003–03 post deregulation. However, the rate of increase in farm gate milk prices has outpaced that of retail milk prices in recent years, meaning that farmers have received an increasing share of the retail milk price over this period. The difference between the rate of increase in farm gate and retail prices has been most pronounced over the last 12 months, reflecting the current shortage of supply that has allowed farmers to enjoy significantly higher farm gate prices. As noted previously, farms can expect to receive similar farm gate prices in the immediate future.

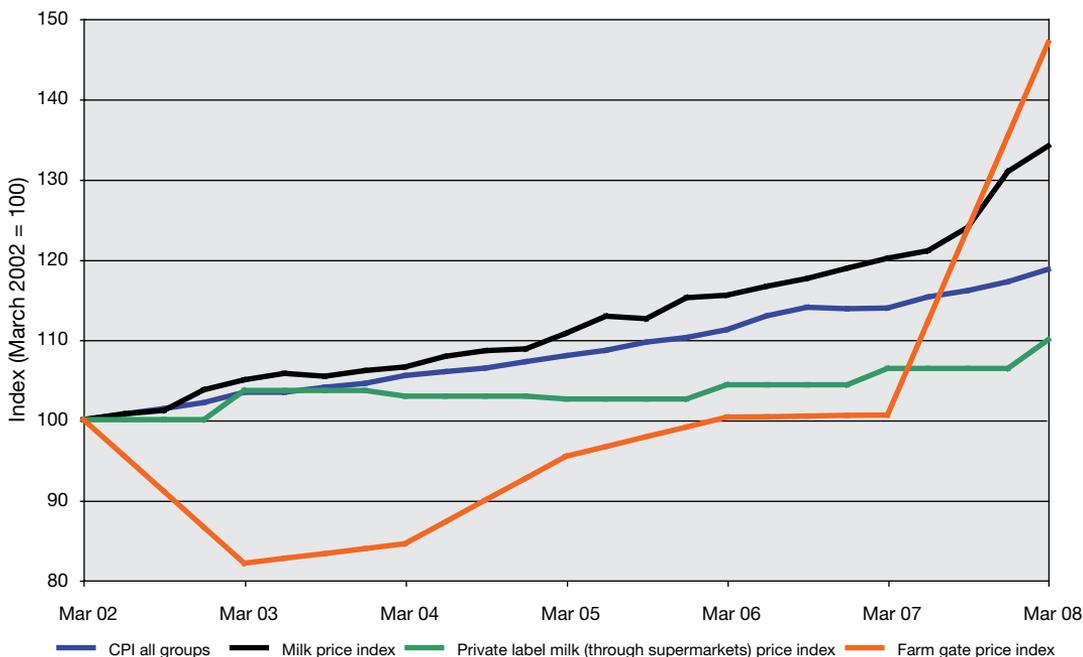
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19 ACCC public hearing transcript, Melbourne, 15 May 2008, p. 6.

20 ACCC public hearing transcript, Sydney, 1 April 2008, p. 144.

21 ACCC determination, application for authorisation A90745, Premium Milk Supply Pty Ltd.

**Chart 12.1 Increases in CPI, milk price index, private label milk sold through supermarkets price index and farm gate price index, 2002 to 2008.**



Source: CPI and milk price index data sourced from ABS (cat. no. 6401.0); private label milk sold through supermarkets price data sourced from Dairy Australia and first reported in *Dairy Australia Industry in Focus 2007*, p. 26, ACNielsen and Dairy Australia; farm gate price data sourced from Dairy Australia

### 12.1.2 Dairy processing

#### Key inputs/costs and their movements over time

Raw milk is the key input into the production of drinking milk. Information provided by processors in response to s. 95ZK notices indicated that the cost of raw milk ranged from around one-third to over half of the total cost to the processor of producing white drinking milk. As noted previously, the cost of raw milk to processors has increased by upwards of 40 per cent in the last 12 months and in some states is expected to continue to increase for the immediate future.

Other key costs in producing drinking milk identified by processors were packaging, labour and distribution, including freight and transportation. Processors reported significant increases for each of these costs over the last 12 months, in many cases by more than 10 per cent. Increases in distribution and transport costs were primarily driven by rising fuel prices while packaging costs were affected by rises in the price of high-density polyethelene resin.

All processors stated that they had not been able to fully pass on these cost increases through increasing wholesale prices for either branded or private label products. Processors stated that they had particular difficulty in recovering increases in costs of supplying private label products to supermarket chains because of existing contractual arrangements. These arrangements are discussed further in this report.

### *Supply arrangements with supermarket chains*

Supply arrangements between dairy processors and retailers differ depending on whether the processor is supplying their own, branded milk or retailer branded private label milk.

Branded product is generally supplied on trading terms, setting out the products to be made available, which are fixed for one to three years and subject to automatic renewal unless renegotiated. Trading terms do not ordinarily specify wholesale prices. Rather, wholesale, or list, prices are set by the processor.

While processors set list prices, most customers do not pay the list price. Rather, trading terms, as negotiated on a customer-by-customer basis, set out a range of discounts, rebates (including warehouse allowances, discount allowances, access to promotional activity, settlement discounts, ullage and business volume rebates) and fees applicable to supply.

Processors are not generally contractually restricted in their ability to raise wholesale list prices for branded milk. However, increases in wholesale prices are generally passed on by retailers and reflected in retail prices.

Generally speaking, larger customers will be supplied on more favourable terms (i.e. more generous rebates and discounts). For example, in its public submission Fonterra stated that it achieves lower unit costs, predominantly linked to volume, when selling to large customers. Fonterra states that additional benefits in dealing with larger customers include consistent purchasing patterns which enable manufacturing efficiencies. Fonterra stated that if a smaller wholesaler or retailer was to purchase the same volume as a larger customer, in general, they may be able to achieve similar discounts from Fonterra to the larger customer.<sup>22</sup>

Private label product is supplied under fixed contracts, generally of between 12 months' and three years' duration, set through competitive tender processes.

Contracts set out fixed wholesale prices and other terms and conditions. Contracts provide details of the specifications of the product, including packaging and branding, delivery and usually include an estimated volume, although actual volumes are determined through the life of contract terms based on actual retail sales.

Contracts usually allow for limited review of wholesale pricing at specified intervals. However, more generally, the capacity to vary wholesale prices during the life of the contract—for example, where input costs such as farm gate prices rise—is more limited.

The ACCC understands that Woolworths tenders for supply of private label milk on a national basis whereas Coles and Metcash currently tender on a state-by-state basis.

These competitive tender processes have resulted in processors supplying private label milk to the MSCs at much lower prices than the equivalent branded product. Broadly speaking, wholesale prices for private label product are significantly lower than for branded product. While differences in branded and private label wholesale prices varied significantly, many were in the 20 per cent to 40 per cent range.

In confidential evidence provided to the ACCC processors indicated that their key considerations in deciding whether to tender to provide private label milk to retailers included: available production capacity; ability to meet customer specifications and source necessary raw materials (i.e. raw milk) and financial return.

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<sup>22</sup> *ibid.*

As noted, all processors who provided evidence to the ACCC noted significant increases in costs of production over the past 12 months. Processors contended that they have not been able to fully pass through these costs, particularly with private label products. Processors contended that this was because of the highly competitive prices that apply to private label milk as well as the bargaining strength of the MSCs.

Processors noted that the ability to pass through increases in wholesale prices on private label milk is governed by contracts with retailers and retailers' reluctance to accept cost increases while those contracts are in place.<sup>23</sup> However, it was also noted that the MSCs will, on occasion, accept some increases in the wholesale price of private label product notwithstanding that they are not contractually obliged to do so, where it can be demonstrated that input costs for the processor have increased significantly.

The contention that processors have not been able to fully pass through these costs, particularly with private label products—or at least that they have not passed them through—was supported by information provided to the ACCC by processors and the MSCs in response to s. 95ZK notices, which showed that recent increases in cost of production have been more fully reflected in increased wholesale prices for branded milk than private label.

One issue on which the ACCC heard mixed evidence through the inquiry was the extent to which processors have increased the price of branded products to offset cost increases in producing private label products.

In evidence given confidentially at hearings, and in response to s. 95ZK notices, processors indicated that they did not generally engage in this practice. However, one processor did indicate that increased costs for branded products have been able to be recovered in a 'more timely manner' and another indicated that prices of branded products have sometimes been increased to off-set overall cost increases, both for branded and housebrand products.

### *Decision to supply private label product*

Given the comparatively lower wholesale price received by processors when supplying private label milk, for what is essentially the same product, and the limited ability for processors to pass on increases in production costs, this raises the issue of why processors tender to supply private label milk products.

In confidential evidence provided to the ACCC, processors indicated that the main reasons they pursued private label contracts were:

- overhead recovery—generating revenue through private label sales to contribute to fixed costs of running the business
- supply relationships with retailers—supplying private label product provides a stronger relationship and possibly improves processors bargaining position in relation to branded products
- volume—the volume of milk supplied through private label contracts provides some stability to the business.

In addition, in evidence given at a public hearing, Parmalat noted that at the time of farm gate deregulation (in 2000) there was significant excess capacity in the industry, and, consequently, processors were looking for opportunities to utilise that capacity. Parmalat contended that this provided a strong competitive tension to the point where the processors were prepared to tender for private label business at very low prices in order to utilise capacity. Parmalat considered that wholesale prices were

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23 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 49.

driven down by this excess capacity, creating a gap between wholesale prices for branded and private label product which then expanded over time.<sup>24</sup>

### Recent movements in wholesale prices

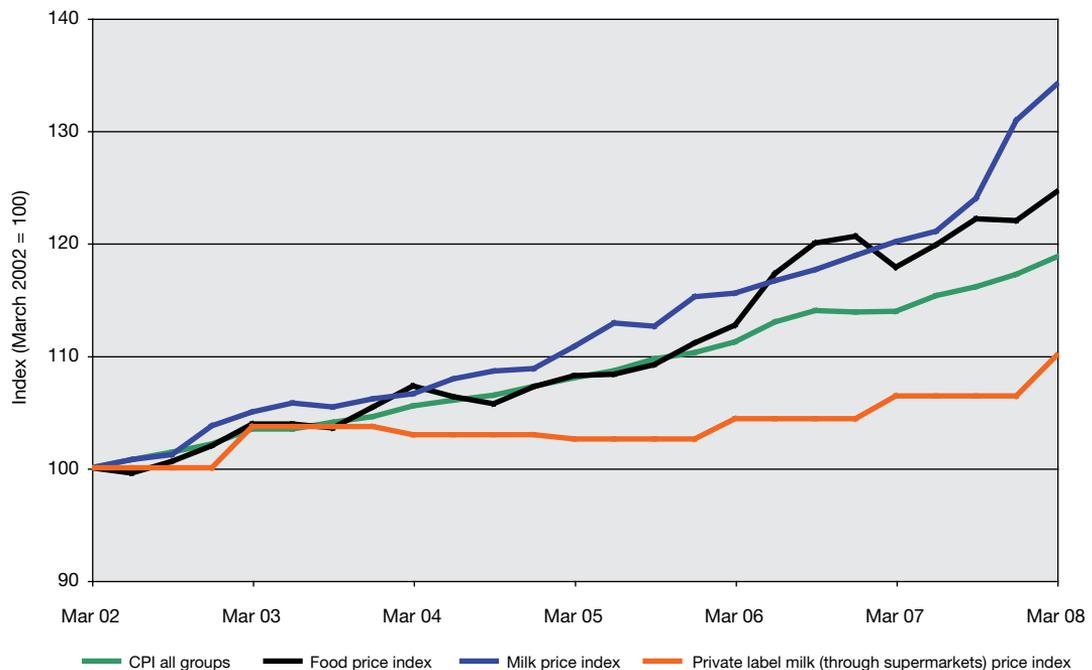
Information provided to the ACCC in response to s. 95ZK notices illustrates the wholesale prices on both branded and private label product supplied to the MSCs increased by about the same amount in 2006–07. However, there was a significant divergence in the rate of increase of wholesale prices between branded and private label product in 2007–08. Reflecting the bargaining position of the MSCs and the processors contractual supply obligations—as processor input costs, particularly farm gate milk prices, increased—the rate of increase in wholesale prices for private label products was significantly lower than for branded products.

## 12.1.3 Retail prices and margins

### Retail prices

White drinking milk sold by the MSCs is priced in three tiers: private label (Woolworths Homebrand and Coles Smart Buy), which from October 2007 to March 2008 retailed at around \$2.20 for a two litre carton; ‘premium’ private label (You’ll love Coles and Woolworths milk) sold at around \$2.60 for two litres; and branded product, such as Pura, Dairy Farmers and Pauls, which generally retailed for around \$3.40 to \$3.60 for two litres.<sup>25</sup>

**Chart 12.2 Increases in CPI, the food price index, milk price index, and private label milk sold through supermarkets price index, 2002 to 2008.**



Source: CPI, food price index and milk price index data sourced from ABS (cat. no. 6401.0); private label milk sold through supermarkets price data sourced from Dairy Australia and first reported in *Dairy Australia Industry in Focus 2007*, p. 26, ACNeilsen and Dairy Australia

<sup>24</sup> ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 49.

<sup>25</sup> Price will vary by state. In particular Woolworths Homebrand and Coles Smart Buy are not available in all states.

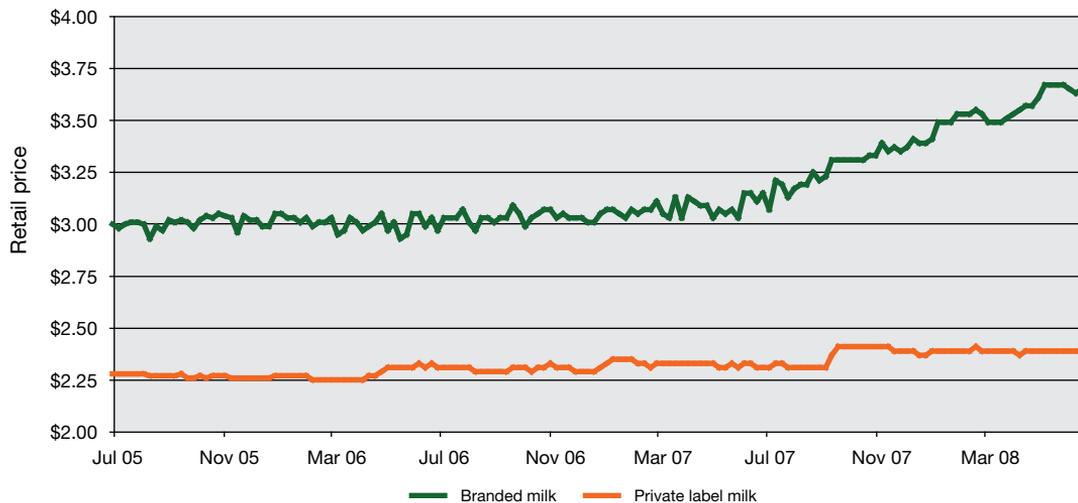
ABS statistics indicate an average annual increase in the retail price of milk of 4.1 per cent for 2002–03 to 2006–07. Questioned about these figures at hearings, dairy processors were of the view that the figures accurately reflected movements in the price of branded milk products, but that increases in retail prices for private label products, which make up around 55 per cent of all drinking milk sales through supermarkets, were significantly less than this.

The ACCC was also provided with retail sales data by the MSCs, dairy processors and Dairy Australia. Price movements varied by product and state, but those reported roughly accorded with the evidence given by processors at the hearing. Price movements for branded white milk sold through the MSCs roughly accorded with movements in the milk price index reported by the ABS, whereas movements in retail prices for private label milk products sold through the MSCs were significantly less than this.

Retail milk prices as measured by the ABS milk price index increased by about 10 per cent in the nine months to March 2008, reflecting increases in farm gate raw milk prices are flowing through into wholesale and retail prices. However, as noted, the extent of the pass through is less on private label than on branded products.

Processors reported increasing gaps between the retail price of private label and branded milk, largely reflecting differences in the extent to which increases in production costs are being reflected in wholesale prices, as discussed in section 12.1.2. It is these price differences that have largely driven the growth in sales of private label products over recent years.

**Chart 12.3 Unit prices 2 litre milk May 2005 to April 2008**



Source: Dairy Australia, *Dairy 2008: situation and outlook*, 2008, p. 36

Processors observed that it may be the case that over time this gap in the wholesale, and retail, price of private label and branded milk is not sustainable given the share of sales MSCs private label products enjoy, and given these volumes, the necessity in the long run for any increases in production costs to be reflected in wholesale prices so as to maintain supply.<sup>26</sup>

<sup>26</sup> ACCC public hearing transcript, Brisbane, 3 April 2008, p. 49.

### *Retail margins*

While retailer gross margins varied between product, retailer and across states, certain trends in the MSCs gross margins were apparent.

Broadly speaking, gross margins on higher price private label products (Woolworths milk and You'll love Coles) were generally in the range of 25 per cent to 30 per cent. Gross margins on branded product were generally in the range of 20 per cent to 25 per cent and gross margins on lower priced private label products (Coles Smart Buy and Woolworths Homebrand milk) general ranged from 15 per cent to 20 per cent.

The difference in the gross margins on higher price private label products and lower priced private label products is almost solely a reflection of the difference in the retail price of these products.

While gross margins have moved over time, by product and across states, information provided by the MSCs and dairy processors indicated little change in aggregate gross margins over the last five years. Specifically, a number of processors provided the ACCC with information in response to s. 95ZK notices, which tracked movements in retail and wholesale prices. This data indicated that movements in retail prices charged by the MSCs for white drinking milk supplied by the dairy processors that provided information to the ACCC generally tracked movements in wholesale prices at which these products were supplied to the MSCs.

This indicates that there has been little change in the competitive environment at the retail level in recent years. This also suggests that the bargaining power of the MSCs in negotiating terms of supply for private label products is being reflected in retail prices. Specifically, it appears that the limited ability for processors to reflect increases in production costs in wholesale prices for private label products means that these increases in product costs are also not reflected in retail prices for private label products. In other words, consumers are benefiting from the buyer power the MSCs have in sourcing private label milk.

### 12.1.4 Conclusions

The cost of raw milk, which makes up about 25 per cent to 44 per cent of the retail price of white full-cream drinking milk, has increased significantly in the last 12 months driven primarily by rising world demand for dairy products and reduced domestic supply.

However, while farmers are enjoying near record farm gate prices, costs of product have also increased significantly, which is reflected in the fact that, notwithstanding historically high farm gate prices, domestic raw milk production has fallen in recent years.

Given that raw milk is such a key input into producing drinking milk, processor costs of production have also increased significantly. These increased costs of production are being reflected in wholesale prices for branded milk. However, processors contractual obligations, and the bargaining power of the MSCs, mean these increased costs of production are not being reflected to the same extent in wholesale, or retail, prices for private label milk.

While retail milk prices have increased at a rate above CPI and the general food category, these figures likely overstate the extent of increases in the price of private label milk sold by the MSCs.

The rate of increases in milk prices has accelerated significantly over the last 12 months, primarily reflecting increasing farm gate prices. However, the MSCs bargaining power for the supply of private label products means that increases in production costs are not being fully reflected in wholesale or retail prices for private label milk.

## 12.2 Chicken

### Key points

- Retail poultry prices have remained relatively stagnant over recent years but have increased significantly since the start of 2007.
- Increases in retail prices have been largely as a result of increasing production costs.
- Strong competition between chicken meat processors has meant that not all of the production cost increases being experienced are being reflected in wholesale prices.
- Competition at the retail level means that retailers have also absorbed some of the increase in production costs.

Consumption of chicken meat has grown steadily in recent years to the point where chicken has overtaken beef as Australia's most preferred meat.<sup>27</sup> This growth in consumption is primarily a consequence of the retail price of chicken, relative to other types of meat, steadily falling and consumers' perceptions of chicken as a leaner and healthier option than red meat. Trends towards convenience food and eating outside of the home have also favoured chicken consumption.<sup>28</sup>

The supply chain for chicken has three main participants:

- the chicken grower
- the vertically integrated processor
- retailers, such as MSCs and other large purchasers of chicken (including takeaway food outlets).

Chicken carcasses can be processed into a variety of cuts and other value added products. However, the chicken breast accounts for about 60 per cent of total revenue for the bird.

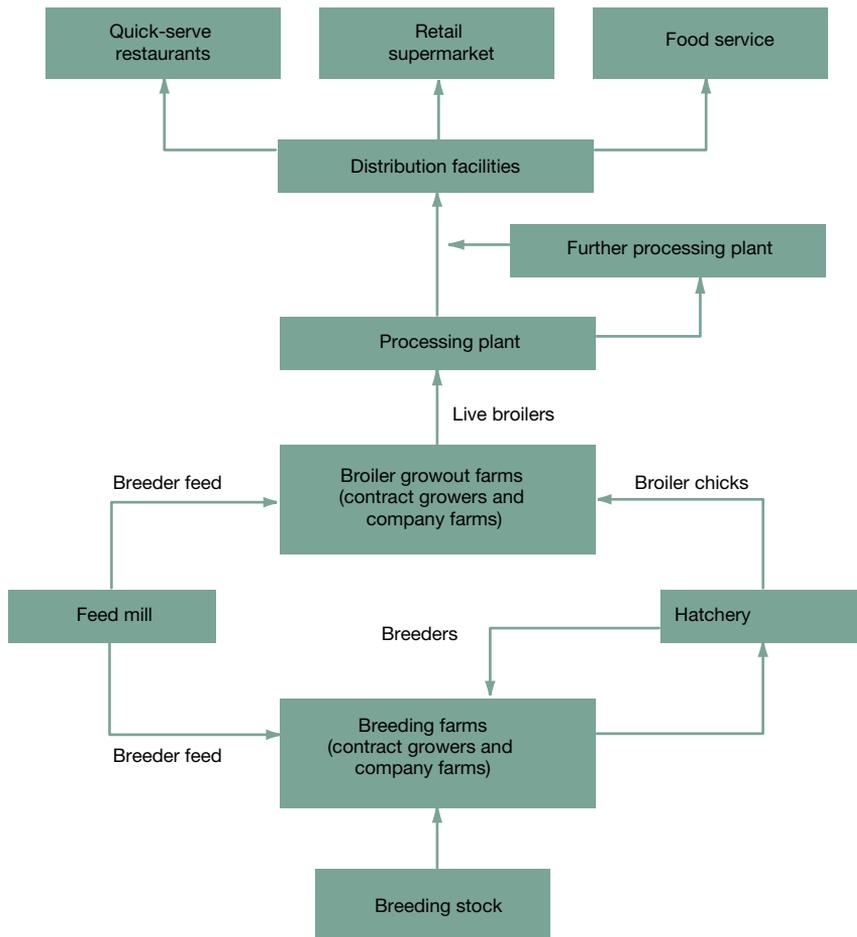
This case study examines costs, prices and margins in the supply chain for chicken, focusing on the chicken breast product.

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27 Department of Agriculture, Fisheries and Forestry (DAFF), *Foodmap: a comparative analysis of Australian food distribution channels*, 2007, p. 38.

28 IBISWorld, *Poultry Processing in Australia*, 4 June 2008, p. 28.

**Chart 12.4 Diagrammatical representation of the chicken meat supply chain**



Source: NSW Farmers Association, submission no. 155, p. 26

### 12.2.1 Chicken growers

The chicken meat industry operates largely through vertical integration with company ownership of breeding farms, multiplication farms, hatcheries, feed mills, some broiler<sup>29</sup> growing farms and processing plants. However, growing of chicks is more commonly outsourced. Integrated processors supply day-old chicks and feed to contract growers or company-owned farms, collect the grown chicks and then distribute and market the meat. Growers provide specialised shedding and variable inputs such as labour, gas, electricity and management expertise in overseeing the growing of the chicks, which remain the property of the processor. The location of chicken farms is influenced by the location of feed mills, water and power supplies, processors and heavy transport.

<sup>29</sup> 'Broiler' is the industry term for a chicken reared for meat production.

The contract growing of chickens is capital intensive. The average contract farm consists of three to four growing sheds, each with floor area of around 1200 m<sup>2</sup>. The replacement cost of such sheds, with their internal equipment, is approximately \$200 to \$300 per square metre. Chicken-growing sheds are highly specialised and have virtually no alternative use; they are also non-portable.

### The processor-grower relationship

Each mainland state has in the past regulated the commercial relationship between chicken meat growers and processors; some of these states are still doing so. These regulations have generally established an industry committee of grower and processor representatives to negotiate standard contract terms for the supply of growing services to chicken meat processors.

As a result of legislative reviews carried out under National Competition Policy (NCP) requirements, a number of states have moved away from regulated commercial relationships between processors and growers to partial or fully deregulated industry arrangements. Following these legislative changes the ACCC granted authorisation to a number of applications lodged by chicken meat growers to collectively negotiate growing contracts with processors.<sup>30</sup>

Submissions argued that following deregulation, competitive pressures on individual growers are increasing as processors demand lower prices. The Victorian Farmers Federation argued that since the deregulation of chicken growing in Victoria, the negotiation of fees and terms between growers and processors has become more difficult.<sup>31</sup> The VFF also claimed that processors do not compete with each other for growing services, which diminishes the bargaining power of growers in negotiations.

As noted, the ACCC has considered a number of applications for authorisation for chicken growers to collectively bargain with processors in recent years. In considering these applications, the ACCC has acknowledged the comparatively weak bargaining position of growers in their negotiations with processors. There is little capacity for growers to provide a different service, primarily because of the specificity of their assets. In addition, there are significant switching costs in moving between processors, costs that are typically borne by the grower. In addition, processors are generally large, well resourced businesses with significant commercial and negotiating expertise. Growers, in contrast, are generally small primary producers with often limited resources and expertise to engage in effective negotiations with businesses with the size and negotiating expertise of processors.

The ACCC has previously concluded that if growers were to negotiate individually with processors, the likely consequence of this imbalance in bargaining power would be the offering of standard form contracts by processors with little input from growers and little scope for them to vary contract terms.<sup>32</sup>

While addressing this imbalance in bargaining power is not in itself the primary reason the ACCC has authorised arrangements allowing growers to collectively bargain with processors, growers are likely to have a degree of countervailing bargaining power in negotiations with processors if they are able to negotiate collectively.

However, the ACCC is also aware that not all processors have chosen to participate in these collective bargaining arrangements and many growers still operate on individually negotiated, or standard form, contracts.

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<sup>30</sup> Details of these applications for authorisation are provided in appendix H.

<sup>31</sup> VFF Chicken Meat Group submission no. 70, March 2008, p. 4.

<sup>32</sup> ACCC determination, *Applications for authorisation lodged by the Victorian Farmers Federation on behalf of its member chicken meat growers in relation to collective bargaining by chicken meat grower groups with their nominated processors in Victoria*, 2 March 2005, p. 30.

## Growing fees

Growing fees often depend on the type of facility used and can be incentive-based. Confidential evidence from various sources indicates that growing fees currently range from 56 to 64 cents per bird. The NSW Farmers Association contended that the fee chicken growers receive equates to 7.9 per cent of the bird's retail price on a dressed frozen chicken (or 30 cents per kg).<sup>33</sup>

While the fee received by the grower may appear to be a small component of the retail price, it is important to note that, unlike livestock farmers, growers are essentially contractors and many of the inputs into the growing process are supplied by the processor.

An industry participant confidentially submitted that fees paid to growers have not kept pace with the increase in growers' costs. Such an outcome is consistent with the assertion that growers are often in a weak bargaining position in their negotiations with processors.

## 12.2.2 Chicken meat processing

The major chicken meat processors in Australia are Inghams Enterprises, Bartter Enterprises and Baiada Poultry. Combined, these three privately owned companies supply about 80 per cent of Australia's broiler chickens.<sup>34</sup> The balance of chickens produced in Australia is supplied by seven processors, each supplying 1 to 3 per cent of the domestically produced chickens and a number of smaller processors. Most of the chickens grown in Australia come from two breeds, the Cobb and the Ross. Bartter has the contractual right to import the Ross, while Inghams and a consortium, which includes Baiada, has rights for the Cobb.<sup>35</sup> Consequently, small processors depend on the larger processors for day-old chicks.

Most chicken meat produced in Australia is consumed domestically, with less than 3 per cent exported. Although quarantine laws permit the importing of cooked chicken meat from New Zealand and several other countries, subject to certain regulations<sup>36</sup>, imports represent a negligible amount of total poultry consumed in Australia. Therefore, unlike other meats such as beef, world prices have little influence on the wholesale price of chicken meat in Australia.

## Trends in key input costs

The major cost contributors to chicken meat processing are:

- the cost of the chick
- growing fees
- feed
- medication
- transportation and processing
- packaging and distribution.

Grain costs have increased substantially in recent years. Chickenfeed comprises 85 to 90 per cent of

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<sup>33</sup> For dressed frozen chicken.

<sup>34</sup> Australian Chicken Meat Federation Inc, accessed at [www.chicken.org.au/page.php?id=2](http://www.chicken.org.au/page.php?id=2), 5 March 2008

<sup>35</sup> ACCC determination, *Applications for authorisation lodged by the Victorian Farmers Federation on behalf of its member chicken meat growers in relation to collective bargaining by chicken meat grower groups with their nominated processors in Victoria*, 2 March 2005, p. 14.

<sup>36</sup> DAFF, *Chicken meat overview*, accessed at [www.daff.gov.au/agriculture-food/meat-wool-dairy/ilg/industries/chicken\\_meat](http://www.daff.gov.au/agriculture-food/meat-wool-dairy/ilg/industries/chicken_meat), 2 June 2008.

grains such as wheat, sorghum and barley.<sup>37</sup> Inghams indicated that feed prices have been increasing since 2002 and that between 2005 and 2007 their feed costs effectively doubled.<sup>38</sup>

While the extent of the impact of the rising price of grain on the final retail price of chicken varies, confidential evidence suggested that every \$10 per tonne increase in feed costs adds around 3.5c to 4c to the cost of each kilogram of dressed bird. The feed cost increase between 2005 and 2007 alone could be estimated to have added from between 88c to \$1 per kg to the final cost of producing a dressed bird.

Confidential evidence from another industry participant indicated that as well as feed cost increases, material cost increases have been experienced in other inputs. In particular, they indicated that from 2002 to 2008 the cost of chicks increased by 26 per cent and the fee paid to the grower increased by approximately 37 per cent per bird.

While the contribution of each of these inputs to the cost of producing a chicken will vary, information provided confidentially suggests that the cost of feed represents more than half of the cost of producing the live bird. However, the substantial costs involved in further processing to produce the chicken breast product are such that the live bird cost represents just under one-third of the wholesale chicken breast price.

Limited data has been received regarding the costs of processing a whole live bird into the chicken products sold at supermarkets. These costs include transportation, processing, packaging and other related costs. An industry participant confidentially indicated that labour and energy costs have increased steadily over recent years and would further add to the total cost of production. However, it was also submitted that continued productivity improvements have occurred in the processing stage of production. Plants have been rationalised and have become increasingly automated. It appears that rising costs in this stage of production have been off-set to some extent by continued productivity improvements.

### 12.2.3 Supply arrangements with supermarket chains and other major customers

Processors predominantly sell chicken meat in the state in which it is produced, although improvements in distribution and transport logistics mean that product may now be shipped safely and economically anywhere in eastern Australia within 24 hours.<sup>39</sup>

Supermarket chains (particularly MSCs), the food service industry and quick-service restaurants, which include large fast food chains such as McDonald's and KFC, are the major wholesale purchasers of chicken meat. IBISWorld estimates that around 30 per cent of final sales of chicken meat are made through supermarkets and major retailers.<sup>40</sup> Small retailers, specialty chicken shops and butchers, are estimated to have a combined share of sales of around 20 to 30 per cent. The combined share of sales of fast food and takeaway outlets is also estimated to be between 20 and 30 per cent. Remaining sales are through other outlets such as restaurants and hotels. However, the sales profile for an individual processor could be considerably different, as submissions have tended to point towards processors sometimes forming long-term relationships with particular purchasers.

37 Australian Chicken Meat Federation, accessed at [www.chicken.org.au/page.php?id=6](http://www.chicken.org.au/page.php?id=6), 4 July 2008.

38 ACCC, excerpts (public) from confidential transcript of Ingham Enterprises Pty Ltd, Sydney, 1 April 2008.

39 ACCC draft determination, *Application for authorisation lodged by Barter Enterprises Pty Ltd, La Ionica Operations Pty Ltd, Hazeldene Chicken Farm Pty Ltd, Inghams Enterprises Pty Ltd, Baiada Poultry Pty Ltd and consenting Victorian chicken growers in relation to the collective negotiation of chicken growers' contracts in Victoria*, 17 November 2004, p. 4.

40 IBISWorld, *Poultry Processing in Australia*, 4 June 2008, p. 7.

Typically MSCs source supply through an annual tender process. Submissions indicated that these tender processes are very competitive. For example, confidential evidence contended that on occasions MSCs will make a processor aware of a lower price tendered by a competitor and provide the opportunity for tenders to be revised accordingly.

Other evidence available to the ACCC supports the view that the processor–purchaser relationship is dynamic. Processors frequently lose and win individual tenders to and from large and small competitors. MSCs and other buyers appear to routinely review supply arrangements to ensure competitive pricing and have a relatively large number of processors vying for their business. Likewise, confidential evidence indicated that processors have the opportunity to negotiate with MSCs to pass on their cost increases during the supply agreement.

Evidence to the inquiry also noted that as the product purchased by MSCs (and other purchasers) is homogenous, purchasers can switch to another processor if they see cost advantages in doing so. Similarly, processors have the option of supplying other purchasers if they can achieve a better price. Notwithstanding this, evidence to the inquiry suggests that the long lead times and the sheer volumes required by the MSCs preclude them from capriciously cancelling orders or switching to another processor as both MSCs and processors would need adequate notice of the beginning or ending of a supply agreement.

Although processors may have a number of outside options, Coles and Woolworths, as the two largest single buyers, are in a position to exercise some buyer power in their negotiations with processors. That is, a processor losing business with either supermarket could result in under-utilised capital until other purchasers of similar volumes are found or the processor regains similar volumes of MSC business through future tenders. Therefore, a processor with a large proportion of its business with either supermarket has a strong incentive to retain it even if the terms are less than favourable. Similarly, processors are likely to compete strongly for business with MSCs because they have the attraction of a high volume customer base.

Evidence obtained during the inquiry suggests that the strong competitive tension between processors has meant they have not been able to fully pass on recent increases in production costs. Competition to supply the MSCs appears particularly strong, with the MSCs sometimes playing processors off against each other to ensure supply on the most favourable terms possible.

In addition to tender processes, the MSCs and processors often engage in further negotiations on discounts and volumes for the purpose of running promotions. These negotiations are often beneficial to, and sought by, both parties. For example, processors and an MSC often devise promotions to even out demand across different poultry products, enabling processors to sell cuts of the carcass accumulating through another part of the business while increasing custom for the MSC.

As noted, there appears to be quite vigorous competition between processors. Processors compete against each other mainly on price and are under constant pressure to reduce costs and increase productivity to ensure they can offer the lowest price to retain or gain business. At the same time, processors are confident that the volumes they are supplying cannot be supplied by their competitors at short notice and that they do have outside options in terms of buyers. This environment appears to have been conducive in recent years to strong productivity growth and cost increases being minimised or absorbed.

## Wholesale prices

The breast cut of chicken is the highest value cut of the chicken, accounting for about 60 per cent of

total revenue from the bird. Based on data provided confidentially, the ACCC has estimated that the average net price of skin off breast fillet (per kilogram) sold to major MSCs, wholesalers, independents and specialty stores by major processors increased by around 10 per cent between 2001–02 and 2004–05. Prices fell by around 4 percentage points in 2005–06, primarily as a consequence of reduced demand relating to concerns regarding avian influenza outbreaks overseas, before they returned to their 2004–05 levels in 2006–07.

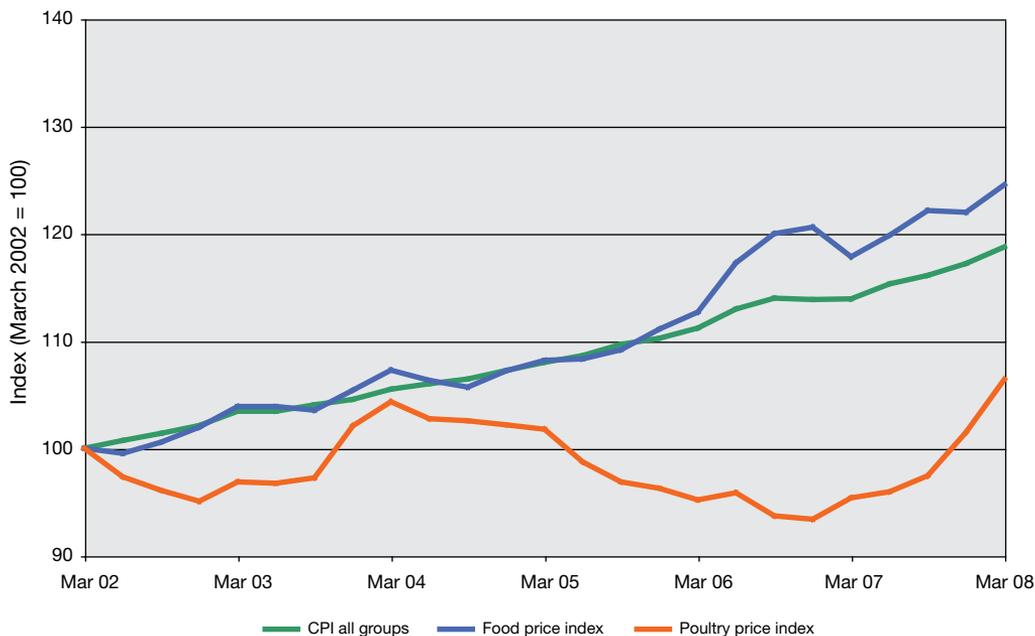
As noted, while processors have submitted that these increases in wholesale prices have been insufficient to offset increases in production costs, some of the increases in production costs have been offset by improvements in the productivity of processor operations.

### Retail supply of chicken meat

In real terms the retail price of chicken has fallen substantially since the 1950s. For example, between 1980 and 1989 alone the retail price of poultry (at constant 2006–07 dollars) fell from \$7.08 per kg to \$5.03c per kg.<sup>41</sup> This decrease in real prices was primarily a consequence of improvements in on-farm and off-farm productivity through a combination of better management, genetic improvement, economies of scale and mechanisation of processing facilities.<sup>42</sup>

The ABS poultry price index indicates that while poultry prices have fluctuated over the last five years, they have not changed significantly, with prices in March 2008 around 6 per cent higher than six years earlier. This is significantly below the rate of increase in CPI and the food price index recorded by the ABS.

**Chart 12.5 ABS CPI comparisons—all product groups, food products and poultry**



Source: ABS, consumer price index, Australia, catalogue no. 6401.0, March 2008

41 IBISWorld, *Poultry Processing in Australia*, 4 June 2008, p. 30.

42 ABARE, *Poultry industry overview*, accessed at [www.abareconomics.com/interactive/ausNZ\\_ag/htm/au\\_poultry.htm](http://www.abareconomics.com/interactive/ausNZ_ag/htm/au_poultry.htm), 5 June 2008.

One confidential submission suggested that MSCs quickly pass on wholesale price increases to consumers, while price falls are often retained by the retailer. However, the ability of the retailer to do this would depend upon the level of competition in the retail market. The fact that the real price of chicken has declined over the past few years—and evidence provided to the ACCC suggests that the MSCs' gross margins on the sale of chicken breast have also fallen in the last two years, as discussed below—would suggest that to the extent this does occur, it is at best a short-run phenomenon.

Confidential data obtained has enabled the ACCC to calculate the average gross margin of the two MSCs from April 2006 to December 2007 on chicken breast. Over this period, the rate of increase in retail prices did not keep pace with the rate of increase in wholesale prices, resulting in declining gross margins for the MSCs. This suggests that while some of the noted increase in production costs is being absorbed by processors, of the proportion of the increase that is being passed through in wholesale prices, some is being absorbed by the MSCs, indicating competitive tension at the retail level.

#### 12.2.4 Conclusion

Decreasing poultry prices, relative to red meats, and consumer perceptions of chicken as a leaner and healthier option than red meat have seen consumption of chicken meat growing steadily in recent years to the point where chicken has overtaken beef as Australia's most preferred meat.

While the rate of increase in poultry prices has been significantly less than CPI or general food price inflation over the last five years, retail poultry prices have risen significantly in the past 12 to 18 months.

Increasing poultry prices have been primarily driven by increasing production costs. However, strong competition among poultry meat processors has constrained their ability to raise wholesale prices. Similarly, competition at the retail level has meant that the proportion of the increase in production costs reflected in wholesale prices is not fully reflected in retail prices.

## 12.3 Apples

### Key points

- The ACCC has found that the price of apples sold in supermarkets generally follows the wholesale market prices.
- While the margin made on apples fluctuates, the ACCC has not found any evidence that retailers are charging more for apples while at the same time pushing the wholesale price of apples down.
- There appears to be strong competition throughout the supply chain for the production and supply of apples.
- Between 50 and 65 per cent of fresh apples sold in Australia are sold through either Coles or Woolworths, approximately 5 per cent through other grocery retailers, 25 per cent to 40 per cent through greengrocers and 5 per cent are exported.
- At the retail level the local competitive dynamic plays a strong role in setting prices. A competitively priced greengrocer in the immediate vicinity of a MSC will be reflected in the MSC charging lower prices for apples.

Apples are grown in all six Australian states (although not in the Northern Territory). Victoria is Australia's largest producer of apples, producing more than 30 per cent of the nation's apples—mostly from the Goulburn Valley area, around Shepparton. New South Wales is the next largest apple-producing state.<sup>43</sup>

The main apple varieties grown traditionally have been Red Delicious and Granny Smith (55 per cent of production in 1998–99). However, newer varieties such as Gala, Fuji, Cripps Pink (which may be sold using the trademark brand name Pink Lady) and Cripps Red (which may be sold using the trademark brand name Sundowner) now account for more than 40 per cent of production.<sup>44</sup>

### 12.3.1 The supply chain

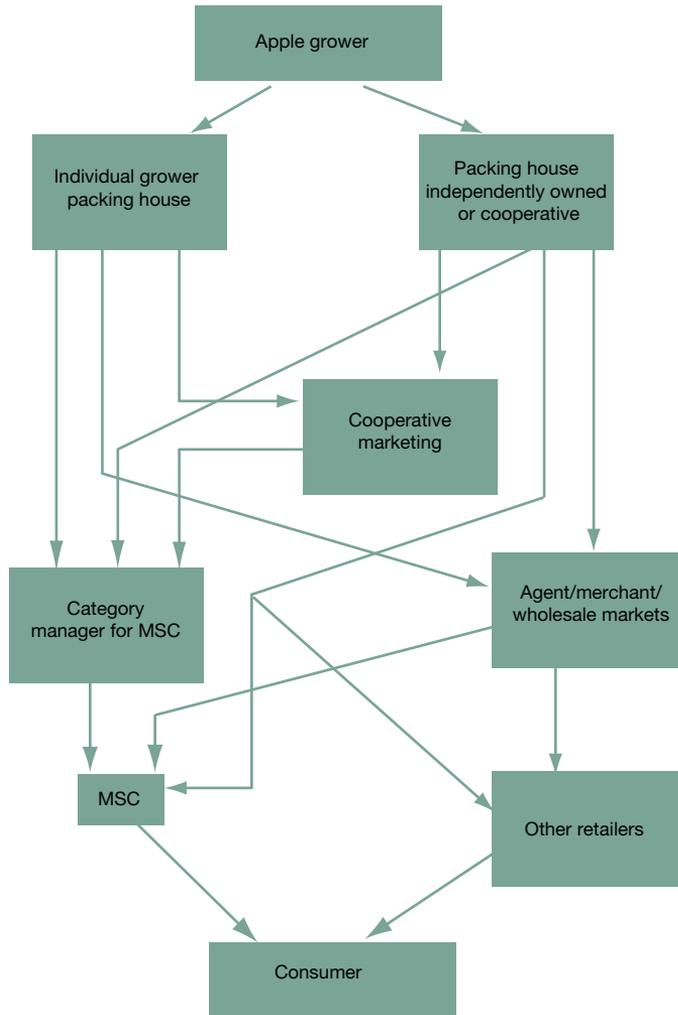
Chart 12.6 is a diagrammatic representation of the apple supply chain. Once grown, apples are picked into large bins. They are then packed into cartons, either on-site in the case of large integrated grower/packers or by a third party in circumstances where the grower does not operate their own packing facility.

Packed apples are then supplied directly to some larger retailers through their distribution centres or to wholesale markets. Smaller retailers will generally source their apples from the wholesale markets rather than directly from growers/packers.

43 Apple and Pear Australia Limited (APAL), 'Statistics', viewed on 28 April 2008, [www.apal.org.au](http://www.apal.org.au).

44 APAL, 'About APAL', viewed on 28 April 2008, [www.apal.org.au](http://www.apal.org.au).

**Chart 12.6 Diagrammatic representation of the apply supply chain**



Source: APAL

As apples vary in variety, appearance, size, taste and general marketability, they can be sold in various forms, from premium apples to second grade or prepack apples. Premium apples generally meet the size, colour and taste specifications of the MSCs, and are therefore able to be sold at a premium price in retail stores.

If the apples are of a poor quality and are unable to be sold either through retailers or the wholesale markets as fresh produce, they are generally used in juicing or canning (although canning does not represent a significant portion of the apple processing performed in Australia).

There has been significant development in the preservation of apple quality in the last 10 years. R Ceravolo & Co. noted in a public hearing that apples are now:

... picked into bulk bins. From bulk bins they're transported into the cold storage facility where they're either dipped or drenched ... to stop any mould spreading in the bins if there is any or anything breaking down. From there they get put into ... Controlled Atmosphere, which [reduces] the oxygen in the room and the carbon dioxide, slowing down the ripening process.<sup>45</sup>

Controlled atmosphere processes allows growers to slowly release produce over the length of a year, thus allowing retail outlets to source apples all year round.

## 12.3.2 Apple growing

### Key inputs and changes in their costs

The major inputs in apple growing are:

- labour
- water
- fuel, fertiliser and transport
- packaging requirements
- grading requirements.

Of these, the single greatest input is labour. The chairman of Apple and Pear Australia Limited (APAL) has stated that labour costs represent on average more than 70 per cent of the cost of apples at the farm gate.<sup>46</sup> Labour shortages in recent years have particularly affected the industry as production is predominantly regionally based and to some extent reliant, particularly with picking, on casual labour.

In recent years the drought has severely affected apple crops. As a result of the declining availability of water, many apple growers have been forced either to buy water allocations or to reduce the size of their crop, which in turn has affected apple supply.

The increasing price of fuel has also severely affected input costs. As orchards are generally located in regional areas, transportation costs have, by some estimates, doubled in 2008 because of high fuel prices.<sup>47</sup> Fertiliser, an important input into apple growing, has also increased dramatically in price in the last 12 months, adding significant costs to apple production.

Another factor growers identified as increasing their production costs is the recent introduction by both Coles and Woolworths of their own individual packaging, either black plastic crates or black boxes. Growers are required to rent the crates from either Coles or Brambles (CHEP)—which manages the supply and distribution of the crates for Woolworths. For many growers, this has added a significant cost as they are required to pack stock for each MSC in a different type of packaging, while all other stock must be packed in their own packaging. This has resulted in increased costs in the initial stage of packing and can significantly adds to costs if produce is rejected by either MSC and needs to be repackaged. In the case of Woolworths, the ACCC received confidential information from growers concerning shortages of the required plastic crates, resulting in growers/packers stockpiling crates, thus adding to crate costs.

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45 ACCC, public hearing transcript, Adelaide, 28 April 2008, p.47.

46 Darral Ashton, *Planning for the future—presentation to Outlook 2007*, viewed on 5 May 2008, [www.abareconomics.com/interactive/Outlook07/files/dayONE/Ashton\\_Hort.pdf](http://www.abareconomics.com/interactive/Outlook07/files/dayONE/Ashton_Hort.pdf).

47 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 69.

The use of these crates has enabled both Coles and Woolworths to use ‘one-touch packaging’— where rather than unpacking the grower’s own boxes to fill the supermarket shelves, the supermarket packer is now able to simply accept the crate from the grower and place it straight onto the shelf, thus reducing the MSCs’ labour costs. As such, the introduction of these crates has reduced Coles and Woolworths packing and handling costs. However, it also appears to have increased the costs of growers in supplying Coles and Woolworths. The ACCC understands that the increased cost to growers has not been reflected in the prices paid by either MSC for the produce.

### 12.3.3 Packing

Packing of apples is one of the key input costs for growers, after the costs of actual production. The packing shed/grading facilities play an integral role in the apple supply chain.

The latest grading machines use a conveyor system which utilises an individual cup system that weighs each piece of fruit and passes the fruit through a colour vision grader where the colour and blemish levels are assessed by a computer. This system automatically allocates fruit of a certain appearance and weight onto different conveyer belts: premium, second grade and bulk prepack. Grading machines have become increasingly technologically advanced in recent years, and constitute a significant cost outlay for new entrants into the industry or growers wishing to vertically integrate (in excess of \$1.3 million for a high-speed grader with two lanes).

The ACCC estimates from information received from APAL and Fruit Growers Victoria (FGV) that the cost of packing apples for a fully integrated grower/packer represents around 37 per cent of the total cost of a bin of apples, while for a grower who is not vertically integrated, the cost of getting apples packed off site by a third party is more likely to be around 42 per cent of the cost of producing a bin of apples.

#### Indicative costs of producing a carton of apples

Each bin picked holds enough apples to fill 33 12 kg cartons. However not all apples in the bin will be suitable for sale as fresh produce. Many apples contain blemishing, bruising and markings that make them unsuitable for fresh consumption. While these defects are usually present at the time the apple is picked, they are generally not identified until apples are sorted and packed.

Once those apples unsuitable for sale as fresh produce are excluded, an average bin will include enough apples for around 16 to 18 12-kg cartons. The remaining apples are generally used as processing apples (juice and canned). Growers receive very little return on the sale of apples that are not fit to be sold as fresh produce.

Table 12. 1 shows indicative costs to a grower of producing a carton of apples based on a bin producing 18 cartons of saleable apples. The figures were supplied by APAL and were verified by various growers. These figures are indicative only as costs will vary, sometimes significantly, depending on location of orchard, size of orchard and variety of apple grown.

As noted previously, some growers are completely vertically integrated, while others simply grow apples and then transport them to a third party for packing and sale. Table 12.1 shows indicative costs for a vertically integrated grower. For a vertically integrated grower, packaging costs are not accounted for separately. Rather, they are an integrated cost in each step in the production of apples.

**Table 12.1 Indicative cost to the grower of producing a carton of apples<sup>48</sup>**

<b>Action</b>	<b>Average price</b>
Orchard production cost (includes all growing costs, including harvest)	\$200/bin
Bin hire and freight to storage/packing shed	\$25/bin
Storage (cool)/dipping or smart-fresh	\$60/bin
Packaging cost per carton	\$2.60
Outbound freight per carton	\$3.20
Gross bin cost	\$389.4/bin
Total cost of production per carton <sup>49</sup>	\$21.63/carton (12 kg)

In table 12.1 the packaging cost per carton is the actual cost of the carton or crate in which the apples will be placed, not the cost of packing the apples into the carton or crate. As stated previously, the cost of packing apples, including the sorting and dipping is between 37 and 42 per cent of the cost of producing a carton of apples.

The ACCC understands from information provided confidentially by growers—and information received from APAL and FGV—that apple growers aim to achieve at least a margin of 20 per cent over their gross bin cost. It was submitted that a minimum 20 per cent return is necessary to provide a reasonable return on funds employed after overheads and to take account of the high level of risk that, it was argued, apple growing involves. It was submitted that apple growing is a high-risk industry mainly because of the unpredictable nature of the Australian climate. Apples are easily damaged by changing weather conditions, particularly hail. In recent years apple crops in certain areas have been decimated as a result of severe hail storms.<sup>50</sup>

### 12.3.4 Supply options for growers

Interested parties have advised the ACCC that growers have varying degrees of choice as to where their produce is ultimately sold. The level of alternatives available to growers is largely dependent upon the size of their operation and the way in which they manage their business. Some growers only deal directly with one or both MSCs, while smaller growers, because of their smaller volumes, must deal with MSCs through a grower consolidator. Consolidators are generally growers themselves, who supplement their own produce with that of smaller growers from within their region to obtain greater volumes. Consolidators will generally be fully integrated, having on the one site controlled atmosphere facilities, grading facilities, packing and prepacking facilities. The majority of apples supplied to the MSCs are supplied by large consolidators or growers.

In some instances consolidators will take ownership of the apples and then on-sell them. In other instances consolidators will sell them on behalf of the grower and take a commission.

### 12.3.5 Wholesale markets

In addition to selling directly to retailers, growers are also able to sell their apples through the wholesale markets. In the case of smaller growers, supply to the wholesaler can be either direct or through a grower or consolidator.

48 The average bin of apples also contains roughly 15 cartons of apples not sold as fresh produce. Apples sold for processing provide very little return to the grower. Accordingly, in calculating costs of production per carton, bin costs have been allocated across 18 carton bins of apples.

49 This is based on a pack out of 18 cartons—from approximately a possible 33 cartons per bin.

50 ABC online, 'Hail damage hurts apple crops', viewed on 1 May 2008, [www.abc.net.au](http://www.abc.net.au).

Where growers provide their apples to a consolidator for on-selling, without the consolidator taking ownership, or where a grower sells directly to a wholesaler, growers have submitted that they are sometimes unsure of where their produce is being sold, and how much the wholesaler is receiving for their goods. This issue is examined in greater detail in chapter 18, which examines the effectiveness of the Horticulture Code and makes recommendations aimed at addressing concerns, such as those raised by apple growers and noted here.

Where apples are sold by a third party, either in the wholesale market or to an MSC, the ACCC understands that the third party may charge between a 5 and 10 per cent fee from the final selling price of the apples for providing that service.

### 12.3.6 MSC buying

Generally the MSCs conduct an annual forecast of the amount of produce they envisage they will need before the apple season commences. Then, on a weekly basis they will meet with their growers to discuss the price and volumes required for that week. Once packed, apples are transported to an MSC's distribution centre in pallet quantities. Title passes to the MSC upon acceptance of the goods received, on the condition that they meet the quality specifications of the MSC in question. The MSCs generally have a number of growers who supply them directly, and both orders and delivery are generally made on a daily basis to ensure that sufficient stock is maintained in store.

The ACCC understands that while the MSCs buy the bulk of their apples directly from growers or packing houses owned by large consolidators or growers, at times they do rely on buying through wholesale markets to top up their supply.

### 12.3.7 Relative bargaining position of growers and the MSCs

Submissions received by the ACCC on the fruit and vegetable sector have by and large contended that the sector is dominated by the MSCs, and that producers are generally price takers.<sup>51</sup> The Bundaberg Fruit and Vegetable Growers Association stated that growers have very little capacity to negotiate as they do not hold a position of strength in the supply relationship.<sup>52</sup>

As discussed in chapter 14 of this report, one of the key considerations in an assessment of relative bargaining positions is the possibility of sellers or buyers having 'outside options'. From an apple grower's perspective, while there may be a range of outside options, including export, the only practical alternatives to selling to an MSC are selling to another retailer or through the wholesale markets. The range of options available to the MSCs in sourcing supply from other growers and/or through wholesale markets is far greater and more easily exercised. As would be expected in the short term, the balance of bargaining power in negotiations between the MSCs and growers will generally rest with the MSC. This may be particularly the case in instances where the grower has structured their business around supplying to the MSCs and produce large quantities of fruit that they may have difficulty selling through alternative routes.

A number of industry participants complained during the course of this inquiry that it is not uncommon practice for the MSCs to ask suppliers to reduce a negotiated price so that an MSC can match a competing retailer's offer. Some industry participants contended that while the suggestion is made in the form of a request, it is more of a demand, where the implication of not agreeing to change the price is that the volume of orders could be reduced the following week.

<sup>51</sup> NSW Farmers Association, submission no.155, p. 3.

<sup>52</sup> Bundaberg Fruit and Vegetable Growers Association, submission no. 88. p. 7.

The MSCs accept such requests are made but deny there is any implied threat of retribution if the request is not acceded to. However, the Costa Group, which buys on behalf of Coles, indicated in the context of questions about sharing losses of rejected produce that:

... we all do business with people that make our job easy. Every one of us. So the consequence would be that our preference would be to align ourselves with people that make our job easy.<sup>53</sup>

This suggests that the MSCs and their buyers see this behaviour as rewarding loyalty whereas the grower sees it as a threat to enforce compliance with demands. Requests are often agreed to by producers, but a lower agreed price is often accompanied by lower quality product being supplied. In the ACCC's view what occurs is consistent with the operation of a working market price reduction.

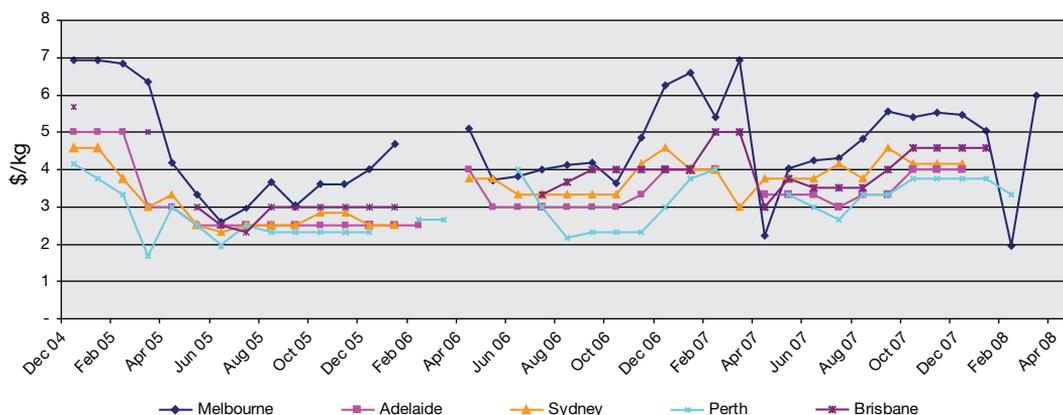
The ACCC has also confidentially received complaints from a number of suppliers of instances where the MSCs have rejected produce in store after accepting delivery at their distribution centre. Allegations were also made that rejection of produce has occurred where the produce was within specification but the price at which equivalent produce was available through wholesale markets had dropped subsequent to the growers produce being accepted at the distribution centre. The inference being that the MSC could reject the produce and obtain the same produce at a cheaper price through the wholesale markets.

The MSCs specifically denied such conduct ever occurred. In addition, growers who were summonsed to appear at hearings denied knowledge of any instance where produce is rejected for any reason other than that it was out of specification.

Given the lack of detail in the allegations made and specific denials by well-informed growers, the ACCC considers it unlikely that this kind of conduct occurs otherwise than in exceptionally rare circumstances. If specific complaints are made, the ACCC would investigate the matter under the unconscionability provisions of Part IV of the Trade Practices Act. What is clear, however, is that some growers have concerns, legitimate or otherwise, in their relationships with the MSCs. In the absence of specific complaints, the ACCC will not be able to address these issues.

## Wholesale prices

**Chart 12.7 Movements in wholesale prices (per kg in the Melbourne, Sydney, Perth, Brisbane and Adelaide wholesale markets for the last five years)**



Source: Ausmarket

53 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 66.

As demonstrated in chart 12.6, prices have fluctuated greatly in wholesale markets, with the general trend observed being prices increasing slightly. The slight increase in average prices over the last five years is likely a reflection of tighter supply conditions as a result of the drought. The ACCC notes comments from industry participants that the drought resulted in limited supply of apples within MSC specifications, which has had the effect of:

- enabling the grower to demand more money for high-quality fruit
- specifications being altered, or
- the supply of apples at a retail level being limited.<sup>54</sup>

The prices received by growers through wholesale markets fluctuate on a week-to-week basis and reflect supply and demand. The price paid by the MSCs will also generally reflect the prices paid in the wholesale market. The ACCC has received evidence at public hearings that suggests that the price paid by MSCs is generally close to the top price being paid in the wholesale markets.<sup>55</sup> This is understandable given that the MSCs seek to stock premium quality apples.

While the price paid by the MSCs broadly reflects the price in the wholesale markets, this is not to say that the wholesale markets set the price paid by the MSCs. The MSCs purchase around 50 to 60 per cent of all apples in any given week, mostly at the premium end of the range.<sup>56</sup> As such, the purchasing patterns of the MSCs, which play a major role in setting demand for apples at the wholesale level, exert a strong influence over the wholesale price.

The ACCC also understands that in some weeks where the MSCs may be running specials on apples, they can pay significantly less than the market wholesale price. The ACCC understands that growers participate in these specials to generate sales volume and to maintain a healthy relationship with the MSCs. The ACCC also understands that such specials are not always initiated by the MSC; rather, in circumstances of oversupply, growers will sometimes suggest a promotion be run and offer their produce at a lower price to push through greater volume.

Data obtained by the ACCC suggests that when promotional specials are run by the MSCs in periods where there is not excess supply of apples, shortages of similar quality apples in the wholesale markets have been observed. Such a shortage may drive up wholesale prices and may result in retailers other than MSCs, which rely upon the wholesale markets for their supply, paying significantly higher prices than those paid by the MSCs.

### The retail price and retail margins

APAL estimates that between 50 and 60 per cent of apples sold as fresh produce are sold through the MSCs. However, APAL considers that this figure has been slowly declining in recent years as a result of independent fruit and vegetable retail stores increasing their presence in the market.<sup>57</sup>

Coles noted in their public submission that the target margin for fresh produce is generally higher than dry groceries. According to Coles, this is because of:

- high spoilage rates
- higher labour costs in product preparation
- customer service and replenishment

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54 ACCC, public hearing transcript, Adelaide, 28 April 2008, pp. 51–53.

55 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 51.

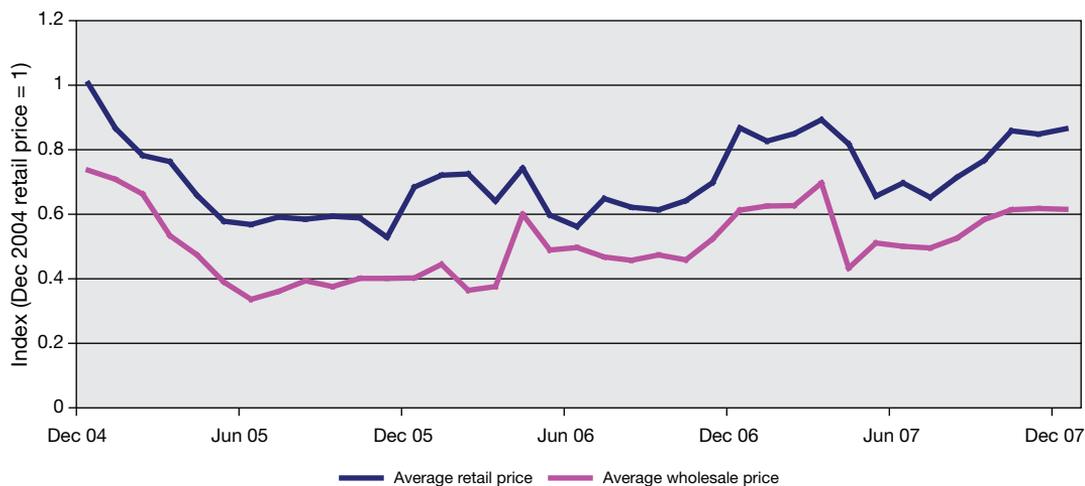
56 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 5.

57 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 5.

- costs associated with maintaining a cold chain through to display
- stringent regulations on the sale of fresh produce
- waste, or shrinkage, which can be as high as 10 per cent for some fresh produce.<sup>58</sup>

As illustrated in chart 12.6, price movements in the wholesale market are volatile. Confidential information provided to the ACCC by retailers suggests that fluctuations, particularly dramatic drops in wholesale prices, are not always reflected at the retail level suggesting that retailers are able to make additional profit during these times.

**Chart 12.8 Pink Lady—retail average price v. wholesale average price<sup>59</sup>**



Source: Ausmarket, Franklins, Foodland, Coles and Woolworths

Chart 12.7 is an index of retail and wholesale prices for Pink Lady apples from December 2004 to December 2007. The wholesale price data was obtained from Ausmarket, an organisation that collects pricing data at each of the wholesale markets throughout Australia, and comprises the average price across Australia's five major wholesale markets in Sydney, Melbourne, Brisbane, Perth and Adelaide.

In calculating average wholesale prices, the ACCC has used the high price given in Ausmarket market reports that give the quality specifications of the major supermarket chains. While the wholesale markets are not the primary source of apples for the major chains, the wholesale market prices reported are broadly indicative of the prices at which they are supplied.

The resulting chart (with retail prices for the first month set to 1) indicates that the retail price has moved in a pattern consistent with movements in the wholesale price. Retail margins for the most part have been reasonably constant. While at times the margin increases or decreases, the ACCC understands that this is determined by supply and demand factors. In particular, the retail price rises when supply levels fall. Movements in Pink Lady prices are broadly in line with movements that occur in the wholesale market. There is no evidence that the retailers from which the ACCC obtained data, including both Coles and Woolworths, can hold down wholesale prices while increasing retail prices. Rather, it appears to the ACCC that price movements are dictated by seasonal factors.

<sup>58</sup> Coles, submission no. 157, freshlogic report, 28 March 2008, p. 39.

<sup>59</sup> Data obtained from Ausmarket, Franklins, Foodland, Coles and Woolworths.

Generally, the ACCC has received confidential information from retailers that indicates that gross margin for varieties of apples are generally between 35 and 50 per cent.

While the data presented above is broadly indicative of national trends, the ACCC understands that apples are considered by supermarket retailers to be a key value item. The concept of key value items is examined in detail in chapter 4. Broadly, key value items are grocery items the larger retailers understand are compared by consumers in determining which retailer to visit. Key value items are generally products that are purchased frequently by consumers.

Large retailers will generally price their key value items at a local store level by reference to what competing retailers—be they other large retailers or, in the case of apples, greengrocers—in their immediate vicinity are charging.

For example, if a greengrocer in the immediate vicinity of an MSC is offering apples on special, it is not unusual for the MSC to similarly discount the price of apples to retain customers or attract them away from the grocer.

As a result, prices charged by large retailers can vary from store to store based on local competition. This is discussed in greater detail in chapter 5. Where competition from other large retailers or greengrocers is weaker, apples will, on average, be priced higher. Where there is strong competition, this will be reflected in retail prices. As such, the local competitive dynamic plays a strong role in setting prices of apples with a competitively priced greengrocer in the immediate vicinity of a large supermarket likely to constrain the pricing practices of the large supermarket.

In short, the price at which apples are sold by large supermarket retailers will vary from area to area dependent on the local competitive tension provided by other retailers.

### 12.3.8 Conclusion

Wholesale prices for apples have fluctuated significantly over the past four years, with a general trend of prices increasing slightly. Given the climatic conditions that have been prevalent over that four-year period, including substantial periods of drought and decreased water availability and allocations, it is likely that the slight increase in prices is a result of reduced supply of the types of apple suitable for sale as fresh produce.

The increase in price at the wholesale level may also in some way reflect the increased cost to growers in producing apples given the rising costs of labour, fuel and fertiliser and given that growers appear to seek a minimum margin of 20 per cent above their bin cost of production.

Retail prices for the MSCs have similarly fluctuated over time, and appear to have mirrored the trends demonstrated in wholesale pricing. The general trend for retail prices is again one of a slight increase, likely caused in some way by increasing input costs at both the wholesale and retail level.

Retail prices for apples are affected by a number of factors other than the wholesale market price. It should be remembered that the vast majority of apple products sourced by the MSCs are obtained directly from growers rather than through the central wholesale markets. Retailers price apples after examination of prices offered by their competitors in the immediate vicinity. As a result, areas where there is significant competition by the other MSC or independent retailers are likely to benefit from lower apple pricing. The retail price may also be affected by the negotiating power of specific growers, which in turn is affected by the options available to the grower to sell their product. Growers with a greater reliance upon the MSCs are likely to provide fruit at a lower price than those who are not dependent upon the same extent.

## 12.4 Bread

### Key points

- Increases in the general price of bread have outpaced both food prices and the CPI in the last three years. However, many consumers have avoided the price increases by switching to private label bread, for which prices have remained flat.
- There appears to be strong competition throughout the bread supply chain.
- The main factor contributing to higher bread prices is higher input costs. Worldwide demand-and-supply conditions for wheat have increased the price of flour, but the rising prices of other inputs have also been important. As the cost of wheat only makes up between 5 and 10 per cent of the final retail price of bread, the affect of increases in wheat costs on bread prices appears to be overstated.
- In their dealings with the MSCs, bread producers appear to be able to pass on higher production costs more readily for branded bread, but less so for private label bread. This reflects both the buyer power of the MSCs and strong competition between manufacturers. Consumers appear to have benefited from this in the form of lower prices for private label bread.
- Retailer gross margins can vary greatly and do not exhibit a widespread trend either up or down. Competition appears to be strongest in cheap bread varieties, although the success of specialty bakeries would be imposing a constraint on supermarkets and their suppliers with regards to higher quality products.
- Of all the bread sold in Australia (excluding bread sold to the food services sector), approximately:
  - 59 per cent is sold in supermarkets
  - 31 per cent is sold in specialty bakeries
  - 10 per cent is sold in convenience stores.

There are more steps in the bread supply chain than for most other grocery items. Specific steps in the supply chain include the growing of wheat, milling the wheat into flour, baking and distribution and, finally, retailing.

This case study examines costs, prices and margins in the supply chain for bread, with a particular focus on bread produced by large wholesale suppliers and sold in supermarkets.

### 12.4.1 Wheat

Wheat is the most important ingredient for the production of bread. However, a number of parties (such as Agforce Grains) advised the ACCC during the inquiry that the contribution of the cost of wheat to the price of bread had been overstated by the media.<sup>60</sup> Coles also argued that grains make up a small portion of the total cost of bread product, and that the majority of the cost is in the form of labour, energy and packaging.<sup>61</sup>

60 Agforce Grains, submission no. 111, p. 1; Southern Sydney Retailers Association, submission no. 10; the Western Australian Farmers Federation, submission no. 106, p. 2.

61 Coles, submission no. 157, attachment A, p. 61.

Based on information provided to the ACCC during the inquiry, it appears that wheat (as opposed to flour, which is discussed later) accounts for between 5 and 10 per cent of the retail price of a loaf of bread.

### Production of wheat and trends in key input costs

In Australia wheat is produced primarily in the wheat belt, which extends through central Queensland, New South Wales, Victoria, South Australia and south-west Western Australia. The Australian wheat industry comprises around 29 500 growers<sup>62</sup>, generally producing around 25 million tonnes of wheat annually.<sup>63</sup> Most of this is exported with Australia representing between 10 and 15 per cent of the world's wheat trade.<sup>64</sup>

Both Agforce Grains and the WA Farmers Federation stated that real returns to grain farmers have been falling despite high wheat prices. They argued that farmers' inputs have also risen significantly, with the price of fertiliser doubling within 12 months and the most important chemical, glyphosate, tripling in cost.<sup>65</sup>

### The supply of wheat to millers

Wheat is an internationally traded commodity and the price is largely set according to international supply and demand. Domestically, wheat used in bread production is sold to flour mills, both directly from farmers or through traders. One of the largest mills in Australia, Weston Milling, purchases about 70 per cent of its grain requirements from farmers, with the balance coming from traders.<sup>66</sup>

Given that grain producers export the majority of their produce, flour mills are effectively price takers. Agforce Grains submitted that the domestic grain market is transparent and effective, with farmers receiving prices that reflect supply and demand conditions.

### Trends in the price of wheat

The recent rapid rise in the price of wheat has been well documented. Wheat prices reached record highs in both nominal and real terms in 2007–08.<sup>67</sup> The price of a tonne of wheat in Australia increased from \$192 in 2005–06 to a forecast of \$440 in 2007–08.<sup>68</sup> The rise in price occurred because demand for wheat has been growing in developing countries such as China and India, but supply has also been an issue.<sup>69</sup> Starting with low opening stockpiles, output has reduced due to poor seasonal conditions in many of the wheat producing regions such as the European Union and Australia.

## 12.4.2 Milling

Wheat is the essential raw input into flour milling. The flour milling process involves the wheat being cleaned, conditioned, ground, sifted and either transferred to bulk storage or packed. Flour mills supply to flour wholesalers and large retailers, bakeries, and large pasta manufacturers.

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62 DAFF, Wheat Export Marketing Consultation Committee discussion paper, January 2007, p. 4.

63 ABARE, *Australian commodities*, March 2008, p. 33.

64 *ibid.*

65 Agforce Grains, submission no. 111, p. 3, and ACCC, public hearing transcript, Perth, 22 April 2008, p. 63.

66 George Weston Foods, response to informal information request.

67 ABARE, *ibid.*

68 *ibid.*

69 *ibid.*

Australia had around 25 flour mills in 2005, spread across all Australian states and in both metropolitan and country areas.<sup>70</sup> The key milling companies—Allied Mills, Weston Milling and Manildra—own multiple mills.<sup>71</sup>

### The supply of flour to bread producers

There are two characteristics of flour milling that could potentially limit competition. The first is that some wholesale bread manufacturers are vertically integrated by also owning flour mills. However, the ACCC did not hear any complaints that non-integrated flour users had difficulty in obtaining flour at what they considered to be reasonable prices.

The second possible threat to competition in flour milling is that rationalisation within the industry could lead to the concentration of flour milling infrastructure in fewer hands. Rationalisation appears to be a response to the considerable under-utilisation of mills that has been reported in recent years.<sup>72</sup>

However, no evidence was presented to the inquiry to suggest that flour milling is not competitive. Bakers Delight stated that flour could be obtained at reasonable prices, even if prices would be lower if there were more players in the market.<sup>73</sup> The WA Farmers Federation stated that it believed the flour industry was competitive.<sup>74</sup> A 2004 report by the Department of Agriculture, Fisheries and Forestry (DAFF) also stated that the flour industry is highly competitive and that participants receive low margins.<sup>75</sup>

### Trends in key input costs and the price of flour

Wheat is the main cost component in producing flour, with DAFF estimating that wheat and other ingredients account for around 60 per cent of total costs ex mill (excluding warehousing and distribution).<sup>76</sup>

The ACCC heard evidence that higher wheat prices are being passed directly through to higher flour prices. A number of suppliers of flour-based products confidentially advised the ACCC of frequent and significant increases in the price of flour of over 50 per cent over the last two years.<sup>77</sup>

## 12.4.3 Baking and distribution of bread

### Different models of bread production

There are three models for the production of bread:

- bread wholesalers
- bakeries located within supermarket stores
- specialty bakery stores.

Bread wholesalers produce most of the branded loaves available in supermarkets, convenience stores and petrol stations. These manufacturers also produce private label bread products on behalf of the supermarkets.

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<sup>70</sup> Flour Millers Council of Australia, submission to the Agriculture and Food Policy Reference Group, May 2005, p. 1.

<sup>71</sup> The Australian Wheat Board, accessed at [www.awb.com.au/aboutawb/communityeducation/thefourmillindustry](http://www.awb.com.au/aboutawb/communityeducation/thefourmillindustry), 30 April 2008.

<sup>72</sup> DAFF, *Price determination in the Australian food industry*, 2004, p. 74.

<sup>73</sup> ACCC, public hearing transcript, Melbourne, 30 May 2008, p. 29.

<sup>74</sup> ACCC, public hearing transcript, Perth, 22 April 2008, p. 6.

<sup>75</sup> DAFF, *Price determination in the Australian food industry*, 2004, p. 74.

<sup>76</sup> *ibid.*, p. 78.

<sup>77</sup> For an example of public comments, see Bakers Delight's comments, ACCC public hearing transcript, Melbourne, 30 May 2008, p. 27.

A number of MSCs have in-store bakeries. In-house supermarket bakeries commonly source partially prepared frozen or ambient product from the large bread wholesalers. This enables the supermarkets to offer freshly baked bread without having to produce bread from scratch in the manner of a specialist bakery.

Specialty bakery stores include independent hot bread shops as well as the Bakers Delight- and Brumby's-owned and franchised outlets. Strong growth of these franchises in recent years has depleted the quantity of sales of independent bakeries.<sup>78</sup> Bakers Delight now has over 600 stores and Brumby's over 300 stores in Australia.<sup>79</sup>

## Distribution of bread

A number of considerations in distributing bread are not relevant in the distribution of other grocery items. The main restrictions on distribution systems are the demand for fresh product, the short shelf-life of bread and, consequently, the timely delivery of bread required for peak buying periods.

The need for freshness means that large bread wholesalers predominantly distribute their bread directly to supermarkets on the day of baking, rather than using supermarket distribution centres as is the case for most grocery items. It is common practice for bread producers to collect any bread that went unsold the previous day, with full refund for the retailer. Return loaves typically represent 5 to 15 per cent of sales.

## Trends in key input costs

There are a range of inputs to the baking and distribution process, with the relative importance of each depending on the product and production method. Broadly speaking, the main input costs are ingredients, labour and overheads, followed by distribution and packaging.

Information (both public and confidential) provided to the ACCC suggests that flour accounts for approximately 5 to 15 per cent of the retail price of a loaf of bread. Bakers Delight stated that flour was the single biggest purchase it makes, but that it only accounts for approximately 20 cents of the \$3.20 retail price of a standard white loaf.<sup>80</sup> So while the price of flour has definitely contributed to the increase in bread prices, it only partially explains any increase.

George Weston Foods submitted that grain and fuel were the main drivers of rising costs of production.<sup>81</sup> Another supplier made similar claims confidentially and pointed to increases in the prices of flour, gluten, transport, labour and energy. Bakers Delight said that the top five to ten individually significant ingredients in terms of cost had all recently gone up by at least 10 per cent.<sup>82</sup>

## The supply of branded bread to supermarkets

Supply arrangements between wholesale bread producers and supermarkets differ depending on whether the producer supplies its own branded bread or private label bread.

Branded bread is sold to supermarkets like many other grocery items. A supplier will typically have a list price setting out the starting wholesale price available to all customers. Greater detail is provided in the

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78 DAFF, *FoodMap: a comparative analysis of Australian food distribution channels*, 2007, p. 37.

79 Bakers Delight, accessed at [www.bakersdelight.com.au/cms/document.php?objectID=151](http://www.bakersdelight.com.au/cms/document.php?objectID=151); Brumby's, accessed at [www.brumbys.com.au/about/default.aspx](http://www.brumbys.com.au/about/default.aspx). Both websites viewed on 30 April 2008.

80 ACCC, public hearing transcript, Melbourne, 30 May 2008, pp. 27–28.

81 George Weston Foods, submission 138, p. 10.

82 ACCC, public hearing transcript, Melbourne, 30 May 2008, p. 27.

trading terms mutually agreed to by both supplier and customer. The trading terms will describe many of the procedures by which supply is to occur, but most significantly the terms will specify discounts or fees.

The type and level of discounts and fees will depend on the advantages that the customer provides to the supplier, including business volume, promotional opportunities and the speed with which payment is made. Another determinant of price is further promotional activities which typically see the supplier pay the retailer to lower the retail price.

Trading terms will typically be more favourable to larger customers. George Weston Foods' submission discussed the benefits of dealing with the larger supermarkets:

Broadly, MSCs offer national scale, reach and access to critical shelf space that smaller retailers cannot provide. This scale allows MSCs to drive larger volumes, influence and run promotional programmes independently and ultimately reduces the end price they are able to source product for.<sup>83</sup>

The eventual price paid by the retailer is affected by the relative negotiating power of each party, as discussed in chapter 14. George Weston Foods noted that it supplies its products through a variety of channels (such as wholesalers, major and independent supermarkets, convenience outlets, fast-food outlets and caterers) and each customer has a different level of bargaining power.<sup>84</sup>

Despite the many channels to retail customers available to bread producers, around 59 per cent of bread is sold through supermarkets.<sup>85</sup> As this figure includes bread sold through specialty bakery stores, supermarkets would account for a higher proportion of sales of bread produced by wholesale suppliers.

As a consequence, the MSCs are likely to have considerable buyer power in negotiations with bread manufacturers. For example, George Weston Foods claimed that any decision by the MSCs to cease purchasing from them would have significant ramifications for George Weston Foods' business.<sup>86</sup>

Further strengthening the ability of the MSCs to influence the terms of supply of branded bread is the rise in sales of private label bread, as discussed below, which means the MSCs are less reliant on branded bread sales.

Against this, both George Weston Foods and Goodman Fielder account for sizeable shares of total bread sales in supermarkets (28 per cent and 26 per cent, respectively<sup>87</sup>); they have also invested heavily in brand names that would be missed by consumers if they were removed from supermarket shelves. This is likely to give them a degree of countervailing power in any negotiations with the MSCs.

However, the balance of bargaining power in any negotiations between MSCs and smaller manufacturers is likely to be heavily weighted in favour of the MSCs. This was most notably illustrated in the case of *ACCC v Australian Safeway Stores Pty Ltd*.<sup>88</sup>

In this case the ACCC alleged that Safeway had a policy of removing a particular baker's products from sale when their products were on special at nearby independent stores. The ACCC alleged that the conduct of Safeway in ten separate incidents involved, among other things, price fixing and the misuse of market power.

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83 George Weston Foods, submission 138, p. 6.

84 George Weston Foods, response to informal information request.

85 Roy Morgan Single Source survey of grocery consumers, 2008.

86 George Weston Foods, response to informal information request.

87 George Weston Foods, response to informal information request.

88 *Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores Pty Ltd (N. 3)* (2001) 119 FCR 1.

On 30 June 2003 the Full Federal Court of Australia unanimously agreed that the ACCC had established that Safeway had engaged in price fixing.<sup>89</sup> The majority of the court also found that Safeway had misused its market power in four of nine incidents pleaded.

This case is discussed in detail in chapter 14.

### The supply of private label bread to supermarkets

Supermarkets' private label bread products play an important role in the range of options available to consumers. According to Coles, the share of private label products in supermarket bread sales has increased from around 20 per cent in 2003 to nearly 50 per cent in 2007.<sup>90</sup>

The arrangements for the supply of private label bread differ from those for branded bread. Supply occurs under fixed contracts of one to two years. The contracts are generally awarded through an open tender process, although sometimes existing supply contracts are extended without a fresh tender process when both manufacturer and retailer are satisfied with the existing arrangements.

In awarding private label contracts, it appears that MSCs may prefer to award a single national contract for each bread product. Only two manufacturers can offer national coverage when tendering for contracts—George Weston Foods and Goodman Fielder.

Despite the limited choice of suppliers that can offer national coverage, the ACCC believes that the MSCs still have a degree of buyer power in sourcing private label product, given the volumes on offer and the importance of this supply channel to bread manufacturers. Further, while MSCs appear to prefer national contracts, they have the option of tendering on a state basis if they consider there is insufficient competitive tension in the national tender process.

The importance of private label contracts to manufacturers is reflected in the wholesale prices of private label bread supplied to the MSCs; these prices have remained relatively stable despite rising input costs and associated increases in the wholesale price of branded bread. This suggests there is strong competition among manufacturers to be awarded these contracts.

### Trends in wholesale prices

The ACCC gathered confidential information about the wholesale price of selected breads sold in supermarkets. Different trends in wholesale prices were apparent for branded and private label bread.

The wholesale price of the selected branded bread remained stable or declined slightly between 2002 and early 2005, before increasing significantly over the last three years. This suggests that the suppliers of these branded breads have been able to pass on, at least in part, increases in the cost of production.

In contrast, the information gathered on selected private label bread products showed wholesale prices have generally remained stable over the last five years, indicating that suppliers have been more constrained in their ability to pass on increases in production costs than is the case for branded bread. Possible reasons behind this inability of suppliers to pass on increases in input costs include MSC buyer power, rigidity in contracts and strong competition among manufacturers to be awarded private label contracts.

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<sup>89</sup> *Australian Competition and Consumer Commission v Australian Safeway Stores Pty Ltd* (2003) 129 FCR 339.

<sup>90</sup> Coles, submission no. 157, attachment A, p. 41.

## 12.4.4 Retail supply of bread

### The retail competitive environment

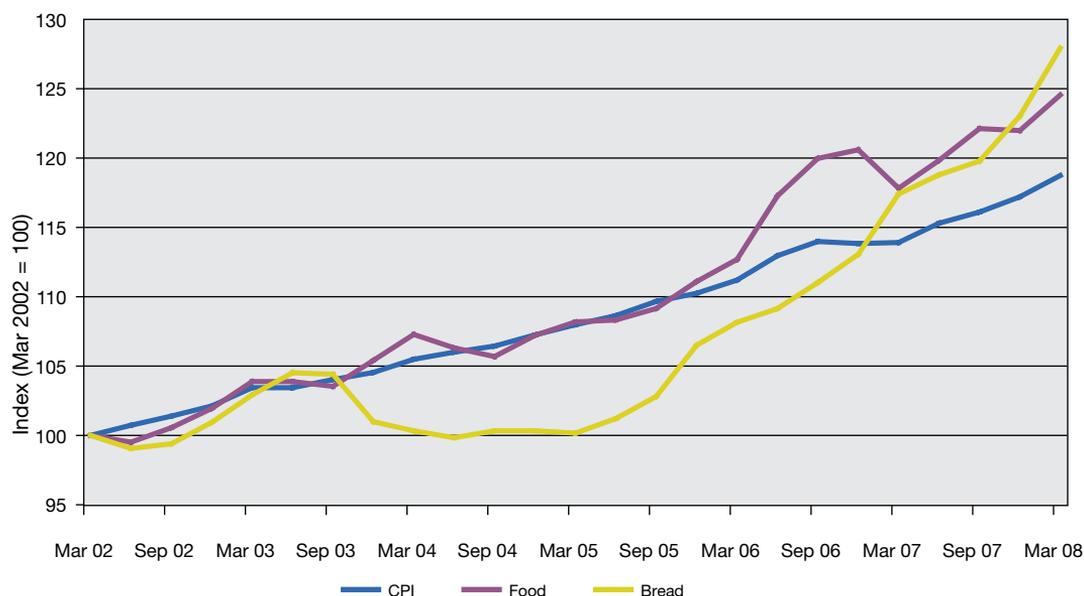
Bread is sold in a large range of retail outlets, including supermarkets, specialist bakeries, convenience stores and petrol stations. This creates stronger retail competition than for some other grocery items. While the majority of bread sales are made through supermarkets, their 59 per cent share of bread sales is smaller than for some other grocery items.<sup>91</sup> Specialty bakeries account for 31 per cent of bread sales, while 10 per cent of bread is bought from convenience stores.

The ACCC survey of grocery consumers found that people who mainly bought their bread from bakeries did so because they believed they were getting better quality products, better prices and a wider range of products.<sup>92</sup> Alternatively, people who made most of their bread purchases from supermarkets did so because they believed they were getting better prices, as well as minimising their travel time.

### Trends in retail prices

Chart 12.9 contains data from the ABS that shows that nominal prices for bread in March 2005 were essentially the same as they were three years earlier. In contrast, prices for food and the CPI both grew at 7 per cent over this period. Since then, prices for bread have gone up substantially. Bread prices have leapt 28 per cent since March 2005, compared to more moderate growth in the price of food (15 per cent) and the CPI (10 per cent).

**Chart 12.9 ABS CPI comparisons—all product groups, food products and bread**



Source: ABS (cat. no. 6401.0)

91 Roy Morgan Single Source survey of grocery consumers, 2008.

92 ACCC, survey of grocery consumers, 2008.

The ACCC analysed confidential information showing the retail price trends of specific bread products. The retail prices of the specific branded bread products examined demonstrated a similar trend to the ABS data. Prices were relatively stable between 2002 and early 2005, before increasing significantly in the last three years. However, the specific private label bread products considered by the ACCC did not exhibit the same trends as the branded bread products or the ABS data. Broadly, prices of these products at the end of 2007 were very similar to those in 2002.

The result is that consumers purchasing private label bread from supermarkets have not been exposed to any significant price increases over the last five years. However, purchasers of branded bread have experienced significant price increases since 2005. One consequence of this is that price sensitive consumers have switched to private label products to avoid these price increases.

Other consumers are paying more for bread as a consequence of consumer preferences shifting to bread types with higher production costs. Bread varieties now include fortified bread, gluten-free, additional iron, high fibre, low GI, soy and linseed, oat bran and honey, and bread with fruit.

### Retailer gross margins

The ACCC obtained various confidential data showing that the gross margins obtained by retailers in bread varied significantly. The most important factor influencing margins appears to be the degree to which the retailer wishes to use cheap bread to attract customers. The strategy of using low-cost bread to attract customers means that simply observing gross margins does not necessarily provide an insight into whether a particular player has a degree of market power.

This is particularly true for private label bread, where the relatively low wholesale price provides the retailer with the opportunity either to obtain high margins or sell very cheap bread. ALDI in particular was driving competition in this area with loaves for sale at 99 cents for a number of years (ALDI recently increased the price to \$1.09).

Margins are generally lower for private label bread than branded bread, which suggests retailers are prepared to offer private label product at lower prices to attract customers. This practice is likely to create competitive pressure on cheaper branded products. Although both wholesale and retail prices for specific private label bread products have remained relatively stable over the past few years, there has been sufficient movement in wholesale prices for retail margins to decline slightly.

Confidential information gathered by the ACCC through the inquiry and other activities suggests that retail gross margins for branded bread range from 0 to 40 per cent of the retail price. Larger supermarket chains typically operate with margins of approximately 30 per cent, while smaller retailers are more likely to be operating at margins of 20 per cent. There were no widespread trends in gross margins relating to the specific branded bread products considered by the ACCC. The gross margins were increasing on some bread products and declining on others.

### 12.4.5 Conclusion

As an overall category, the price of bread has risen substantially since March 2005, outpacing both the price of food generally and the CPI. However, prices for private label bread have remained relatively flat, which has resulted in many consumers switching to private label bread to avoid higher prices.

While the rising prices of bread reflect increasing production costs, the impact of increases in the cost of wheat on bread prices has been overstated. More generally, it appears that some of the observed increasing costs have been absorbed by manufacturers rather than being passed on in wholesale prices.

Particularly in respect to private label bread, it appears that the buyer power of MSCs and strong competition between manufacturers has kept wholesale prices low, allowing retailers to offer these products at low retail prices to attract customers.

There also appears to be strong competition at the retail level, particularly among supermarkets in respect of cheaper bread products.

## 12.5 Eggs

### Key points

- The price of the cheapest dozen eggs sold through the MSCs in 2003 was approximately \$2.40.<sup>93</sup>
- The price of the cheapest dozen eggs sold through the MSCs in the first quarter of 2008 was approximately \$2.65.<sup>94</sup>
- This increase in the price of the cheapest dozen eggs is less than the rate of increase in the CPI over the same period. However, the rate of increase in the price of eggs overall has been greater than the increase in the CPI over this period.
- Retail sales of eggs account for around 50 per cent of all shell eggs produced, with the foodservice sector accounting for the remainder. Approximately 50 per cent of these retail sales of shell eggs are through the MSCs. Up to 70 per cent of the MSCs' egg sales are private label.
- The price of feed grain, which represents in excess of 50 per cent of producers' variable costs, has increased by 132 per cent since 2005, significantly increasing overall egg production costs. There has been a significant shift in consumer preferences from branded to cheaper private label eggs in recent years.
- Consumer preferences have also shifted towards barn laid and free range eggs, and 'value added' eggs such as organic eggs. These eggs are more costly to produce and, consequently, consumers who have made this switch are paying significantly more for their eggs.
- The MSCs have a degree of buyer power, particularly in respect of sourcing eggs to sell under their private label brands. This is reflected in lower producer and retail prices for private label eggs.
- There appears to be strong competition at the producer level both for the supply of branded and private label eggs.

### 12.5.1 Introduction

Eggs are either sold as whole 'shell' eggs to retail outlets and the food service sector, or as egg product (including frozen, liquid or powdered egg), sold predominantly to the food service sector.

The primary focus of this case study is shell eggs sold through retail channels. However, a producer's ability to switch between supplying retail outlets, food service providers and manufacturers of egg products is relevant to a consideration of issues of buyer or seller power through the supply chain.

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<sup>93</sup> This figure is a national average based on information provided by Woolworths.

<sup>94</sup> This figure is a national average based on information provided by Coles and Woolworths.

## 12.5.2 Structure of the egg industry in Australia

The gross wholesale value of eggs produced in Australia in 2006–07 was \$398 million, up from \$375 million the previous year.<sup>95</sup> Australians consumed three billion eggs in 2005–06, which were sourced from 423 egg producers from a brood of over 16 million hens Australia-wide.<sup>96</sup> Shell eggs represent around 45 to 48 per cent of total egg sales, with sales to the food service industry, predominantly of egg product, taking up the remainder.<sup>97</sup> Of the national supermarket shell egg sales, Coles' and Woolworths' share is estimated at up to 70 per cent.

Historically, egg production in Australia was controlled by state-based statutory egg boards that regulated both the marketing of eggs and the setting of production quotas to control the level of supply. Deregulation was introduced progressively across Australia, starting with New South Wales in 1989. Egg production in Western Australia was not deregulated until 2005. Egg production in Australia is predominantly located close to major population centres, and over 50 per cent of producers are located in Victoria and New South Wales.

In the latter part of the twentieth century the egg industry experienced a downturn, which was attributed to changing dietary habits caused by health concerns that egg consumption led to cholesterol problems and heart disease. At the same time there was a change in consumer preferences, with an increase in sales of free range eggs likely driven by concerns for animal welfare. By 2005–06 free range eggs represented 23 per cent of retail egg sales.<sup>98</sup>

Australia has little overseas trade in eggs and quarantine restrictions prevent the importation of shell eggs. Some egg product is imported from countries such as New Zealand. The value of egg product imported in 2005 was comparatively low at \$6.5 million. The value of exports was lower again at \$2.2 million.<sup>99</sup>

### The supply chain

Chart 12.10 shows a diagram of the functional levels of the Australian egg industry.

There are only two functional levels in the egg supply chain, the producer and the retailer. Among producers, there are varying degrees of vertical integration. Some producers focus purely on egg production, while others are also involved in other functions including grading and packaging.

Since deregulation, concentration of production in the egg industry has increased. Today the industry consists of a few large producers, complemented by a larger number of medium and smaller producers.

The largest egg producer in Australia is the New South Wales-based Pace Farms, followed by the Victorian producer, Farm Pride. Farm Pride and major producers from several other states established a joint marketing venture, NOVO Foods, with the responsibility for marketing their products to the MSCs.

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95 ABS, *Principle agricultural commodities produced*, preliminary cat. no. 7501; and ABS, *Value of agricultural commodities produced*, cat. no. 7503.

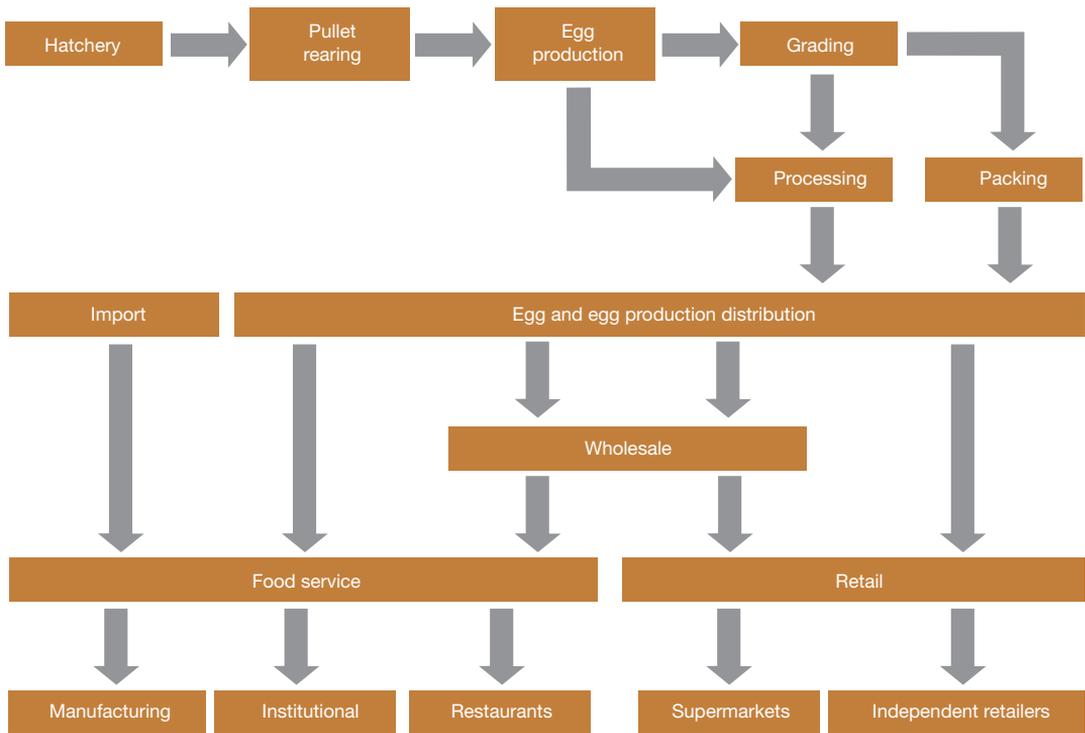
96 Australian Egg Corporation Limited (AECL), *Annual report 2007*, p. 4.

97 AECL, submission no. 113, p. 4.

98 AECL, *Annual report 2007*, p. 3.

99 *ibid.*

**Chart 12.10 The Australian egg industry**



Source: AECL submission no. 113, p. 3

Shell eggs are produced by several different methods, including cage, barn-laid and free range, and are usually sold through retail outlets such as supermarkets, convenience stores and specialty retailers. Table 12.2 shows the breakdown of retail sales of shell eggs by the three methods of production for 2005–06.

**Table 12.2 Retail sales of eggs by method of production in 2005–06 (per cent)**

	Volume	Value
Cage eggs	71.4	61.1
Barn laid	5.3	6.9
Free range	23.4	32

Source: AECL, *Annual Report 2007*, p. 4.

### 12.5.3 Egg production

This section examines the egg production process.

#### Input costs to egg production

The different methods of egg production have different cost structures, with free range eggs being significantly more expensive to produce. A study by the Rural Industries Research and Development

Corporation in 2002 estimated the respective costs of production for a dozen 700gm eggs to be<sup>100</sup>:

- cage eggs \$1.25
- barn eggs \$1.70
- free range eggs \$2.15.

While these figures are somewhat dated, they illustrate the relative cost of producing different types of shell eggs.

The major variable cost in the production of eggs is feed grain costs, which represents in excess of 50 per cent of a producer's variable costs and more than 30 per cent of the retail price of eggs.

Egg producers have faced significant increases in the cost of grain in recent years with evidence provided to the ACCC showing feed costs more than doubling since 2005.<sup>101</sup> This increase in the cost of grain has been attributed to various factors, including drought conditions in Australia and increasing global demand for biofuels. The Australian Egg Corporation Limited (AECL) stated that the feed costs to produce a dozen eggs have recently increased by 40 cents, but the impact on retail prices has been delayed because egg producers have entered forward contracts for grain.<sup>102</sup>

According to the AECL, the other major variable costs of producing eggs are labour, pullets (young birds) and packaging, all of which have been increasing in cost in recent years. The increasing cost of fuel and transportation has also added to cost pressures faced by egg producers.

### Determinants of producer price

Shell eggs are a commodity with little product differentiation (other than by production method) possible at the producer or retail levels. Evidence presented to the ACCC shows that the price paid to producers varies with the level of supply and demand. As there is a significant lead time before birds produce eggs, producers have limited ability to change their level of output quickly in response to changes in market conditions.

In a period of over-supply, a producer may offer promotions to the MSCs in an attempt to maintain market share or may try to sell more product through other avenues such as food service. Alternatively, a producer may process the shell eggs into egg product, which usually attracts a lower price.

The AECL submitted that the domestic market is also affected by the price of imported egg products. It submitted that domestic manufacturers of egg powder cannot compete on cost with overseas manufacturers and that therefore:

... imported powder does displace the local manufacture of powder forcing more fresh shell eggs onto the Australian market increasing supply and hence placing downward pressure on egg prices.<sup>103</sup>

### Supply arrangements with supermarket chains

The majority of eggs supplied to the MSCs are supplied by the larger vertically integrated producers that are responsible for the rearing of the chicks, egg collection, grading and packing. These larger producers often supplement their own supply by purchasing eggs from smaller producers. Once

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100 DAFF, *Price determination in the Australian food industry*, 2004, p. 89. The ACCC recognises that since the publication of the DAFF report, there have been significant shifts in costs and that these figures may not reflect more recent changes in the relativities between the cost of each method of production.

101 AECL, submission no. 113, p. 6.

102 Food Week, no. 1919, 2 May 2008, p. 15.

103 AECL, submission no. 113, p. 5.

packed, the eggs are transported to the retail distribution centres in pallet quantities and title passes to the MSC upon acceptance of the goods received.

Supply terms and conditions differ depending on whether proprietary branded or private label eggs are being supplied. The MSCs usually seek tenders for the supply of private label product on a regional basis. This allows producers who would not have the capacity to supply an entire state to respond to a tender. Eggs sold under private labels will usually be packed and delivered by the supplier according to requirements set out by the MSC. Contracts for the supply of private label eggs usually last 12 months and stipulate a set price for the duration of the contract. Despite the private label contracts stipulating a buy price, the ACCC is aware of instances where MSCs have agreed to an intra-period price increase in circumstances where the contracted party has experienced significant cost increases.

For proprietary branded eggs, the major producers have set price lists, but deviate from these prices in response to market conditions. Given this price flexibility, producers have a greater ability to pass on costs in a timely manner through their branded product than through private labels. However, evidence provided to the ACCC indicates that, in practical terms, producers are constrained in how much they can increase the price of branded product because of the presence of the competing private label product.

Information provided confidentially to the ACCC indicates that the terms of trade between the MSCs and the large producers have not changed significantly over recent years. This suggests that the relative bargaining positions have not changed.

## Producer prices

The ACCC has obtained evidence from egg suppliers and the MSCs on wholesale egg prices.

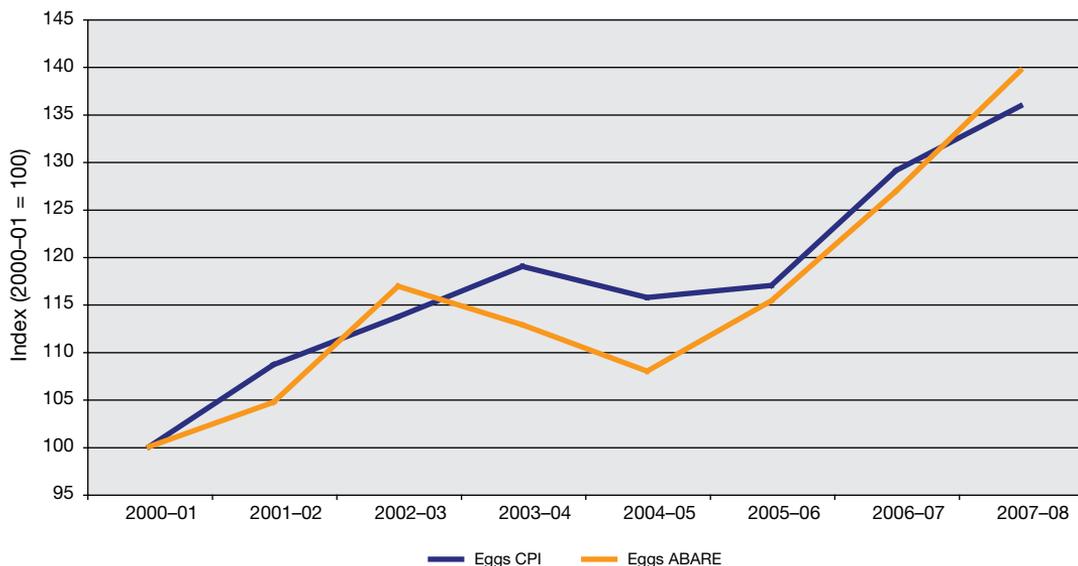
While there is significant variation across states, producers and product, the average price received by producers for a carton of 700gm branded caged eggs has increased from approximately \$2.00 in 2006 to approximately \$2.50 in early 2008. Over the same period, the average price received by producers for 700gm cage eggs sold under private label has increased from approximately \$1.70 to approximately \$2.30.<sup>104</sup>

Chart 12.11 plots an index of producer and retail prices for eggs for the period from 2000–01 to 2007–08. The figure highlights that the retail price of eggs has closely tracked producer prices over the period. Further, it shows that both price series have risen steadily, except for a period of decline in 2002–03 to 2004–05. Changes in the retail price of eggs are examined in more detail below.

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<sup>104</sup> Figures displayed are aggregated to an extent that no conclusion can be drawn regarding the amount any retailers paid for any one particular product.

**Chart 12.11 Index of producer prices and retail prices for eggs (2000–01 to 2007–08)**



Source: ABARE, *Australian commodity statistics*, 2007, pp. 22–23; ABARE, *Australian commodity statistics*, March 2008; ABS, *Consumer price index, Australia*, catalogue no. 6401.0, March 2008

### Differences between prices on branded and private label products

As stated above, information provided to the ACCC indicates that producers receive a higher price for proprietary branded products compared with private label products. This may be due to factors such as:

- Lower costs associated with supplying private label products—for example, some suppliers only supply private label eggs and therefore do not have the overhead costs associated with promoting and maintaining a branded product.
- As private label contracts often have a 12-month duration and stipulate a sale price, it is more difficult for a producer to increase price during the life of the contract—for example, in response to rising input costs.

Another reason suggested for the difference in wholesale prices for branded and private label eggs is the buyer power of the MSCs. Private label eggs sold through the MSCs represent a significant volume of all shell eggs sold through retail channels. Accordingly, failure to secure some of this business would be likely to impact significantly on any large producer. It appears that the importance of these contracts to egg producers is reflected in the lower wholesale price at which the MSCs are able to source eggs for sale as private label product.

## 12.5.4 Egg retailing

This section examines the retail sale of eggs.

### Retail price of eggs

There are two characteristics of egg products that lead to price differences on the retail shelf:

- method of production (cage, barn and free range)
- whether the egg is private label or proprietary branded.

Along with proprietary branded eggs, MSCs stock two tiers of private label eggs. The cheapest private label products are Homebrand (Woolworths) and Smart Buy (Coles). A carton of a dozen cage Homebrand or Smart Buy eggs currently sells for approximately \$2.65. The next tier of private label caged egg products sold by the MSCs includes You'll Love Coles and Woolworths Select, which are both priced at approximately \$3.35.<sup>105</sup> The price of a dozen branded cage eggs sold through the MSCs currently ranges from approximately \$3.90 to \$4.50.<sup>106</sup>

According to the AECL, in 2007 private label eggs represented 61 per cent of all eggs sold at retail<sup>107</sup>, and evidence presented to the ACCC indicates that private label sales through the MSCs may be as high as 70 per cent. The increasing share of sales through the MSCs held by private label is a relatively recent development. Sunny Queen submitted that, over the last five years, the private label eggs produced by Sunny Queen had increased from 20 to 80 per cent of its total egg production.<sup>108</sup>

The growth has been primarily driven by the lower prices at which the MSCs purchase private label eggs, which is reflected in retail prices.

Focusing specifically on the cheapest private label caged eggs available through the MSCs, the current average retail price of approximately \$2.65 compares with an average price of approximately \$2.40 five years ago. This represents an increase of approximately 10 per cent. Over the same period general inflation was 14.8 per cent<sup>109</sup>, meaning that the retail price of the cheapest dozen eggs sold by the MSCs has increased at a rate below the CPI.

Despite this relatively modest increase in the price of lower tier private label eggs sold through the MSCs, retail prices for eggs generally—as measured by the ABS—have increased at a rate above the CPI in the last couple of years.

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<sup>105</sup> This figure is a national average for 700 gm eggs and will vary between states.

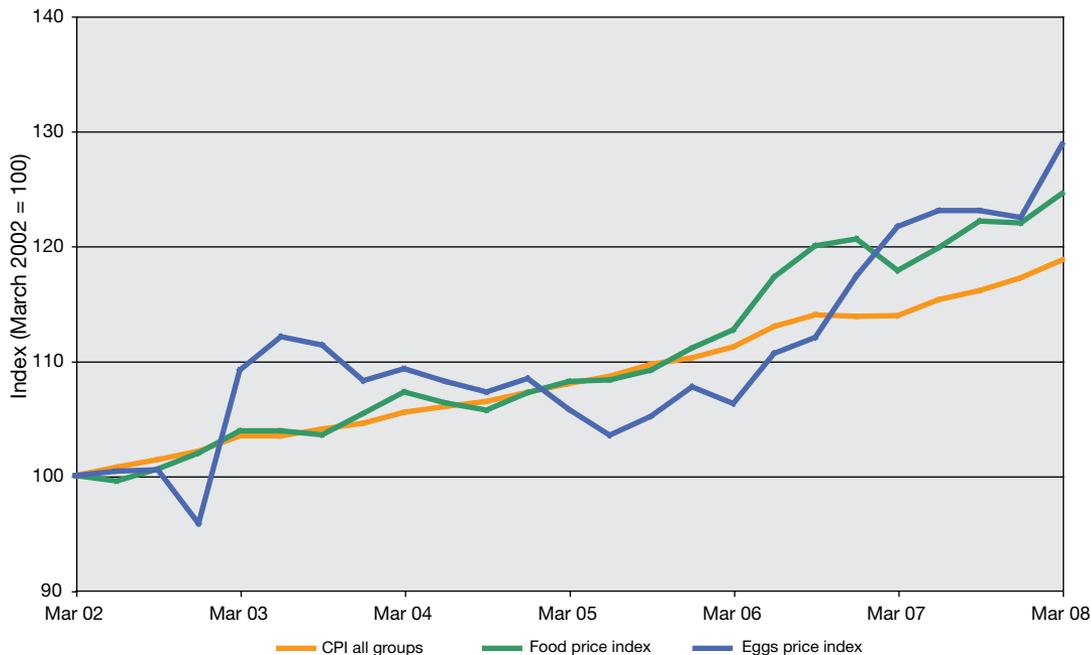
<sup>106</sup> These figures are snapshots only and do not attempt to capture the price of every branded caged egg product.

<sup>107</sup> AECL, *Annual report 2007*, p. 3.

<sup>108</sup> ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 5.

<sup>109</sup> Overall CPI from March 2003 to March 2008.

**Chart 12.12 ABS CPI comparisons – all product groups, food products and eggs**



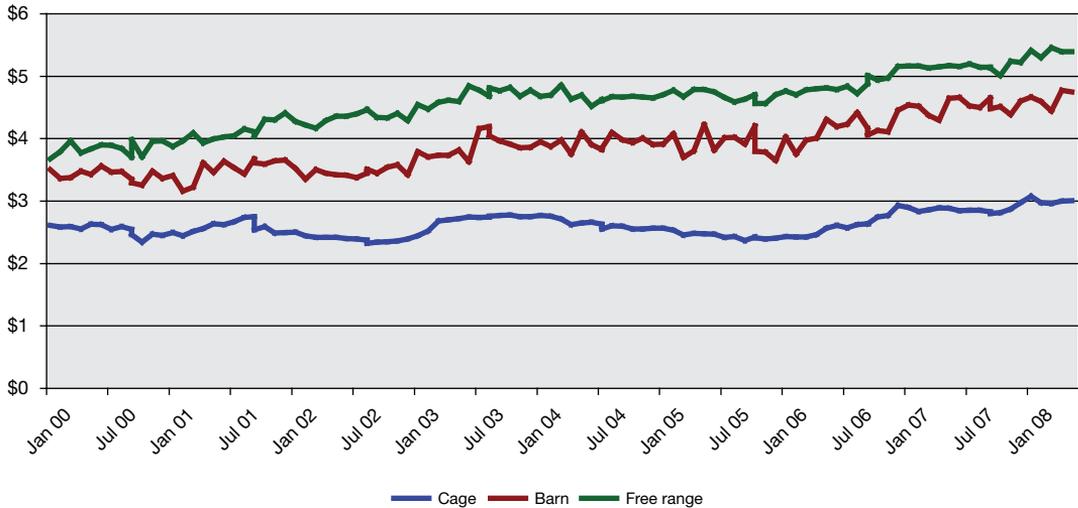
Source: ABS, *Consumer price index, Australia*, catalogue no. 6401.0, March 2008

Between 2002 and 2007, the average annual increase in the retail price of eggs was 4.3 per cent, compared with a 3.7 per cent annual increase in overall food prices and a 2.7 per cent annual increase in the CPI. As illustrated, retail egg prices have increased significantly in the last 18 months. This recent upward trend in the relative price of eggs is not unexpected given the significant increases in input costs faced by egg producers.

Chart 12.13 shows that the rate of increase in the retail price of eggs has varied across cage, barn laid and free range eggs. Prices of barn laid and free range eggs have increased significantly more than cage laid eggs over the period, although the nominal price of free range eggs has decreased since 2003. The AECL has attributed this decline in nominal prices of free range eggs to market saturation of this egg category.

The data suggests only modest increases in the nominal price of cage laid eggs as a category.

**Chart 12.13 Nominal retail prices for eggs by method of production**



Source: AECL submission, p. 19 (incorporating updated data provided by the AECL)

### Movements in retailer margins

During the inquiry the ACCC sought information regarding gross margins from the MSCs and other retailers. The MSCs' gross margins on eggs fluctuate from year-to-year and across states. While there has been considerable fluctuation in margins over recent years, there does not appear to be a discernable upwards or downward trend in these margins.

The MSCs appear to make lower margins on the high volume egg products such as caged eggs and a greater margin on the more expensive 'value added' products like barn laid and free range eggs.

Gross margins on private label caged eggs, where most of the volume lies, varied between the two tiers of private label eggs, with the higher priced private label product attracting a higher gross margin than the cheaper private label product. This is not surprising given that there is often little difference between the two tiers of private label product and accordingly they are often sourced at similar wholesale prices. Gross margins on proprietary branded eggs were above those for the higher priced private label eggs.

### 12.5.5 Conclusion

The egg industry has undergone significant change in the past decade with an increase in sales of free range eggs because of animal welfare concerns and shifts in consumer preferences to value added eggs such as organic eggs. At the same time, consumer preferences have shifted away from branded eggs towards private label eggs, with private label product now making up over 60 per cent of all retail shell egg sales.

The cost of producing eggs has increased significantly in the last couple of years, most notably because of escalating feed costs.

There is strong competition at the processor level, particularly in respect of the MSCs' private label contracts. Given that private label eggs sold through the MSCs represent approximately half of all shell eggs sold through retail channels, the MSCs have a degree of buyer power in sourcing private label eggs that is reflected in lower wholesale, and retail, prices for private label eggs.

The price of eggs, as measured by the ABS, has increased at a rate faster than the CPI, and food prices in general, over the last two years. This is primarily a reflection of rising production costs. However, for the many consumers who have switched from branded to private label eggs, the increase in the price paid for eggs over this period will be lower than the overall increase in prices in the egg category.

## 12.6 Nappies

### Key points

- In 2002, the average shelf price in the MSCs for a Jumbo pack of leading brand Huggies was in the range of \$37 to \$38, while in 2007 the average price was in the range of \$33 to \$35.<sup>110</sup>
- Supermarket share of nappy sales has increased significantly over the last 20 years.
- Brand loyalty means that private label nappies only account for around 10 per cent of nappy sales through the MSCs.
- Consumers are generally more price sensitive in respect of nappies than many other grocery purchases. Reflecting this, there is strong competition among supermarkets and other retailers selling nappies.
- Huggies are often sold by supermarkets at heavily discounted prices, sometimes below cost, in order to attract customers into stores.

Disposable nappies for children are an important and costly single element of the grocery basket for many families with young children in Australia. Disposable nappies are generally produced in six sizes that cater for children as they grow—newborn, infant, crawler, toddler, walker and junior.

### 12.6.1 The supply chain

The supply chain for nappies is simpler than for most products. Producers in the nappy industry sell their product direct to the wholesaler or the MSC and the product is delivered to the warehouse before being distributed to retail stores.

#### Nappy manufacturers and brands<sup>111</sup>

Kimberly-Clark is the largest producer of nappies in Australia with manufacturing facilities located throughout south-eastern Australia. Kimberly-Clark produced 78 per cent (by retail value) of all nappies sold in Australian supermarkets in 2007 (excluding sales through ALDI stores). This figure is up from 72 per cent in 2001.

Kimberly-Clark produces the Huggies brand, which accounted for 67 per cent of nappy sales in supermarkets in 2007, up from 52 per cent in 2001, and the Snugglers brand, which accounted for 10 per cent of supermarket sales in 2007, down from 13 per cent in 2001.

DSG Pty Ltd, trading as Australian Pacific Paper Products (APPP), is the second largest nappy producer in Australia; it manufactures proprietary and private label disposable nappies for Australian and overseas markets from a facility in Melbourne. APPP had approximately 15 per cent of nappy sales

110 Kimberly-Clark response to s. 95ZK notice, cited with consent from Kimberly-Clark.

111 The figures for this section have been obtained from *Retail World's Australasian Grocery guide*, Barry Flanagan (Ed.), and relate only to supermarket sales. Figures exclude ALDI.

through supermarkets in 2007, with its Babylove brand constituting around 11 per cent of sales, which is approximately the same share of sales it had in 2001.

Private label products constituted around 10 per cent of supermarket nappy sales in 2007, up from 8 per cent in 2001. If sales through ALDI stores are included, the ACCC considers that the percentage of private label nappy sales through supermarkets would be higher, given ALDI's focus on private label products.

Woolworths offers two tiers of private label nappies: the lower priced Homebrand and the (comparatively) higher priced Select brands. Coles, by comparison, offers a single private label range of nappies under its You'll Love Coles label.

Category share of other brands has fallen over the six years to 2007 to be less than 2 per cent of sales through supermarkets in 2007, primarily because of the growth in sales of Huggies and, to a lesser extent, private label products.

### Input costs and trends in input costs<sup>112</sup>

Most disposable nappies are produced using a combination of materials, including paper pulp, non-woven materials, tapes, flaps, elastics and fastening materials. Inputs may be sourced locally or from overseas. Cardboard and plastic is also used in the packaging of nappy products. However, some nappies are produced using different combinations of inputs. For example, the outer layer of Nature Babycare nappies is manufactured using maize instead of plastic.<sup>113</sup>

Information provided to the ACCC by nappy producers indicates the contribution of the various inputs and other costs to the total cost of production varies according to the type of nappy and from producer to producer. The ACCC has aggregated data from a number of producers to give an approximate range of the proportion of the production cost of nappies attributable to each factor of production.

Information provided to the ACCC indicates that raw materials, including pulp fibre, absorbents, base materials, and other materials such as fastening devices and elastics account for approximately 60 per cent of the production costs associated with nappy production in Australia.

In the past 12 months, the cost of importing pulp and/or fibre has increased by around 10 per cent as a result of, among other things, increased demand from China and India. However, the cost of some other imported inputs has fallen over the same period because of the appreciation of the Australian dollar.

Labour is another significant cost associated with the production of nappies, accounting for approximately 10 to 15 per cent of production costs. Nappy producers indicated that staff wages have increased by approximately 5 to 10 per cent over the last two years.

Maintenance on machinery varies from manufacturer to manufacturer depending on factors such as the age of the machinery. The figures provided to the ACCC indicate that maintenance costs account for approximately 5 per cent of the retail price of a nappy. Producers of nappies also experience depreciation of approximately 5 per cent on the assets required for production.

Packaging, including cardboard and plastic, accounts for approximately 5 per cent of the cost of producing nappies. Nappy producers advised that packaging and cardboard costs have been steady in recent years.

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<sup>112</sup> Information in this section has been sourced from confidential information provided by nappy producers and is cited with their consent.

<sup>113</sup> Nature Babycare, [www.naty.com](http://www.naty.com), viewed 22 July 2008.

Freight also accounts for up to 10 per cent of the production cost of nappies. Freight costs have been increasing recently due to rising fuel costs.

Other factors such as insurance, consultancy, office and travel expenses make up the remaining portion of the production costs.

## 12.6.2 Negotiations with retailers

Nappies may be supplied to supermarkets under supply agreements for branded products or under contract for private label products. Branded products are generally supplied on trading terms, which involves the producer setting a list price that is a starting point from which rebates and other fees are deducted by the retailer for promotional and advertising costs, settlement allowances, business volume rebates and other activities associated with the sale of the product.

Private label nappies are supplied under contract, often for fixed terms. These contracts specify the quality specifications of the required product, price and other trading terms.

The share of nappy sales through supermarkets has increased significantly in recent years. For example, Kimberly-Clark stated that in 1984 significantly more than 50 per cent of its nappies were sold through channels other than the MSCs. This included sales through stores such as pharmacies, Toys 'R' Us, Kmart, Big W, hospitals and small stores. By 2007 around 70 per cent of Kimberly-Clark nappies were sold through the MSCs.<sup>114</sup>

This shift in where consumers purchase nappies has been driven in large part by the MSCs' use of nappies as a loss-leading product to attract customers. In particular, supermarkets will often sell Huggies on promotion at prices close to or sometimes below cost in order to attract customers.

Given the large share of nappy sales made through supermarkets, producers are heavily reliant on their relationship with the MSCs. Smaller manufacturers are therefore likely to be in a comparatively weaker bargaining position now than they were when they relied less on sales through the MSCs. However, the relatively low level of private label nappy sales, compared with many other grocery items, suggests that consumers do expect to see a range of nappy products for sale, including the premium brands. As a key item that attracts consumers to stores, producers of products with strong brand recognition will have some countervailing bargaining power in negotiations with the MSCs.

Kimberly-Clark in particular, with its strong Huggies brand, is likely to have significant countervailing power in its negotiation with the MSCs. While the MSCs are a vital retail distribution channel for Kimberly-Clark nappies, Kimberly-Clark's Huggies brand is also very important to the MSC's because it has strong recognition and brand loyalty among supermarket customers. The MSCs use of Huggies price promotions to attract customers further underpins the importance of the Huggies brand to them.

## 12.6.3 Retail prices and margins

The retail price of nappies varies depending on a range of factors, including the number of nappies in the packet, the size of the nappy, the brand, whether the product is being sold on discount and the retailer from which the nappy is purchased.

The different size nappies and size of packets makes direct comparison of prices difficult. However, the comparisons undertaken do suggest that private labels are sold at a lower price than branded nappies. A packet of Woolworths Select Toddler 24's and the You'll Love Coles Toddler 24's costs approximately

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<sup>114</sup> Kimberly-Clark response to s. 95ZK notice, cited with consent from Kimberly-Clark.

\$13 to \$14. The premium Huggies Toddler 24's packet costs in the range of \$16 to \$17.

There are also differences in the price of branded products. Comparing branded products, Huggies' Junior 30's costs in the range of \$22 to \$23, Babylove Junior 30's costs in the range of \$20 to \$21, and Nature Junior costs in the range of \$22 to \$24.

Prices will vary outside these ranges due to promotions.

Nappies are only purchased by one segment of grocery shoppers: parents with small children. However, for these customers, nappies are one of the highest cost products in their grocery shopping basket. As such, consumers are generally more price sensitive in respect of nappy purchases than most other grocery items.

In recognition of this, supermarkets often engage in heavy price promotions on nappy products to attract customers. In particular, supermarkets will often run promotional specials on the leading Huggies range, pricing the product at close to or below the cost of supply. One retailer provided evidence to the inquiry that a reduction in the price of Huggies nappies from \$38 to \$28 for a one-week promotional period in 2008 resulted in a 40-fold increase in sales.

This use of nappies as a key value item to attract customers into supermarkets means that price competition at the retail level on nappy products is particularly strong and any retailer seeking to increase prices on nappy products would be likely to quickly lose business to their competitors.

## Margins

With the exception of Huggies, gross margins, measured as the difference between the retail and wholesale price of the product, for nappy products sold through the MSCs on which the ACCC obtained information were generally in the range of 25 per cent to 30 per cent.

As would be expected, given the heavy promotional discounting of Huggies nappies that regularly occurs, gross margins on Huggies nappies were much lower than this. Gross margins fluctuated significantly across time and between states but were generally less than 10 per cent and occasionally negative.

### 12.6.4 Conclusion

- Kimberly-Clark is the largest supplier of nappies in Australia, accounting for approximately 70 per cent of the nappies sold in Australian supermarkets, including the leading Huggies brand.
- Reflecting strong consumer loyalty to the Huggies brand, Huggies is often sold by supermarkets at heavily discounted prices, sometimes below cost, in order to attract customers to the store.
- Brand loyalty among consumers also means that private label nappies only account for around 10 per cent of nappy sales through the MSCs.
- More generally, nappies are one of the highest cost products in the grocery shopping basket of many consumers. As such, consumers are generally more price sensitive in respect of nappy purchases than most other grocery items. Reflecting this, there is strong competition among supermarkets and other retailers selling nappies.

## 12.7 Biscuits

### Key points

- After increasing at a rate well below CPI and the general food category from 2002 to 2005, biscuit and cake prices have increased by around 17 per cent over the last three years. This is slightly higher than the rate of increase in general food prices and significantly above the CPI.
- Recent price increases appear to reflect increases in the cost of manufacturing biscuits.
- Strong brand recognition means that private label products are not nearly as prevalent in the biscuit category as in many other grocery item categories.
- Compared to other grocery items, a high proportion of biscuits are sold in supermarkets, which would ordinarily place the MSCs in a strong position when negotiating with suppliers. However, the buyer power of supermarkets is mitigated to some extent by the strong brand recognition that some biscuit brands enjoy.
- Arnott's in particular is likely to have countervailing power in negotiations with the MSCs as a consequence of its dominant share of biscuit sales and strong brand names such as Tim Tam.
- Overall, it does not appear that biscuit manufacturers are significantly constrained in their ability to pass on increases in costs of production by the buyer power of the MSCs.
- Where biscuit manufacturers do not pass on their increased production costs in full, it appears that this is partly due to strong competition between manufacturers and a desire to see their brands remain price-competitive on supermarket shelves.

Biscuits come in different varieties, including chocolate, sweet and savoury. Dry packet biscuits have a long shelf life and are distributed in much the same way as other dry groceries. The supply chain for biscuits has only two main stages: biscuit production and retailing.

### 12.7.1 Wholesale supply of biscuits

Arnott's is the largest supplier in the \$1.1 billion Australian biscuit industry.<sup>115</sup> Its products span the whole range of biscuit varieties. Arnott's produces biscuit brands including Tim Tam, Chocolate Royal, Mint Slice, Iced Vo Vo, Tiny Teddy, Scotch Finger, Monte Carlo, Nice, Granita, Salada, Sao and Vita Wheat.

The next largest biscuit producers in Australia are Paradise Foods and Kraft, although both are much smaller biscuit producers than Arnott's. Paradise Foods produces the Cottage, Vive and Veri Deli brands, as well as biscuits under contract for Woolworths, Coles, ALDI, Kellogg's and Nestle. Paradise Foods has recently been bought by one of Australia's largest food companies, Goodman Fielder. Kraft produces the Oreo and Nabisco brands.

The relatively long shelf life of biscuits means suppliers can take advantage of economies of scale by producing biscuits for sale throughout Australia at centralised locations. The importance of scale in the production of the biscuits was demonstrated by Kraft's decision in early 2006 to cease producing locally and instead consolidate production at a large plant in China.

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<sup>115</sup> Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2008*, Retail Media, Sydney, 2008, p. 63.

## Trends in key input costs

Confidential information provided to the ACCC indicated that ingredients account for approximately 15 to 25 per cent of the retail price of biscuits. Flour, cocoa (for chocolate biscuits), dairy, sugar and oil are all important for biscuit production.

The ACCC understands that the costs associated with many of these inputs have been rising significantly. As described in the bread case study earlier in this chapter, flour prices have been rising because the price of wheat has increased from \$192 a tonne in 2005–06 to a forecast \$440 a tonne in 2007–08.<sup>116</sup> The effect of wheat price rises on the price of flour is explored in the bread case study. A number of suppliers of flour-based products confidentially advised the ACCC of frequent and significant increases in the price of flour, amounting to an increase of more than 50 per cent over the last two years.<sup>117</sup>

Confidential information from a supplier showed substantial price rises in dairy, sugar and flour, while Paradise Foods told the inquiry hearings of increases in the prices of butter, shortening and palm oil.<sup>118</sup> Producers identified labour, overheads, packaging, distribution and warehousing as other major costs in manufacturing.

## Supply arrangements with supermarkets

Biscuits are sold to supermarkets in a similar manner to other grocery products. For proprietary brand biscuits, each supplier has a price list specifying the starting wholesale price that applies to all customers. The list price is generally a single price, although Arnott's has recently announced that its list prices will be subject to a service charge or discount dependent on the volume of product purchased in any single order.<sup>119</sup>

While the list price applies to all customers, it is generally only a starting point for negotiations. More detailed trading term arrangements are negotiated between the manufacturer and each customer. These trading terms include rebates and discounts provided to the retailer in return for matters such as display support, participation in promotional programs, volume purchased, early payment and distribution to stores. The most favourable trading terms are typically given to larger customers, particularly the MSCs.

The net price paid by the retailer will also reflect further funding by the supplier to support promotional activity. This could involve the sale of the product to consumers at discount prices, product placement in gondolas at the end of aisles or advertising in supermarket catalogues.

Supply arrangements for private label products differ to those for proprietary branded products. Generally, the retailer will specify the required product and estimated sales volumes, and manufacturers will tender for supply of the product. In the case of some premium private label products, supply arrangements will be set through bilateral negotiations between the retailer and a supplier that the retailer considers will be able to deliver the premium product required, rather than through an open tender process.

Contracts for private label supply typically last one to two years, with an option to extend if parties are satisfied.

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116 ABARE, *Australian commodities*, March 2008, p. 33.

117 For an example of public comments, see comments by Bakers Delight, ACCC public hearing transcript, Melbourne, 30 May 2008, p. 27.

118 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 6.

119 Arnott's Biscuits, submission no. 53, p. 2.

## Relationship with retailers

As with other grocery items, the final price and other terms on which biscuits are supplied (after allowing for rebates and discounts) are affected by the relative bargaining power of the supplier and retailer. As discussed in chapter 14, key determinants of the relative bargaining power of the parties are the degree to which each party depends on the other.

For the wholesale supply of biscuits, the balance of bargaining power varies considerably depending on the manufacturer and retailer concerned.

As discussed elsewhere in this report, MSCs wield large buying power because they account for such a high proportion of retail sales of groceries in Australia. In this respect, the proportion of biscuits sold through supermarkets is significantly higher than for many other common grocery items because biscuits are not generally sold in specialty outlets in the manner of other grocery items such as bread, meat, seafood, fruit and vegetables. However, some limited sales of biscuits do occur through convenience stores and other retail outlets.

However, a number of factors assist biscuit manufacturers in their negotiations with retailers. Arnott's is a very important supplier from the retailers' point of view, accounting for 57 per cent of supermarket sales of biscuits.<sup>120</sup> Enhancing Arnott's position is the strength its brands names have built up over time. Most notably, the Tim Tam product was identified in a 2006 study as Australia's third most popular brand across all products<sup>121</sup>, which means that Arnott's is likely to have significant countervailing power in negotiations with the MSCs.

The next two largest biscuit manufacturers in Australia, Paradise Foods and Kraft/Nabisco, each supply around 6 per cent of biscuits sold in Australia.<sup>122</sup> Given the volume of the MSCs biscuits sales generated by their products, these manufacturers are likely to have considerably less bargaining power in negotiations with MSCs. However, because both companies sell some products with strong brand recognition that are likely to be valued by consumers, they would have a degree of countervailing bargaining power in negotiations.

The strength of biscuit brand names may also explain why private label products are less prevalent in the biscuit category than for some other standard grocery items.

A strong private label presence in a grocery category can affect the relative bargaining power of suppliers and retailers by making the retailer less reliant on branded products. However, private label products account for just over 10 per cent of supermarket sales of biscuits, compared with half or more of sales of sugar, eggs, milk, butter and bread.<sup>123</sup> The ACCC survey of grocery consumers found that 42 per cent of respondents always chose snack foods on the basis of brand.<sup>124</sup> In terms of how important brand name is when choosing a product, snack foods rated second only to soft drinks.

Although private label sales do not currently account for a high proportion of biscuit sales, there has been a major drive to introduce and expand the Woolworths Select range of biscuits. Biscuit manufacturers confidentially said that this has affected sales of their lesser known brand names but that sales of biscuits with strong brand recognition have been largely unaffected.

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120 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2008*, Retail Media, Sydney, 2008, p. 63.

121 George Patterson Y&R, 'Brand asset valuator', 2006.

122 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2008*, Retail Media, Sydney, 2008, p. 63.

123 Coles, submission no. 157, attachment A, April 2008.

124 ACCC, survey of grocery consumers, April 2008.

## Trends in wholesale prices

The ACCC collected confidential data on the wholesale prices of a number of specific biscuit products. The biscuit category has many varieties and many products experienced fluctuations in wholesale prices over time (e.g. because of promotional activity).

Because of these fluctuations, it was hard to determine clear trends in wholesale prices, particularly in respect of proprietary branded biscuits. While there were some changes in wholesale prices over the last few years for the selected products, these changes were not substantial and were not consistent between biscuit products and retailers.

Wholesale prices for private label products were more stable and did not exhibit any discernable upward or downward trend over the last few years.

Arnott's submitted that its direct production costs have increased at a rate faster than its wholesale prices over the last three financial years.<sup>125</sup> One biscuit manufacturer also advised the ACCC confidentially that it had not passed on all its cost increases in its most recent price review.

The pressure on biscuit manufacturers not to pass on increased production costs is likely to be partly caused by strong competition between manufacturers and a desire to see their brands remain price-competitive on supermarket shelves. The MSCs do not appear to constrain biscuit producers from passing on cost increases, possibly because the use of list prices means supermarkets can be satisfied that a change in the wholesale price will apply to all retailers. This is different for private label products, where supermarkets place considerable pressure on their suppliers to justify any price increase.

## 12.7.2 Retail supply of biscuits

### Trends in retail prices

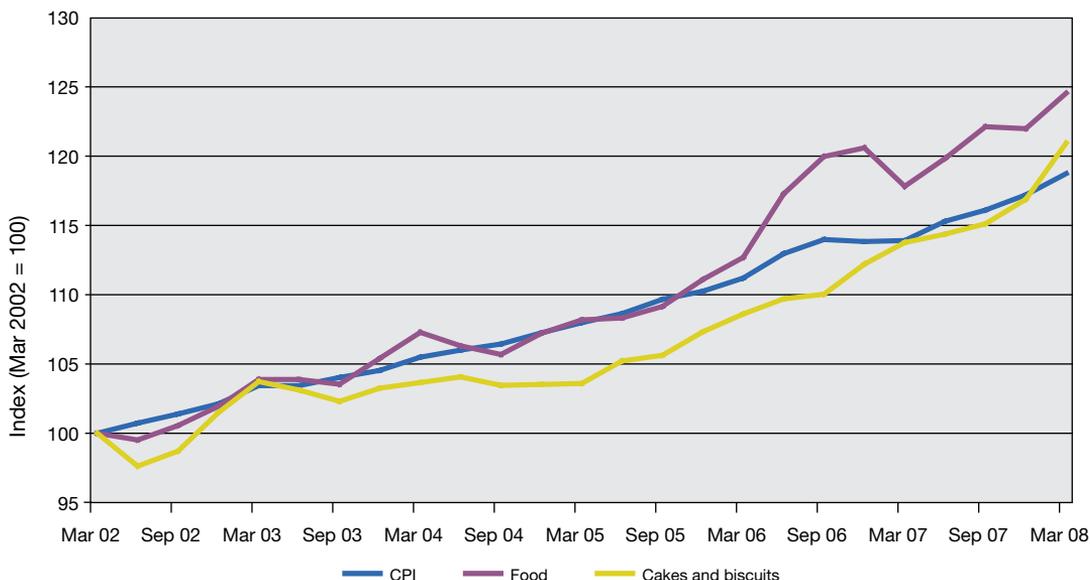
The ABS reports on a subcategory of cakes and biscuits as part of its work on consumer prices. Chart 12.14 shows that nominal prices for cakes and biscuits, as measured by the ABS, increased at a moderate rate of 4 per cent over the three years to March 2005.<sup>126</sup> This was less than half the rate of increase in the food price index and the CPI.

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<sup>125</sup> Arnott's Biscuits, submission no. 53, p. 3.

<sup>126</sup> ABS, *Consumer price index*, catalogue no. 6401.0, March 2008.

**Chart 12.14 ABS CPI comparisons— all product groups, food products, and cakes and biscuits**



Source: ABS, Consumer price index, catalogue. no. 6401.0, March 2008

Since March 2005 prices for cakes and biscuits have risen by 17 per cent. While this was not much more than the rise in food prices generally (15 per cent), it was much higher than the rate of increase in CPI (10 per cent).

The movement in the prices of cakes and biscuits reported by the ABS is largely consistent with evidence given by suppliers in relation to changes in their input costs. The strong increase in the prices of cakes and biscuits from March 2005 is also seen in the prices of bread, another flour-based product.

As discussed earlier, the overwhelming majority of retail biscuit sales are by supermarkets. This means there is less retail competition in biscuits than for other products, where specialty stores such as bakeries and fruit and vegetable stores promote greater price competition between retailers.

### 12.7.3 Conclusion

Retail prices for biscuits and cakes increased by a moderate amount in the three years to March 2005, but since then they have increased at a rate slightly more than food prices generally and much higher than the CPI.

Biscuit producers receive approximately 70 to 80 per cent of the retail price of biscuits. Suppliers have advised the ACCC that the cost of many inputs to production have been increasing significantly, in particular ingredients such as flour, butter, shortening and palm oil.

The balance of bargaining power in the relationship between biscuit supplier and retailer can vary greatly depending on the manufacturer and retailer concerned. Supermarkets account for a higher share of biscuit sales than for other grocery items, which places the MSCs in a strong position when negotiating with suppliers. However, a biscuit manufacturer with strong brand names could have a degree of countervailing bargaining power. In particular, Arnott's dominant share of biscuit sales and

strong brand names such as Tim Tam are likely to provide it with significant countervailing power in negotiations with the MSCs.

Overall, the ACCC believes that biscuit manufacturers are generally not significantly constrained by the MSCs in their ability to pass on increases in production costs. However, strong competition between biscuit manufacturers and a desire to see their brands remain competitively priced on supermarket shelves appears to constrain price rises to some extent.

## 12.8 Beef

### Key points

- The supply chain for beef is long and complex with the farm gate price of livestock only one of numerous inputs into the eventual cost of a cut of beef. As such, direct comparisons between farm gate and retail prices are difficult and not necessarily instructive.
- Prices at the farm gate and wholesale levels are strongly influenced by international prices. The primary determinants of farm gate prices appear to be international prices and domestic supply and demand.
- The largest domestic purchasers of beef, Coles and Woolworths, each purchase around 6 per cent of domestic production.
- Retail beef prices have risen at roughly the same rate as CPI over the last six years.
- Movements in retail prices are correlated with wholesale prices.
- Gross margins for meat are one of the lowest across the MSC's product categories.
- Given the complexity of the supply chain it is not possible to rule out that there may be some competition problems in specific geographic regions or in specific sale yards. However, given low margins at the retail level and export alternatives the ACCC is satisfied that the supply chain is for the most part competitive and that any competition problems are not occurring at the retail level.

The supply chain for red meat from farm gate to consumers is long and complex. There are a variety of different supply arrangements making it difficult to directly compare farm gate and retail prices. Comparison is further complicated by the variety of cuts that can be produced from a single carcass, with each cut as a proportion of the carcass in terms of volume and value varying depending on the cut set extrapolated.

Accordingly, it is not possible to follow a particular cut of meat from the farm gate through to the supermarket shelf with any precision. As such, the ACCC has taken a whole-of-carcass approach in attempting to track costs and margins through the beef supply chain.

### 12.8.1 ACCC red meat report

The ACCC red meat report to the Minister for Agriculture, Fisheries and Forestry, *Examination of the prices paid to farmers for livestock and the prices paid by consumers for red meat*, was publicly released in February 2007.<sup>127</sup>

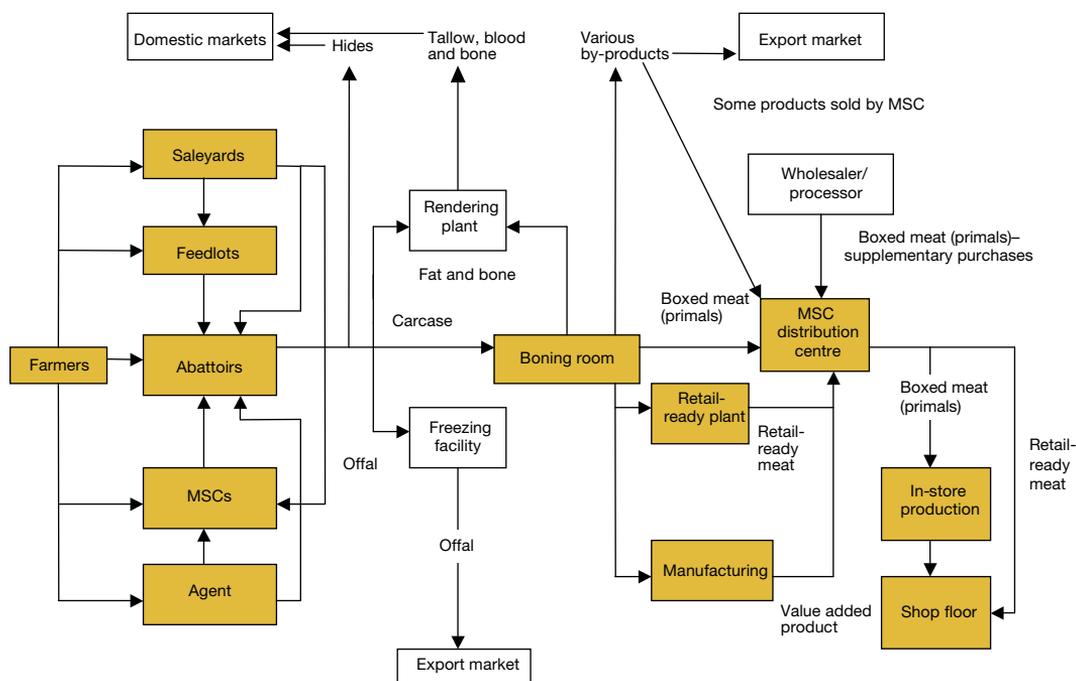
<sup>127</sup> ACCC, *Examination of the prices paid to farmers for livestock and the prices paid by Australian consumers for red meat*, February 2007. Copies of this report are available from [www.accc.gov.au](http://www.accc.gov.au).

This report did not consider costs and prices at all levels of the supply chain. Rather, the focus of the report was prices paid to farmers for livestock—specifically cattle and sheep—and retailer prices of beef/veal and mutton/lamb.

This case study considers all stages in the supply chain for beef from the farm gate to the checkout. However, much of the analysis in the red meat report is relevant to consideration of the supply chain for beef and has been drawn on in this case study.

## 12.8.2 Background

**Chart 12.15 Beef supply chain**



Highlighted areas indicate the main steps in the supply of saleable beef products from the farm gate level through to the supermarket shelf.

There are a number of stages in the supply chain of beef from farm gate to consumer.

The main levels of the beef supply chains are:

- cattle farming
- feedlots where livestock are fed a particular mix of feed for a period to reach quality specifications
- processors and/or wholesalers who slaughter and prepare the beef for retail sale
- retailer sale.

## Markets for cattle

There are three basic markets for cattle: store, domestic and export.<sup>128</sup> Store cattle are not suitable for immediate slaughter. Rather they are purchased for 'backgrounders'<sup>129</sup>, by feedlots for finishing to specification and for live export. Store cattle are also not generally suitable for the domestic market.

Cattle sold in the domestic market are generally younger and lighter than those specified for export, although there can be some overlap depending upon the country the meat is likely to be exported to.

Purchasers of cattle at the farm gate level are primarily lot feeders, processors and the MSCs.

At the wholesale level (post processing) there are four main categories of domestic purchasers: the food service industry, supermarkets, food manufacturers, and institutions, such as hospitals.

The MSCs purchase beef at both the farm gate and wholesale and/or processor level.

Around 65 per cent of Australian produced beef is exported.<sup>130</sup> Meat and Livestock Australia (MLA) estimated that of the 35 per cent of beef sold domestically in 2007, approximately 5 per cent was directed to the processing sector, 27 per cent to the food service industry and 68 per cent went to the retail sector.<sup>131</sup> Of the 68 per cent of beef sold at the retail level the MLA estimated that the MSCs accounted for approximately 52 per cent and butchers, 30 per cent; with the remaining 18 per cent being accounted for by other supermarkets, delicatessens and other parties.<sup>132</sup> This places the share of total Australian beef production sold through the MSCs at approximately 12 per cent.

While the MSCs purchase a relatively small proportion of Australia's total beef production, it was submitted that they are the biggest domestic purchasers of beef.

## The MSCs supply arrangements

This case study examines each step in the supply chain for beef from farmer through to retailer.

Both Coles and Woolworths have vertically integrated supply and service agreements throughout the supply chain with farmers, feedlots and processors.<sup>133</sup> Before considering in detail each stage of the supply chain for beef, Coles and Woolworths vertically integrated supply arrangements are briefly summarised here.

In submissions to the ACCC inquiry into red meat prices, the MSCs stated that their service and supply arrangements involve setting prices based on prevailing costs of production, including the cost of grain feed and a profit margin. These prices are negotiated in advance and set for various periods, providing supermarkets and producers with a degree of price certainty.<sup>134</sup>

Woolworths purchases finished cattle from both feedlots and farms (supplementary cattle).<sup>135</sup>

Woolworths submitted that it does not purchase cattle from saleyards.<sup>136</sup>

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128 R Cheffins, *Nutritional and managerial opportunities for meeting beef markets*, Queensland Department of Primary Industries, 1996, p. 5.

129 A backgrounder is a cattle producer who produces young cattle ready for lot feeding.

130 ABARE, *Australian beef industry: financial performance to 2005–06*, Canberra, 2006, p. 1

131 Meat and Livestock Australia, information provided to the ACCC, 16 July 2008, based on data provided by BISHrapnel/Roy Morgan.

132 Meat and Livestock Australia, information provided to the ACCC, 16 July 2008 based on data provided by BISHrapnel/Roy Morgan.

133 ACCC, *Examination of the prices paid to farmers for livestock and the prices paid by Australian consumers for red meat*, February 2007, p. 9.

134 ACCC, *ibid.*, pp. 9, 20.

135 Woolworths, response to ACCC informal information request, cited with the consent of Woolworths.

136 Woolworths, *ibid.*

In line with industry practice, suppliers pay transportation costs to abattoirs and Woolworths pay transportation costs from that point.<sup>137</sup>

Woolworths also produces some of its own value-added products such as rissoles and sausages.<sup>138</sup>

Coles submitted that to overcome supply constraints in the early 1990s caused primarily by the attractiveness of returns in overseas markets to meat processors, Coles established a group of dedicated livestock producers to provide a reliable supply of quality meat. Colestock livestock producers grow and deliver cattle and lambs to Coles' specifications.<sup>139</sup> Coles submitted it negotiates prices in advance with Colestock suppliers taking into consideration key drivers such as feed prices, store cattle costs (the costs producers pay prior to entering feedlots) and other market forces. Coles submitted the desired outcome of these negotiations is to achieve a fair price for both parties that is relative and competitive with the market.<sup>140</sup>

Coles further submitted that livestock costs associated with its 'Alliance' processors are based on daily commodity prices, dictated by market conditions. The daily prices may be aggregated over a period of time for consideration during negotiations.<sup>141</sup>

Coles sources its beef through both the integrated supply chain and the open market in the form of boxed beef.<sup>142</sup>

### 12.8.3 Cattle farming

There are approximately 75 000 properties in Australia on which beef cattle are bred, many of which are small scale family owned farms.<sup>143</sup>

These farms produce around 4 per cent of the world's beef supply and Australia is the second largest beef exporter in the world, behind Brazil. Australia produces over 2 million tonnes of beef and veal annually.<sup>144</sup>

The Western Australian Red Meat Industry submitted that the Australian livestock market is not a single homogenous market.<sup>145</sup> As a very broad generalisation, beef production systems can be split in to northern Australian and southern Australian systems. Production of beef in northern Australia is characterised by large property and herd sizes. Moreover cattle produced in northern Australia tend to be from *Bos Indicus* breeds<sup>146</sup> better suited to the warmer conditions in the north. Such cattle are also better suited to export market specifications (including the live export market) because they are heavier than cattle produced in southern Australia.

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137 Woolworths, *ibid.*; Woolworths response to s. 95ZK notice cited with the consent of Woolworths.

138 Woolworths, *ibid.*, cited with the consent of Woolworths.

139 Coles, response to ACCC informal information request, cited with the consent of Coles.

140 Coles, response to ACCC informal information request, cited with the consent of Coles.

141 Coles, response to ACCC informal information request, cited with the consent of Coles.

142 Coles, response to ACCC informal information request, cited with the consent of Coles.

143 ABARE, *Australian beef industry: financial performance to 2005-06*, Canberra, October 2006, p. 4.

144 ABARE, *ibid.*, p. 1.

145 Western Australian Red Meat Industry, submission no. 82, p. 4.

146 *Bos indicus* are breeds of cattle referred to as tropical or humped breeds such as Brahman, Sahiwal and other Zebu breeds. Source: [www.mla.com.au/HeaderAndFooter/Glossary.htm](http://www.mla.com.au/HeaderAndFooter/Glossary.htm).

Beef production in southern Australia can be characterised by smaller property and herd sizes to those in the north of the country. Cattle is usually of a *Bos taurus*<sup>147</sup> breed, which is better suited to cooler southern conditions and also produces lighter weight cattle more suited to domestic market specifications. That said, industry sources submitted there is some overlap of specifications and different breeds of beef are substitutable for both the domestic and export markets.<sup>148</sup>

### Key inputs into cattle farming

In addition to the farming property and (grass-fed) cattle, the key inputs at the farm level are fertilisers and chemical costs, labour, fuel prices and interest rates. Combined (excluding cattle) these factors comprise over 56 per cent of total cash farm costs.<sup>149</sup> Submissions from a range of parties<sup>150</sup> indicate that fertiliser and chemical costs have more than doubled over the past 12 months, which has significantly increased the cost of producing cattle. The ACCC heard that producers are not adequately covering their costs of production and are therefore exiting the industry.<sup>151</sup> Parties also submitted that producers have been known to forgo making a profit to maintain their preferred supplier status but acknowledged that this could not be sustained long term.<sup>152</sup> Costs associated with grain-fed beef are considered below in the discussion of feedlots.

### Sale methods

There are a number of channels through which producers can sell cattle including paddock sales, over the hooks (OTH), auction sales and over the scales. Auction sales (generally at saleyards) and OTH are the most common methods for selling cattle,<sup>153</sup> with auction sales at 44 per cent and OTH sales at 40 per cent in 2003–04. The shift over the past decade from auction systems to more direct selling methods, such as OTH, is to some extent driven by changes in the distribution of beef cattle, herd sizes and markets targeted.<sup>154</sup>

Victoria, South Australia and New South Wales, being states with a higher proportion of relatively small herds, have the highest proportion of auction sales. Other factors accounting for the comparatively higher level of auction sales in these states are likely to be the closer proximity to saleyards and the fact that abattoirs in southern states predominantly service domestic markets.<sup>155</sup>

Stock sold at auction is either on a dollars per head basis, or if weighed, on a cents per kilogram live-weight basis. Auction sales involve additional costs and stock handling which may mask the quality–price relationship.<sup>156</sup> Paddock sales are more likely to be used by producers with large herd sizes or for producer-to-producer sales of store or breeding stock.

As suggested by the name, cattle sold OTH are weighed and a price is calculated following slaughter and trimming. Processors and MSCs primarily purchase stock OTH with the payment method to

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147 *Bos taurus* are temperate, British or European breeds of cattle such as Angus, Poll Hereford, Charolais and Limousin. Source: [www.mla.com.au/HeaderAndFooter/Glossary.htm](http://www.mla.com.au/HeaderAndFooter/Glossary.htm).

148 Cattle specification information sourced from the Queensland Department of Primary Industries and Fisheries.

149 NFF, submission no. 137, p. 11; ABARE, *Australian Commodities—December quarter, 07.04*, December 2007, [www.abareconomics.com/interactive/ac\\_dec07/pdf/ac\\_dec07.pdf](http://www.abareconomics.com/interactive/ac_dec07/pdf/ac_dec07.pdf).

150 NFF, submission no. 137, pp. 10–11; NSW Farmers Association, submission no. 155; WA Farmers Federation, submission no. 106; AgForce Grain, submission no. 111, to cite a few.

151 ACCC, public hearing transcript, Perth, 22 April 2008, p. 74; ACCC, public hearing transcript, Bunbury, 23 April 2008, pp. 47, 53, 55.

152 ACCC public hearing transcript, Bunbury, 23 April 2008, pp. 9, 51–52.

153 ABARE, *Australian beef industry—production and sale of beef cattle*, December 2004, p. 7.

154 ABARE, *ibid.*

155 ABARE, *ibid.*, p. 8.

156 ABARE, *ibid.*, p. 7.

producers based on a hot standard carcass weight (HSCW)<sup>157</sup> using a pricing grid that sets out various price points depending on the weight, grade and quality of the meat and the value of the hide.

Processors and/or the MSCs retain the co-products from these animals while producers are paid for the gutted and trimmed carcass and generally receive a rebate or credit for their hides.

Co-products account for approximately 11 per cent of the value of a slaughtered animal.<sup>158</sup> MLA estimated the value of co-products is \$1.7 billion per annum.<sup>159</sup> Processors and retailers sell co-products to both domestic and export markets, both retail and non-retail. DAFF noted in its report, *Price determination in the Australian Food Industry*, a research report prepared by Whitehall and Associates<sup>160</sup>, that on the basis of its model the extracted value of co-products makes up more than 20 per cent of gross returns.

Where stock is purchased by an MSC, the MSC will usually have a service agreement with a processor. Depending on the arrangements the MSC has with processors with regard to excess meat and co-products, this may offset some or all of the MSC's processing costs.

### Key determinants of farm gate prices

The NSW Farmers Association submitted that farm gate prices are determined by supply and demand and farmers are price takers.<sup>161</sup> Previous reports have also noted that supply and demand are the predominant determinants of farm gate prices. DAFF's report, noted that farm gate cattle prices are influenced by:

- the strength of international demand
- the demand for store and breeding cattle
- the level of available supply
- prevailing export prices.<sup>162</sup>

In particular, with 65 per cent of all production being exported, world prices significantly influence farm gate returns to Australian cattle farmers.

Concerns were raised during the course of the inquiry that the buyer power of the MSCs was acting to suppress farm gate prices.<sup>163</sup> In particular, the Red Meat Action Group suggested that while international prices are important the buyer power of the MSCs was an equally important influence on farm gate prices. Other sources accepted that the MSCs were an influence on the market but suggested that the MSCs' influence is limited to the particular types of cattle they purchase.<sup>164</sup>

Specifically, it was argued confidentially that as the MSCs are known for buying quality stock, other purchasers in the market set their farm gate price below or around the price set by MSCs, allowing the MSCs to effectively create a price ceiling. The mechanism by which this price setting was done was never clearly articulated.

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157 HSCW is where the carcass is weighed following slaughter and trimming but before it is cooled or chilled.

158 See [www.mla.com.au/TopicHierarchy/Informationcentre/CoProducts/Default.htm](http://www.mla.com.au/TopicHierarchy/Informationcentre/CoProducts/Default.htm), sourced 9 July 2008.

159 See [www.mla.com.au/TopicHierarchy/Informationcentre/CoProducts/Default.htm](http://www.mla.com.au/TopicHierarchy/Informationcentre/CoProducts/Default.htm), sourced 9 July 2008.

160 S Spencer, *Price determination in the Australian food industry, a report*, Department of Agriculture, Fisheries and Forestry, Canberra, p. 42.

161 NSW Farmers Association, submission no. 155, p. 15.

162 S Spencer, *Price determination in the Australian food industry, a report*, Department of Agriculture, Fisheries and Forestry, Canberra, 2004, p. 39.

163 ACCC, public hearing transcript, Bunbury, 23 April 2008, p. 47.

164 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 24.

In submissions to the ACCC red meat inquiry, Coles and Woolworths both said that they buy a relatively small share of the total beef produced in Australia. A number of other parties also submitted to the red meat inquiry that no one purchaser was able to distort the market because producers that were dissatisfied with prices offered by one purchaser could alter the specifications of their stock to target other purchasers or export markets.

The ACCC considers that given that each of the MSCs only purchase around 6 per cent of Australian beef production it is unlikely that they would be able to exert sufficient pressure in the market to suppress farm gate prices.

While no one buyer purchases a significant amount of the total volume of cattle at the farm gate, it was submitted by various parties that producers must sell their cattle when market specifications are reached and therefore their options in terms of potential buyers are more limited than they may otherwise appear.<sup>165</sup> In particular, the Australian Beef Association (ABA) submitted that producers only have a small window of opportunity (generally several weeks) in which to shop around before their cattle goes 'off specification'.<sup>166</sup>

The ABA submitted that a farmer must determine which market it wants to sell its cattle to almost at the time that the cattle production is commenced.<sup>167</sup> This includes focusing on particular genetics which are likely to be better for certain markets, and targeting the stage at which cattle need to be finished. The ABA submitted that there is little flexibility in who cattle producers can sell to because they must prepare the cattle with a particular buyer in mind (for example, export, domestic, supermarket etc.).<sup>168</sup> The ABA submitted that efficient low cost beef production requires producers to target specific market segments and each market segment has defined carcass parameters.<sup>169</sup> The ABA further submitted it takes a cow-calf operator a minimum of three to five years to produce a line of cattle for a specific market.<sup>170</sup>

Similarly, the Western Australian Red Meat Industry also submitted producers are unable to alter their specifications to target alternative markets.<sup>171</sup>

Others submitted, both previously for the ACCC red meat report and in the context of this inquiry, that there is sufficient competition between the domestic and export markets to allow domestic producers to switch supply to export markets if they are unhappy with the price offered in the domestic market.

Coles' submission<sup>172</sup> and other confidential submissions to the inquiry, argued that producers have many options available during the lifecycle of the herd to determine how and when to market their livestock. Further, they claim it is possible for producers to change their decision as to which market to sell to in a relatively short period.

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165 ACCC, public hearing transcript, Canberra, 30 April 2008, pp. 20–21; ABA, submission no. 221; Western Australian Red Meat Industry, submission no. 82, p. 15.

166 ABA, submission no. 221, pp. 4, 6.

167 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 108.

168 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 108.

169 ABA, submission no. 221, p. 2.

170 *ibid.*, pp. 2, 7.

171 Western Australian Red Meat Industry, submission no. 82, p. 15.

172 Coles, submission no. 225, 3 June 2008, p. 32.

While it appears possible for a producer to switch supply from the domestic market to the export market, if unable to achieve a reasonable rate of return, the circumstances in which it would be viable for a producer to do so is less clear. This may depend on a number of factors, including the size of the producer, size of the herd, and location—that is, southern versus northern states.

Further, any potential increase in the price that might be obtained from shopping around may be offset by other costs, such as penalties for missing specifications, transport costs, additional feeding costs and so on. Consequently, it appears to be reasonably common for a beef producer in a falling market to find themselves having incurred costs in raising cattle, which they may not be able to recover, when bringing the herd to market. The producer cannot pursue alternative options without further expenditure, nor are they in a position to directly influence or negotiate returns except within the parameters of the current market price.

The ACCC view is that this outcome is one of the inherent risks in raising cattle for a specific market without any forward price protection. This transactional vulnerability of an individual producer should not, however, be mistaken for a broader market failure, or an ability on the part of another market participant to set prices by reference to factors other than supply and demand.

To avoid this, many producers enter into forward contracts with MSCs to hedge against market fluctuations when cattle are ready for sale.

This practise suggests that MSCs do not take advantage of short-term constraints on a producer's ability to switch supply options in order to suppress farm gate prices. Their conduct appears to be directed at providing additional price certainty to maintain reliability of supply. Prices offered by the MSCs, however, remain within the constraints of market conditions.

### Movements in farm gate prices

The National Farmers Federation (NFF) submitted that farm gate prices have either remained stagnant or only increased by a small percentage while farm costs such as chemicals and fertiliser have doubled in the past 12 months.<sup>173</sup> The NSW Farmers Association also submitted the cost of production has increased by at least 35 per cent over the past decade, while the price paid to farmers has not significantly changed.<sup>174</sup>

To investigate this claim that farm gate prices have been stagnant the ACCC looked at farm gate (livestock price) and wholesale price data collected by the MLA.<sup>175</sup>

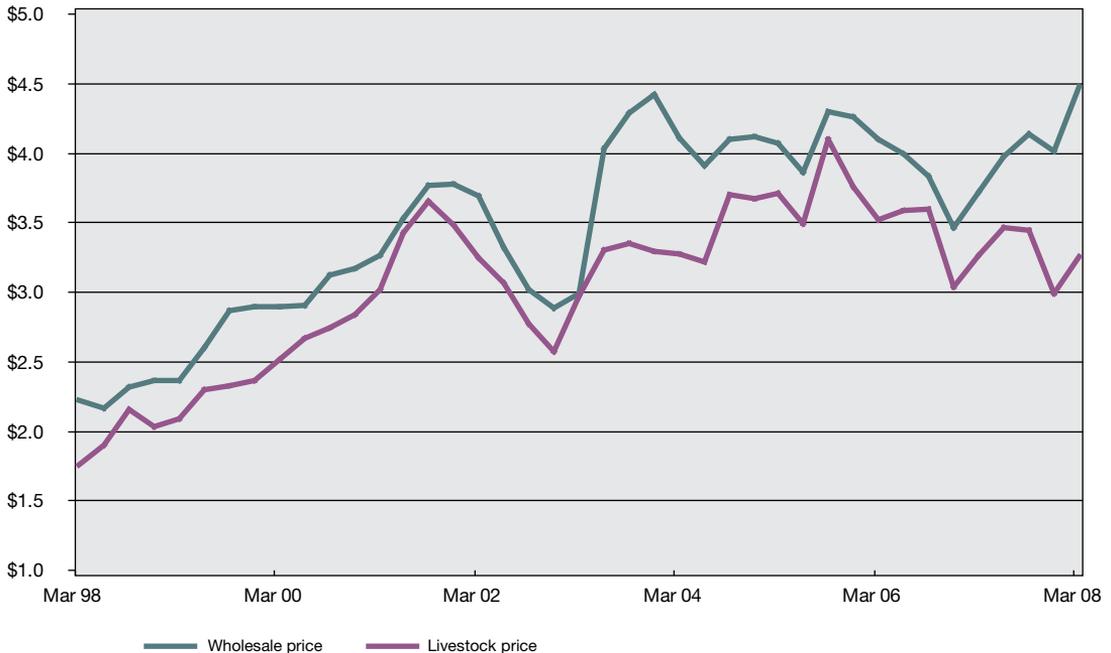
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173 NFF, submission no.137;p. 10, ACCC, public hearing transcript, Canberra, 30 April 2008, p. 13.

174 NSW Farmers Association, submission no. 155, p. 15.

175 Data collected by the National Livestock Reporting System.

**Chart 12.16 Beef livestock and wholesale price movements**



Source: MLA<sup>176</sup>

Chart 12.16 illustrates the average livestock prices for domestic steers<sup>177</sup> and average wholesale prices for beef. The ACCC has used domestic steer prices as the closest proxy for the type of cattle purchased by MSCs. Although these prices do not reflect the prices paid by the MSCs, as they primarily purchase grain fed beef from feedlots, confidential data provided by the MSCs indicates the margin between the two prices is relatively constant.

The chart shows that the farm gate price has not been stagnant. The price is extremely volatile but has moved upwards in nominal terms by 85 per cent between March 1998 and March 2008. Using the CPI as a deflator to account for rising costs, the increase in real terms is slightly more than 35 per cent over the same period.

Looking forward, ABARE forecasts the Australian weighted average saleyard price of cattle will increase by 3 per cent in 2008–09 to 294 cents per kilogram (dressed weight) because of a decrease in cattle turned off for slaughter as producers rebuild their herd numbers.<sup>178</sup> ABARE's projection is based on an anticipated increase in domestic production coupled with an anticipated increase in competition in key export markets.<sup>179</sup>

While farm gate prices have not produced significantly improved returns to primary producers, there have been upward movements in the market price.

176 Livestock price = saleyard cattle prices, national weighted average domestic steer 180–220 cwt (C3). All c/kg cwt (Source :NLRS); wholesale price = young cattle 160–210kg dwt (C3), c/kg (Source: NLRS).

177 Domestic steer prices are considered to be the closest proxy for cattle purchased by the MSCs even though this category may include cattle that are not suitable for processing.

178 ABARE, *Australian Commodities*, June quarter, vol. 15, no. 2, 2008, p. 361.

179 ABARE, *Australian Commodities*, March quarter, vol. 15, no. 1, 2008.

## 12.8.4 Feedlots

The vast majority<sup>180</sup> of beef sold in Australia is finished on grain in feedlots—that is, the livestock are fed a particular mix of feed for a specified period to reach a specified quality.

Cattle are sent to feedlots at around 12 to 14 months of age. Cattle for the domestic market are generally fed between 60 to 70 days, whereas certain cattle destined for the Japanese market may be fed for up to 300 days (wagyu is approximately 450 days).

Grain costs were identified as the primary input in the feedlot sector. As noted in a number of submissions<sup>181</sup> and chapter 2, grain prices have more than doubled in the last two years. This has significantly increased the cost of finishing cattle in feedlots.

### Details of negotiations with processors and MSCs

Cattle sourced from feedlots are generally supplied to MSCs on a forward contract basis taking into account the cost of the animal, feed costs and likely returns which gives the feedlotter certainty and sufficient information to decide whether to take on finishing of an animal.

In its red meat report the ACCC noted industry views that the pricing structure within the feedlot industry is very transparent. If the feedlots are not satisfied with the price offered to them by the supermarkets, they will refuse to supply the supermarkets and target other markets instead.

This view is supported by the Australian Lot Feeders Association (ALFA) which, in preparing its submission to the red meat inquiry, undertook a survey of lot feeders. In respect of this survey, ALFA submitted:

In each response from the feedlots one simple comment was reiterated; that the Australia cattle and beef markets are so highly competitive and complex that the potential for any single business within the market to dictate prices is considered negligible. The high level of global competition and the ability for processors, feedlots or extensive producers to move production from domestic to export markets was noted. Some feedlots described the cattle industry as a near perfect market; in that there is a high level of price disclosure, large numbers of buyers and sellers, relative ease of entry and (to a lesser degree) a uniformity of product. At a retail consumer level the ability to exchange beef purchasing for other competing proteins was also noted.<sup>182</sup>

## 12.8.5 Processors

The meat processing industry is a low margin, high volume business, with profitability and high utilisation closely related.

There are between 250 and 300 meat processors in Australia, with an increasing number becoming vertically integrated, producing cattle and owning feedlot facilities, as well as performing processing and wholesaling.

A survey conducted by MLA found that in 2006 the top 25 processors in Australia accounted for 77 per cent of total red meat production and the majority of these processors operated single species facilities, primarily beef.<sup>183</sup>

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180 Australian Lot Feeders Association, [www.feedlots.com.au/index.php?option=com\\_content&view=article&id=73&Itemid=95](http://www.feedlots.com.au/index.php?option=com_content&view=article&id=73&Itemid=95), 28 July 2008.

181 WA Farmers Federation, submission no. 106, p. 5.

182 ALFA, submission to ACCC red meat inquiry, January 2007.

183 Meat and Livestock Australia, *Top 25 red meat processors 2006*, September 2007.

In 2007 Australia's four largest processors were forecast to account for just below 47 per cent of total meat processing.<sup>184</sup> The ACC, the tenth ranked processor in the survey, supplies Coles. Tasman Group Services Pty Ltd (ranked fourth), Cargill Beef (fifth) and T&R Pastoral (sixth) all provide services to Woolworths, as well as to other customers.

Processors supply a number of different products and services to a range of customers, including processing and supply of primal cuts (boxed/case-ready meat), and service kills for a fee.

Where processors provide service kills, they will also usually provide basic processing such as boning and cutting into primals, which MSCs or other customers will further process in-store.

Prices for products and services are primarily negotiated on prevailing market conditions. The main processing stages are:

- slaughter
- hide removal
- removal of internal organs
- trimming
- weighing
- chilling
- boning
- further processing (in some instances)
- supply of case-ready meat.

Industry sources indicated the key cost for processors is labour. A significant issue for processors in this regard is that throughput of livestock is often variable, making it cost prohibitive to maintain a full-time workforce sufficient to meet a plant's total processing capacity. Accordingly, processors are somewhat reliant on casual labour.

While processors rely on casual labour to some extent, confidential evidence provided to the inquiry suggested they will buy stock at a loss if necessary to keep the plant operating and to retain their labour force.

Confidential information provided to the inquiry indicated that increased costs of production are being offset to some extent by increased efficiencies in slaughtering and processing the cattle rather than being passed on further up the supply chain.

Low margins in processing, the need to maintain volumes of throughput and evidence suggesting that processors have offset recent increases in costs of production with efficiency gains rather than passing on cost increases through the supply chain, suggests that competition between processors is strong.

Processors appear to primarily purchase cattle OTH, which means that they pay for a slaughtered and trimmed animal, on a cents per kilogram basis based on a pricing grid having regard to current market prices. It does not appear that individual negotiations occur between farmers and processors.

Some processors also supply boxed/case-ready meat to the MSCs on a regular and/or contractual and/or ad hoc basis and charge according to international market prices.<sup>185</sup>

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<sup>184</sup> JBS Swift & Co/Australia Meat Holdings Pty Ltd, Teys Bros (Holdings) Pty Ltd, Nippon Meat Packers Australia Pty Limited and Tasman Group Services Pty Ltd.

<sup>185</sup> ACCC, public hearing transcript, Melbourne, 12 May 2008, pp. 21, 23.

## Movements in wholesale price

As can be seen from chart 12.16, there is a close correlation between the movements in wholesale prices and livestock prices.

The wholesale price movements are consistent with claims that processors will buy stock at a loss to ensure throughput at the abattoir and retain labour.<sup>186</sup>

The ACCC was provided with average prices of case-ready meat supplied to wholesalers and the MSCs. The data indicates that prices may vary significantly depending on the particular cut of meat supplied. However, because of insufficient data, the ACCC is unable to draw any meaningful conclusions other than it appears case-ready meat is supplied on the basis of international prices.

### 12.8.6 Retail sale of beef

In submissions to the inquiry, a number of participants raised concerns that the gap between farm gate and retail prices for beef has increased significantly over recent times. Given the amount of processing involved in preparing beef for retail sale, such a trend is not necessarily indicative of a competition problem, but the inquiry gathered data to determine whether this was in fact the case.

In the last two years the Beef and Veal CPI sub-group index published by the ABS has broadly followed trends in the wholesale and retail market.<sup>187</sup> During 2006–07 the index showed an overall fall in the retail price, reflecting falls at the wholesale and farm gate levels. Between June 2007 and March 2008 the Beef and Veal CPI sub-group index showed an increase, as did prices at the farm gate and wholesale levels.

The ACCC then examined whether this trend of increases in the farm gate and wholesale prices was reflected over a longer timeframe. To compare retail, farm gate and wholesale price movements over time the ACCC used the beef and veal CPI subgroup index (which tracks relative movements in retail prices) and constructed a farm gate price index based on the MLA livestock price index which tracks farm gate price movements. Since 1999 increases in farm gate prices have, in percentage terms exceeded retail prices.

### Retail price movements

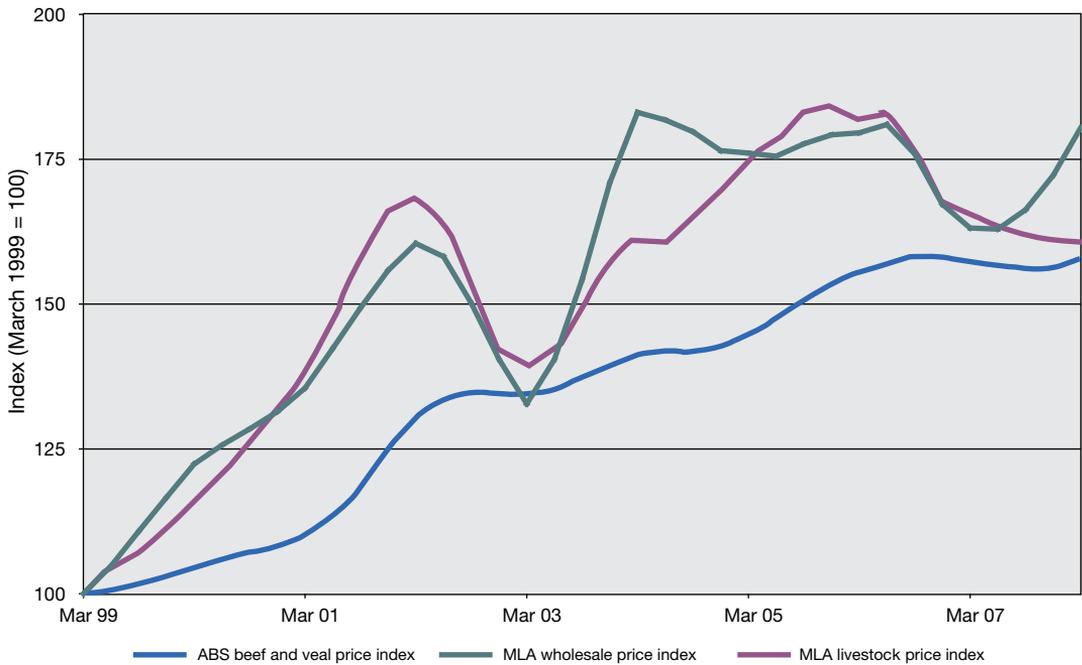
A more reliable method of comparing retail and wholesale price movements is to index the beef and veal CPI (which tracks relative movements in retail prices) and construct a farm gate price index based on the MLA livestock price index which tracks farm gate price movements. Since 1999 increases in farm gate prices have, in percentage terms exceeded retail prices.

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<sup>186</sup> The March 2003 result is the month most consistent with such a conclusion.

<sup>187</sup> ABS cat. no. 6401.0, *Consumer Price Index, Australia, June 2008*, Canberra, 23 July 2008.

**Chart 12.17 Farm gate and wholesale price movements**

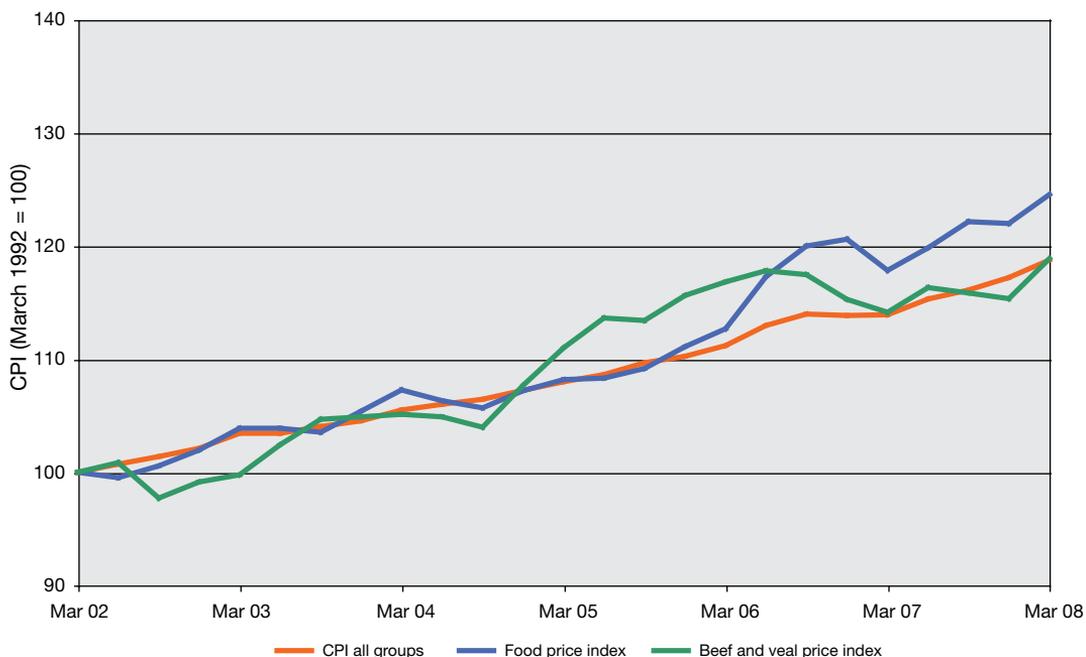


Source: MLA, NLRS

The relationship between prices at the farm gate and wholesale level is reasonably close but there are regular points of diversion. The farm gate and wholesale prices are, however, not closely tied to, and exhibit much more volatility than, retail prices. Over time though there has been no persistent trend of farm gate pricing reducing as a proportion of the final retail price.

It is also instructive to consider where retail price movements in beef and veal sit relative to the CPI and the food price index.

**Chart 12.18 Price indexes**



Source: ABS, ABARE

Chart 12.18 above shows that the beef and veal CPI sub-group index roughly tracked the food price index until late 2004, although more recently the food price index has increased at a greater rate. Between the end of March 2005, beef prices increased at a higher rate before the food price index took over. Beef prices have remained relatively stagnant since that time.

Producers emphasised at hearings that drought is not the cause of increased retail prices as they are continuing to receive the same prices as they did six years ago.<sup>188</sup> The ACCC is satisfied that in relation to beef, drought is not responsible for any price increase. However, there are many other costs in the supply chain that contribute to the relatively modest increases in the retail price of beef. For example, as a large proportion of meat sold in supermarkets is from livestock finished on grain, even where there has been a decrease in the cost of livestock, higher feed costs have offset any decrease. Labour, capital, fuel and other costs have also risen. The increase in the retail price of beef, which has generally been in line with the CPI over the last six years, is modest when compared to the changes in costs that have occurred at the wholesale level.

<sup>188</sup> ACCC, public hearing transcript, Perth, 22 April 2008; ACCC, public hearing transcript, Bunbury, 23 April 2008; Grahame Dunne, submission no. 200.

While the ACCC did not obtain the MSCs' gross margins for beef specifically, the MSCs provided information on the gross margins for the sales of particular product categories, including meat. The information indicated that gross margins for meat have decreased slightly over the last five years. More generally, the MSCs earn lower margins on meat than they do on most of the other standard grocery items examined in these case studies.

At the retail level it appears that the MSCs face strong competition from other retailers—and in particular butchers—in selling beef. As noted in chapter 5, 67 per cent of shoppers surveyed in the ACCC's consumer survey made less than half their 10 most recent meat and fish purchasers through a supermarket. It should be noted, however, that these figures do not take account of the quantity of meat and fish purchased in each of these shopping trips.

As noted in chapter 9, ACNielsen ScanTrack data and Roy Morgan survey data indicated that the MSCs' share of fresh meat sales is less than 50 per cent. Specifically for beef, the MLA estimates that around 50 per cent of retail sales are through the MSCs.

The MSCs gross margins for meat are low compared to other standard grocery items examined. Further, the MSCs have more competitors in respect of meat sales compared to many other grocery items. This suggests that retail competition in supplying beef to consumers is strong.

### Direct comparisons between farm gate and retail prices

The ACCC received a number of submissions comparing the farm gate price with the retail prices for particular cuts of beef. To make valid comparisons a number of factors should be considered, including the 'yield', or percentage of saleable meat, derived from a carcass, as well as the volume and value of the various cuts.

The ACCC received conflicting submissions indicating that yields from an animal can vary greatly depending on the cuts extracted. Figures ranged between 20 per cent and 70 per cent, while Freshlogic submitted that 60 per cent of the total carcass is saleable meat.<sup>189</sup> One industry source indicated that of the 60 per cent to 70 per cent of saleable meat obtained from a carcass, approximately 35 per cent to 40 per cent will be manufacturing meat.

Coles provided a table of an average set of cuts for retail sale derived from a beef carcass, including the percentage of the live weight, saleable kilograms and average retail prices for a particular period. A product set will vary in the type of cuts, volume and value obtained from a carcass.<sup>190</sup>

Two of the highest value cuts, eye fillet and scotch fillet, on average make up 1.3 per cent of the live weight and less than 4 per cent of the total saleable kilograms from a carcass.<sup>191</sup>

Accordingly, caution should be exercised when making comparisons between farm gate and retail prices. In particular, the NFF submitted that the farm gate price of food often represents only a small portion of the end retail price and that, therefore, movements in the farm gate price do not always reflect retail price movements.<sup>192</sup> The ACCC red meat report also noted that there will not necessarily be a direct and immediate relationship between the price of the raw product and the final good.

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189 Freshlogic report, p. 49.

190 Coles response to ACCC informal information request, cited with the consent of Coles.

191 Coles, response to ACCC informal information request, cited with the consent of Coles.

192 National Farmers Federation, submission no. 137, pp. 7, 8.

The 2004 DAFF report estimated the farm gate price as a percentage of retail price of beef at around 20 per cent.<sup>193</sup> Although, as others have also noted, the DAFF report stated that such comparisons are inherently complex and the subject of a large number of assumptions regarding meat quality, market conditions and cost structures.

As noted in the ACCC's red meat report, while there is a relationship between the price paid to farmers for livestock and retail meat prices, there are many factors throughout the supply chain that make drawing simple linear relationships problematic. The assumption that there should be a direct and immediate link ignores the complexity of the supply chain itself and of the supply arrangements within the chain.

### Comparisons between Australia and overseas retail prices

During this inquiry the ABA made a number of claims, both to the ACCC and in the media<sup>194</sup>, identifying the MSCs as the single biggest contributor to what they consider to be poor farm gate prices and inflated retail prices being paid by consumers, particularly when compared to other countries. The Red Meat Action Group also made some similar claims.<sup>195</sup>

Specific claims include that consumers in Australia are paying double the prices paid by consumers in the United States for the equivalent beef products, despite US farmers receiving more for their cattle at the farm gate. In support of this claim, the ACCC notes the ABA compared the average sirloin beef price in Australia to the price in a number of other countries. The ABA cited the United States Department of Agriculture as the source of the US figures:

- Western Australia \$35.95 per kg
- Australia \$28 per kg
- United States \$13.82 per kg
- Japan \$23.94 per kg

The ABA also stated that prices in the United Kingdom and Ireland were \$34 per kg and \$30.51 per kg respectively, but that producers in those countries receive more for their cattle.

The ACCC notes that the NFF advised caution in making direct comparisons with retail prices in other OECD countries, given the distorted nature of agricultural trade globally as indicated by the average tariffs on agricultural products being more than three times higher than those on non-agricultural goods. The NFF submitted the level of domestic support for agriculture in Australia at 4 per cent of farm income (compared to 33 per cent, 18 per cent and 56 per cent in the European Union, the US and Japan respectively) is among the lowest when compared with OECD standards.<sup>196</sup> This, the NFF argued, demonstrates that Australian agriculture is more exposed to the market than its OECD counterparts and results in significant variation in the market dynamics which underpin agricultural prices in different countries.

DAFF advised<sup>197</sup> that comparisons between Australia and other countries are difficult because of differing production methods (e.g. grass compared with grain-fed), processing plants and efficiencies

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193 S Spencer, *Price determination in the Australian food industry, a report*, Department of Agriculture, Fisheries and Forestry, Canberra, 2004, p. 39.

194 ABA, submission nos. 44 and 146; ACCC, public hearing transcript, Canberra, 8 April 2008, p. 98; *Farm Weekly*, 11.6.08; and farmonline, to cite a few.

195 ACCC public hearing transcript, Bunbury, 23 April 2008, p. 56.

196 NFF, submission no. 137, p. 6.

197 DAFF, Livestock Industries Branch, Agricultural Productivity Division, June 2008.

(e.g. relatively small processing plants in Australia compared with some very large integrated plants in the US), selling methods (e.g. livestock saleyard prices that are reported compared with contracts for livestock that are sold direct to works, which are not readily available to the public) and input costs vary (e.g. cheaper feed corn is used in the US).

DAFF noted that the international prices it cited were drawn from a number of data sources which it could not reconcile with the ABA data. Further, DAFF also noted difficulties in how particular cuts were defined—in some circumstances, a US sirloin is the equivalent of an Australian rump—and could not conclude whether the ABA prices reflect like-for-like US and Australian sirloin cuts. All this calls into question the utility of the comparisons.

DAFF also stated that if it is the retail price of an Australian rump<sup>198</sup> steak that is more appropriate for comparative purposes then the average Australian price moves closer to the US sirloin retail price.

DAFF also examined Japanese prices with data provided by the Agriculture and Livestock Industries Corporation (ALIC).<sup>199</sup> DAFF advised it was again unable to reconcile the retail sirloin price identified by the ABA with ALIC's May 2008 figures. DAFF advised the national Japanese average retail price (¥379 per 100 g plus a consumption tax of 5 per cent) for Australian sirloin in March 2008 was calculated to be the equivalent of AUD\$39.28.

Accordingly, the ACCC is reluctant to draw any conclusions from the international comparisons submitted to the inquiry.

## 12.8.7 Conclusion

The supply chain for red meat from farm gate to consumers is long and complex. A variety of different supply arrangements make it difficult to directly compare farm gate and retail prices. Such comparisons are further complicated by the variety of cuts that can be produced from a single carcass, with each cut as a proportion of the carcass in terms of volume and value varying depending on the cut set extrapolated. Further, the farm gate price of livestock is only one of numerous inputs into the eventual cost of a cut of beef. As such, direct comparisons between farm gate and retail prices are difficult and not necessarily instructive.

The ACCC is satisfied that the market is broadly competitive at all levels of the supply chain.

Beef is an internationally traded commodity with 65 per cent of Australian production exported. As such, international beef prices strongly influence returns to Australian producers. It does not appear that any domestic purchasers have significant buyer power with the two largest domestic purchasers, Coles and Woolworths, each only purchasing around six per cent of domestic production.

There appears to be competition at all levels of the supply chain, including the retail level where Coles and Woolworths share of sales is significantly lower than for many other standard grocery items. Retail beef prices have increased at roughly the same rate as CPI over the last six years.

Retail gross margins on beef are low by comparison to most other categories of products sold by the MSCs further suggesting strong retail competition. The ACCC cannot rule out that there may be some competitive weaknesses in some geographic regions, but any weakness is likely to manifest itself in the form of lower returns to producers rather than higher prices to consumers.

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<sup>198</sup> ABS, *Average retail prices of selected items, eight capital cities*, December 2007 and March 2008.

<sup>199</sup> ALIC information provided to DAFF in the form of monthly statistics that includes beef retail prices. ALIC is a government development agency for Japan's agriculture and livestock industries.

## 13 Farm gate and retail pricing

### Key points

- Evidence available to the inquiry does not support the proposition that retail prices have risen while farm gate prices have stagnated or declined.
- Generally speaking, movements in the wholesale price are reflected in movements in the retail price.
- In general, retail prices of food in Australia are going up faster than the CPI, but this is not universal across all product categories or even within categories. Farm gate prices for some products have risen substantially in recent years in response to international factors while others have fallen. These effects have generally, but not universally, been reflected in retail prices.
- Evidence available to the inquiry suggests that retailers do not set farm gate prices, but rather these prices mirror supply and demand factors in the relevant market. In general, the MSCs do not buy sufficient amounts of product to control the market price; however, there may be some categories where it is possible for the MSCs to significantly influence price in certain periods.
- Reasons that retail prices do not always fall in line with farm gate prices are varied and depend on the category of product being examined.

### 13.1 Introduction

A significant concern raised at hearings and in submissions to the inquiry is whether the ‘gap’ between farm gate and retail prices for groceries has been widening in recent times. For example, the Queensland Farmers’ Federation believes:

... it is important for the ACCC to consider why food prices paid by consumers have been rising much faster than the prices paid to farmers. Over the last four years to June 2006, retail food prices had risen on average by 17.8 per cent while average prices received by farmers rose by just 2.3 per cent. Food prices also rose much faster than inflation, with 17.8 per cent for food compared to 12.1 per cent for everything else. These increases have not been felt by farmers, who over the same period, have been struggling with the worst drought in a century which saw their cost of production rise by 16.5 per cent.

Food prices are not delivering fair results for either consumers or farmers. 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 for the major retailers to use their market power to push costs, risks and responsibilities back down the supply chain. Producers’ profit margins continue to decrease, while the profit margins of the major retailers remain at record highs.<sup>1</sup>

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<sup>1</sup> Queensland Farmers Federation, submission no. 93, p. 1.

On the other hand, the National Farmers' Federation (NFF) noted that there will not necessarily be a direct and immediate relationship between the price of the raw farm product or input and the final good. The NFF stated:

It has long been a frustration for agricultural producers that our sector attains only a small portion of the end retail price of food products. Indeed, a study by Whitehall Associates in 2004 titled *Price Determination in the Australian Food Industry*, found that the farm-gate component of the retail price of a basket of food products ranged between 5 per cent and 40 per cent. They also indicated that there appeared to be an increasing gap between farm-gate and retail prices.

While market concentration and competition issues cannot be discounted as being part of the reason behind this increasing gap, the NFF also acknowledges that there is an array of supply chain costs pressures that are being felt by the non-farm sectors which help the consumer to access the end food product. Such costs include marketing, transport, processing, packaging and labelling.<sup>2</sup>

The ACCC considers that there are broadly three possible competition-related reasons that may explain any increasing gap between farm gate and retail prices:

- a lack of competition at the retail level, giving the retailers an increasing degree of discretion in their retail pricing
- a lack of competition or increasing market power at other points in the supply chain
- the buyer power of the major supermarket chains (MSCs), derived in part from their market share, altering profit distribution along the supply chain but not increasing prices above competitive levels.

The first point has been explored in the first half of this report. The second point has been analysed in the context of the case studies contained in chapter 12 of this report. The third point will be examined in more detail in chapter 15.

The purpose of this chapter is to examine the material available to the ACCC on the question of whether there has been an increasing gap between farm gate prices and retail prices of grocery products. Given difficulties in examining the relationships between farm gate prices and retail prices at a broad level, the ACCC has focussed its analysis on a number of product groups. These have primarily drawn from the case studies detailed in chapter 12. In addition, evidence of an increasing gap between farm gate prices and retail prices is assessed with regards to changes in the gross margins of the MSCs and other retailers.

## 13.2 The 'gap' between farm gate and retail prices

The 'gap' between farm gate and retail prices represents the difference between the price paid to the primary producer of a product and the retail price paid by the consumer. The size of the gap is determined by the relative contribution that the following factors make to the retail price of the product:

- the costs associated with turning the 'raw' product into the product found on supermarket shelves—for example, raw milk and livestock require processing before they can reach consumers but eggs are already in their final state
- costs associated with transport, storage, handling, distribution and retailing, including the degree to which some of the product may be lost in the transformation process—for example, spoilt fruit and vegetables and breakages
- the mark-up applied by each party along the supply chain.

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<sup>2</sup> National Farmers Federation, submission no. 137, p. 7.

## 13.2.1 Evidence of the gap between farm gate and retail prices

Comparisons between farm gate and retail prices are difficult for several reasons. Most products go through a number of stages of production. Moreover, in many cases, costs of individual ingredients make up a small proportion of the retail price of the product.

As a result, it is difficult to isolate the relationship between movements in the prices of primary products (such as grain) and the retail price of final product (such as bread). In these cases, it cannot be said that a decrease in farm gate price should necessarily cause a corresponding decrease in retail prices. Various other factors, including changes in processing and transport costs, also affect retail prices.

In other cases, where there is minimal processing of the final product (such as with fresh fruit and vegetables), the relationship between farm gate and the retail prices is more observable.

### Milk

According to the CPI published by the ABS, the consumer (retail) price of milk increased at a broadly steady rate of around 5 per cent per annum from March 2002 to March 2008.<sup>3</sup>

As discussed in chapter 12, the farm gate price of milk has been more volatile than the retail price (see chart 12.1). This makes comparisons of the retail and farm gate prices susceptible to the period chosen. After dropping significantly in 2002–03, farm gate prices increased at around the same rate as retail prices between mid-2003 and mid-2007. Since the middle of 2007 the rate of increase in farm gate prices has significantly outstripped the rate of increase in retail prices.

There is no evidence that processors and retailers are able to suppress farm gate pricing in the face of rising world dairy prices, nor are they free to pass on every cost increase that results from increases in farm gate pricing. This is consistent with strong competition at each level of the chain.

### Eggs

According to the CPI data published by the ABS, the retail price of eggs, after declining steadily between June 2003 and June 2005, increased at a rate above the CPI and above the food CPI until March 2008.<sup>4</sup>

The farm gate price of eggs followed a broadly similar pattern: farm gate prices declined between 2003 and 2005 and then rose strongly between 2005 and 2008.<sup>5</sup> However, the decline in farm gate prices appears to have commenced before the decline in retail prices.

When plotted as an index (as in chart 12.11) there appears to be a strong, but not uniform, relationship between movements in the retail price and movements in the farm gate price. Given how little transformation occurs between the farm gate and the retail level for an egg, this correlation is to be expected.

Based on the material available to the inquiry, it would appear that there was an increasing gap between farm gate and retail prices of eggs between 2003 and 2005 but, since then, the gap has narrowed and egg producers are now receiving a higher proportion of the retail price than they did in 2001.

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3 ABS cat. no. 6401.0 (2008).

4 Chart 12.11.

5 ABARE Australian Commodity Statistics 2007, pp. 22–23; and for March 2008 see Chart 12.10.

Accordingly, for eggs, it is not true to say that there is an increasing gap between the farm gate price and the retail price. The rapid increase in the price of eggs over the last three years appears to be the product of increasing costs for the producer and not an increase in producer or retailer margins.<sup>6</sup>

## Red meat

According to data published by ABARE, the increase in the farm gate price of cattle between March 1998 and March 2008 of 85 per cent exceeded the increase in retail prices for beef of 60 per cent.<sup>7</sup> As with milk, different impressions about the gap between farm gate and retail prices can be gained by looking at data from one year to the next. This results from the more volatile nature of farm gate prices.

It would appear that the farm gate price of beef cattle has risen faster than retail prices over the last 10 years, notwithstanding the strong submissions to the contrary the ACCC has received on this issue. This raises the question of why this perception exists. For beef, that question is difficult to answer comprehensively; however, it may be the product of the highly volatile farm gate and wholesale markets for beef compared with a more consistent retail market which smoothes out the price increases to consumers. The result of the volatility is that in a single year farm gate prices can surge by more than 25 per cent (as they did in 2003), but retail prices rise by only 5 per cent. In later years, as farm gate prices start to decline and retail prices continue to rise (but only to levels which bring retail returns back to levels enjoyed before the price surge) concerns are raised about retail pricing.

Even if there is more foundation to claims that the gap between farm gate and retail prices for beef are growing by more than the ABARE data suggests, the ACCC is confident that, to the extent that there is any divergence between farm gate and retail prices of beef, any increase in retail price is not as a consequence of the retailers earning excessive margins. The gross margins in meat achieved by the MSCs appear to be relatively low as a category and have declined overall over the past five years. Accordingly, any problem that may exist is not a competition problem at the retail level.

## Fruit and vegetables

A pattern of retail prices rising in line with wholesale prices has been generally observed in fruit and vegetables.

The discussion below relies heavily on wholesale market data as a proxy for farm gate price data for fresh produce. The ACCC has been unable to obtain accurate farm gate data as a result of the vast numbers of growers producing fresh produce in Australia. Such a data collection exercise was not able to be performed in the time available to the inquiry. As a result, the ACCC has performed the analysis below on the basis of wholesale market prices, for which the ACCC has been able to obtain accurate data.

The ACCC acknowledges that there is some difference between farm gate and wholesale market prices as a result of growers having to pay agents fees, and potentially some transport costs. However, the ACCC is satisfied that the trends observed will be reflective of movements in the farm gate price. The ACCC considers that wholesale market data is a reasonable replacement for farm gate data for the purposes of the analysis below.

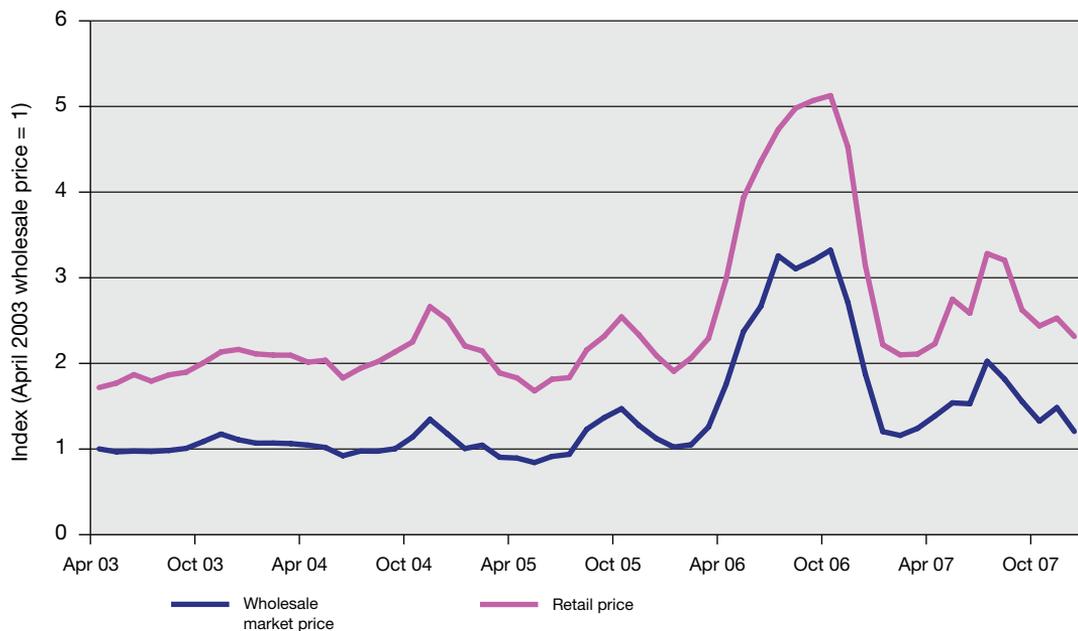
Charts 13.1 and 13.2 indicate that the retail price of eight key standard fruit and vegetable products examined has moved in a pattern generally consistent with movements in the wholesale price.

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<sup>6</sup> See 12.5.9 for more detailed discussion of retailer margins.

<sup>7</sup> ABARE, *Australian commodity statistics 2007*, available at [www.abare.gov.au/publications\\_html/acs/acs\\_07/acs\\_07.pdf](http://www.abare.gov.au/publications_html/acs/acs_07/acs_07.pdf). Retail price data obtained from ABS, the ACCC believes that this data actually overstates the rises in retail price and therefore the retail price increase is likely to be lower. See chapter 12.8 for a further discussion on this topic.

**Chart 13.1 Retail to wholesale price fluctuations from April 2003 to December 2007 for eight fruit and vegetable products**



Source: Wholesale data obtained from Ausmarket, average retail price data obtained confidentially from Coles and Woolworths

**Chart 13.2 Retail to wholesale price fluctuations for seven fruit and vegetable products (those considered in chart 13.1 excluding bananas)**



Source: Wholesale data obtained from Ausmarket, average retail price data obtained confidentially from Coles and Woolworths

Chart 13.3 displays the wholesale price as a proportion of the retail price. While for most of the period the wholesale price has constituted between 50 and 60 per cent of the retail price, there have been extended periods (between August 2004 and June 2005) where the wholesale price as a proportion of the retail price of fruit and vegetables stayed below 50 per cent. The wholesale price as a proportion of the retail price only went above 60 per cent after cyclone Larry.

Care must be taken in interpreting the retail margins captured in chart 13.3 as they can vary widely with wholesale prices. If wholesale prices increase sharply and the retailers maintain the same margin in dollar terms, then the percentage retail margin will fall. This is a major source of the variation in the margins displayed in chart 13.3. It is not surprising that the wholesale price as a proportion of retail prices increased during cyclone Larry. There should be no reasons for retailers to mark-up bananas by the same percentage when the wholesale price of bananas spiked after cyclone Larry.

**Chart 13.3 Wholesale prices as a percentage of MSC retail price for eight fruit and vegetable products**



Source: Wholesale data obtained from Ausmarket, average retail price data obtained confidentially from Coles and Woolworths

In broad terms, the charts indicate that, contrary to information provided in a number of submissions to the inquiry, retail prices are not rising sharply while farm gate prices are static. Movements in fruit and vegetable retail prices are broadly in line with price movements in the wholesale market. There is no evidence that the MSCs or any other player in the market can hold down wholesale prices while increasing retail prices.

Moreover, the MSCs’ gross margins in produce have actually declined since 2002–03. This suggests any increase in the gap between farm gate and retail prices for fruit and vegetables is not through higher retail margins of the MSCs.

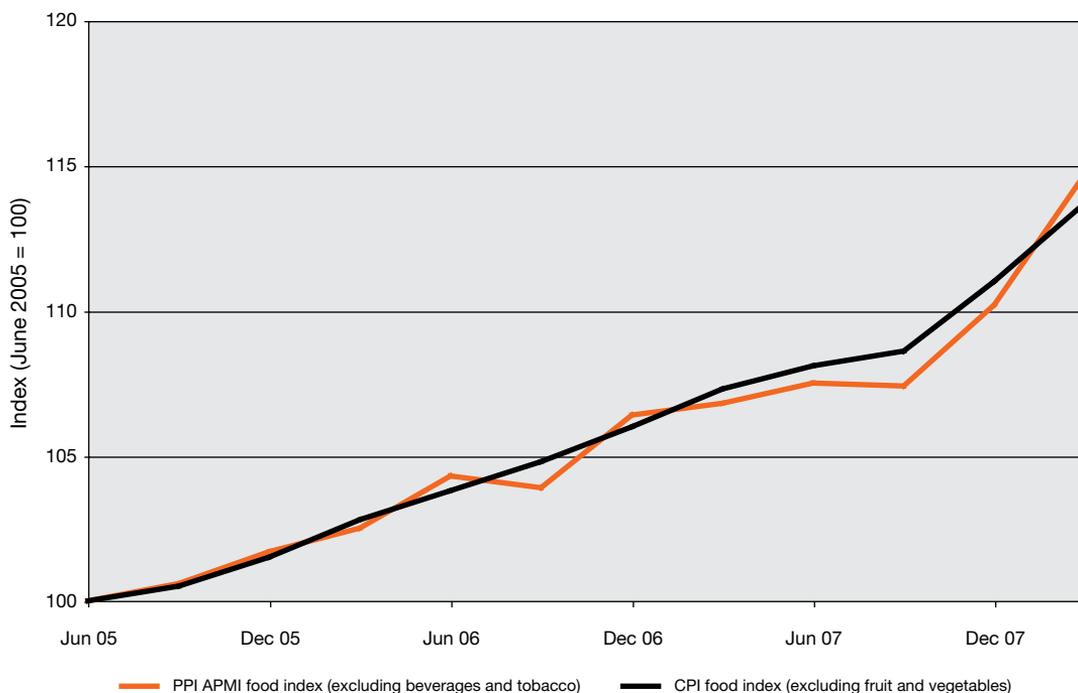
There is very little data to suggest a decline in farm gate prices for fruit and vegetables that is not linked to supply and demand conditions prevailing in the relevant market at the relevant time.

It is easy to look to the MSCs given their size and related buying power and assume that this is leading to a widening of the gap between farm gate and retail prices. However, the data available to the ACCC certainly do not support that as a universal picture. Indeed, the data contradicts it in many fruit and vegetable categories.

### Manufactured food

The wholesale and retail prices of manufactured food products seem to track each other more closely than the prices of fresh food products. Chart 13.4 compares the producer price index (PPI) series for Australian manufacturers of food products (excluding beverages and tobacco)<sup>8</sup> and the CPI data for food (excluding fruit and vegetables which are not included in the PPI). Since June 2005, changes in the retail prices have tracked fairly closely with the changes in ex-factory prices received by producers—though the series do diverge from time to time, as noted by the ABS.<sup>9</sup>

**Chart 13.4 ABS consumer price index and produced price index (articles produced by manufacturers industries) food indexes**



Note: The PPI series above excludes fresh produce as it does not pass through manufacturers. The procedures used to construct these price indices are largely identical to those used to compile the CPI.

Sources: ABS (cat. no. 6401.0); ABS (cat. no. 6427.0)

8 The producer price index (PPI) is a measure of the change over time of both the prices paid by producers for their inputs (the materials used in the production of their product) and the prices they receive for their product (ABS cat. no. 6427.0). The PPI excludes sales to other manufacturers for further use in the production of other goods. For this analysis, the PPI has been adjusted to exclude beverages and tobacco to bring it into line with the CPI food series (alcoholic beverages have a significant effect on the PPI; however, alcohol is not included in the CPI food series so beverages have been excluded from PPI).

9 ABS, submission no. 245, p. xiii.

## 13.2.2 Margins of retailers

An additional method in examining whether there is an increasing gap between retail prices and the wholesale prices received by producers is to assess changes in the gross margins (revenue achieved from sales minus the cost of goods sold) that the MSCs and other retailers are earning over time from supermarket operations. The ACCC considers that an increasing gap between retail and wholesale prices would be reflected in increasing gross margins. This issue was analysed in chapter 6 of the report.

In chapter 6 the ACCC found that the trends in gross margins achieved by the MSCs were mixed. Overall, Woolworths has increased its gross margins over the last five years, while Coles has experienced relatively flat gross margins. However, the trends in gross margins differed quite significantly for different trading departments within the same company.

In particular, both MSCs were able to achieve increases in gross margin for dry groceries and perishables such as dairy products from 2002–03 to 2006–07. The increases in the gross margins for these categories were fairly constant year on year.

The increase in dairy margins is likely a result of the MSCs putting pressure on profits at the processor level given that retail price rises have been broadly consistent with rises at the farm gate. Comparatively, the MSCs gross margins for meat and fresh produce declined over the same period. Trends in gross margins for bakery and deli categories were more varied. These varying trends in gross margin may be related to the different competitive pressure in each category.

## 13.3 Conclusions

The ACCC considers that there is no broad observable trend relating to an increasing gap between farm gate (or wholesale) prices for fresh produce and retail prices. There are a number of product categories and numerous products within specific categories where retail prices have actually remained stagnant or have risen at a slower rate than farm gate prices.

This general conclusion is consistent with the observable structure of most of the markets in which the MSCs operate. While the MSCs seem large as a proportion of retail spending, as a destination for farm produce they are much smaller in most categories. As buyers, Coles and Woolworths compete with other grocery retailers (including specialty stores), as well as the food service industry, the food processing industry and export markets. In categories such as beef, the MSCs only buy around 12 per cent of Australian production.<sup>10</sup> Accordingly, the ACCC considers the structure of the grocery sector does not lend itself to allowing the MSCs to artificially suppress farm gate prices.

This is not to say that there are not subcategories within broader food categories (such as yearlings within the beef category) where the MSCs are extremely large players and may, in certain periods, have significant influence over the market. However, the MSCs are not in a position to reduce returns to beef producers below the prices paid internationally. One beef producer acknowledged during the public hearing in Perth that the current concerns with beef pricing would not be so acute if the Australian dollar was trading at US\$0.45 instead of US\$0.90.<sup>11</sup>

There are, however, some periods where the gap between retail prices and farm gate prices does increase for some products. The exact cause of this increasing gap appears largely dependent upon the circumstances of each particular product category or product.

<sup>10</sup> MLA have estimated, using BIS Shrapnel/Roy Morgan data that of the total beef produced in Australia, 35 per cent is not exported and is used for domestic consumption. Of this 35 per cent, 68 per cent is sold through retail channels. Of that 68 per cent, the MSCs purchase 52 per cent.

<sup>11</sup> For example, see ACCC, public hearing transcript, Perth, 22 April 2008, p. 57.

# 14 Buyer power

## Key points

- The bargaining power concept of buyer power is more appropriate in most instances than the monopsony power concept for analysing buyer power in Australian grocery retail. The inquiry is predominantly using the bargaining power concept of buyer power, not the monopsony power concept.
- Buyer power in bilateral commercial relationships is primarily the result of the buyer in the relationship having higher value ‘outside options’ than the seller.
- Buyer power may arise from the relative sizes of the buyer and seller, their relative dependency on the relationship, and other factors that influence the relative values of their outside options.
- But the broader impact of buyer power on economic welfare is still not yet settled in the economic literature. In particular, it is not yet clear if buyer power results in a gain or a loss to consumers. However, if lower supply prices are passed through to consumers in the form of lower retail prices, then this will generally result in a gain to consumer welfare.
- The impact of buyer power will need to be assessed on the specific evidence in each case. Such impacts are looked at more closely in chapter 15.

## 14.1 Introduction

In recent years, there has been growing concern in Australia and other countries about the levels of consolidation of grocery retailers. In particular, concerns have been raised by suppliers about the extent of the so-called ‘buyer power’ of retailers. Such concerns typically hold that the size and market dominance of the MSCs means that they are able to source fresh grocery products from farmers and growers at decreasing supply prices without passing on the full benefits to consumers in the form of lower prices, but instead achieving higher margins to the benefit of shareholders.

This chapter examines the potential impact on the retail sector of such buyer power. Chapter 15 considers the evidence relating to the actual extent of buyer power in Australian grocery retail and the actual impact on suppliers and consumers. Changes in retailer concentration are discussed in more detail in chapter 3.

To simplify the language in this chapter, it will refer to retailers only. However, it should be noted that Metcash, although not a retailer, is also a significant purchaser of grocery items from producers and therefore much of the discussion is also relevant to Metcash.

A common element of many of the concerns raised is that retailers are said to be able to use their buyer power to extract more favourable terms and conditions from upstream suppliers than would otherwise be the case. Such an outcome may disadvantage suppliers. In the context of this inquiry, this would mean the retailer’s bargaining power (relative to the supplier’s bargaining power) is increased when negotiating trading terms for supply of groceries.

An associated concern increasingly been given attention in the theoretical economic and industry analysis literature is that of the large grocery retailer as ‘gatekeeper’ between large numbers of suppliers and final customers. A typical concern regarding this gatekeeper role is that big retailers supposedly use their buyer power to drive down prices paid to small suppliers of supermarket goods (particularly primary producers, such as farmers, growers, etc.) in an allegedly anti-competitive manner.

Such concerns and complaints have contributed significantly to the motivation behind several related inquiries in Australia, the United Kingdom (UK) and other countries. As with many other aspects of grocery supply, the mere existence of buyer power does not mean competition is necessarily weakened and that consumers will be worse off. Thus it is necessary to examine the impact of buyer power on a case-by-case basis.

This chapter considers the following issues:

- What is buyer power? What frameworks are suggested by economic theory for the analysis of buyer power?
- What are the potential sources of buyer power? Does the size of MSCs and other large buyers mean that they can exercise buyer power in their dealings with farmers, growers and other groceries suppliers?
- When might buyer power be of concern and when may it be beneficial to consumers?
- How has buyer power been analysed by the ACCC and the Australian courts?

This chapter sets up the framework for the assessment of the evidence on buyer power that has been presented to this inquiry and is considered in the following two chapters.<sup>1</sup>

## 14.2 What is buyer power?

A broad definition of buyer power is that it is the ability of a person to exercise power in a market in which they are a buyer.

A typical manifestation of buyer power is the ability of the buyer to influence the price it pays for goods and services. In the context of grocery retailing, buyer power therefore would refer to a grocery retailer's ability to influence the price it pays to suppliers (manufacturers, growers, etc.) of grocery products, which the retailer then on-sells in its stores. This means the retailer has some degree of market power, concurrent with the OECD definition of buyer power as being 'the ability of a buyer to influence the terms and conditions on which it purchases goods'.<sup>2</sup>

Buyer power is typically manifest as the buyer's ability to purchase a good or service at a price below the price at which it would trade in a perfectly competitive market, that is, as:

the ability of a buyer to reduce the price profitably below a supplier's normal selling price, or more generally the ability to obtain trade terms more favourable than a supplier's normal trade terms.<sup>3</sup>

A typical situation where such buyer power may exist is where 'the demand side of a market is sufficiently concentrated that buyers can exercise market power over sellers'.<sup>4</sup>

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1 This chapter is predominantly a discussion of the economic theory underlying the analysis of buyer power. This economic framework is used by the inquiry to analyse the evidence presented to the inquiry, and this analysis of the evidence is presented in the next two chapters. The theoretical evidence referred to in this chapter is not necessarily applicable to the Australian grocery sector but serves to illustrate the uncertainties that can arise in an economic assessment of buyer power. Further, not all of the issues discussed in this chapter have emerged as issues of concern in this inquiry on the basis of the evidence put before the inquiry. The concerns that have emerged are discussed in the next two chapters, in the context of the evidence submitted to the inquiry and analysed in those two chapters.

2 OECD, 'Buying power of multiproduct retailers', Series roundtables on competition policy, DAFFE/CLP(99)21, 1999, p. 18.

3 Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25.

4 RG Noll, "'Buyer power" and economic policy', *Antitrust Law Journal*, vol. 72, 2005, pp. 589–624, at 589.

It should be noted that concerns about the competition effects of buyer power are related to, but also in a sense stand in contrast to, more common competition concerns about monopoly power or seller's market power, where seller-side market power is commonly conceived of as being 'the ability of a firm to profitably set price[s] above competitive levels'.<sup>5</sup>

## 14.3 How should buyer power be characterised?

The economic literature conceives of and analyses buyer power in essentially two distinct ways. The first conception is of buyer power as being monopsony power, meaning that a buyer has market power in the context of a single arm's length market consisting of a number of buyers and sellers. The second is of buyer power as being bilateral bargaining power, meaning that a buyer has bargaining power in the context of bilateral supply relationships between individual buyers and sellers.

These two essential characterisations—and the analytical work that flows from and is built on them—share some characteristics; however, they depart from each other in important ways and give rise to different sets of analytical implications.

This inquiry adopts (in most instances) a bilateral bargaining power model to analyse buyer power in grocery retail. This is because a bilateral bargaining power model of buyer power more fully reflects the structural features of most upstream grocery supply industries and more accurately predicts the observed outcomes of negotiations. Essentially, the bilateral bargaining model is more appropriate for analysing commercial situations where buyers and sellers interact in a series of one-on-one bilateral relationships. This is the predominant situation in Australian groceries supply. The monopsony power model is more apt where buyers and sellers interact in a wholesale market forum, where prices are determined in single markets rather than in individual dealings between buyers and sellers. This is far less often the situation in Australian groceries supply and so is not as a rule used in this inquiry (although the inquiry does use this model for analysis in one instance in chapter 15, where it is appropriate on the facts).

The alternative monopsony power model is outlined in appendix I, as are more detailed reasons for (generally) adopting a bilateral bargaining model in this inquiry.

The bilateral bargaining model is outlined in the next section.

### 14.3.1 The bargaining concept of buyer power—bilateral bargaining power

The concept of buyer power that the ACCC is using for this grocery inquiry is that of buyer bargaining power.

In this concept buyers and sellers interact and trade by way of a series of direct bilateral relationships, rather than trading in a market setting at arm's length. Buyers and sellers in principle negotiate and conclude commercial deals because they can both realise a benefit from the deal. Bargaining over the terms of a deal in essence is bargaining over how the parties will divide the amount of the total (to both buyer and seller) net benefit from the deal, otherwise known as the 'joint surplus' (between both buyer and seller) from the deal.

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<sup>5</sup> D Carlton and J Perloff, *Modern Industrial Organization*, Glenview IL: Scott, Foresman, 1989, p. 97.

This bargaining conception is consistent with the way in which retailers in most cases buy groceries from manufacturers, which generally involves negotiation over prices and other trading terms. Retailers (buyers) and suppliers/manufacturers (sellers) negotiate the prices and specific terms on which the product will be sold to the retailer. These terms may vary from buyer to buyer in this framework as terms are determined by negotiation rather than through a single market trading framework.

Furthermore, this bargaining concept is consistent with a wide variety of supply prices, terms and conditions, and does not predict that lower supply prices will be accompanied by lower quantities. This is in contrast to the monopsony power model, which predicts that lower supply prices will be accompanied by lower supply quantities relative to the competitive outcome, for instance, through withheld demand by a powerful buyer (see appendix I for further details on the monopsony power model).

The relative bargaining power of buyer and seller will be an important determinant in the outcome of negotiations over the supply price (and other terms) between buyer and seller. Bargaining power in a bilateral bargaining relationship is best described as being exercised by threatening to impose a cost, or to withdraw a benefit, if the other party does not grant a concession—for example, a price discount. Buyer power in this context is the ability of powerful buyers to exercise bilateral bargaining power against less powerful sellers to negotiate more favourable price discounts and other favourable terms in these individual supply relationships than would be negotiated in the absence of buyer power.

A simple theoretical bargaining model is contained in appendix I. That model highlights the ‘outside options’ concept. This is one of the key concepts in an assessment of buyer power and bilateral bargaining. Put simply, the outside option is the best option that either the seller or buyer can achieve if they walk away from the negotiations. These walk-away options are the minimum negotiated outcome that the respective parties will accept.

For example, from the supplier’s perspective, there may be a range of outside options, including export to overseas retailers, supply to other domestic retailers (including those in other distribution channels), supply to wholesale markets or direct supply to consumers. For retailers, the outside options may include purchasing from other domestic suppliers or importing from overseas suppliers. In analysing outside options, the whole range of options should be considered.

The more outside options that either buyer or seller has, the stronger will its bargaining position be relative to the other party (all other things being equal). If a buyer and seller are negotiating a supply deal and if the buyer’s outside options improve or the seller’s outside options deteriorate, the consequence in general will be that the buyer will have improved bargaining power and will be able to capture a greater share of the joint net benefit, or joint surplus, arising from the deal between buyer and seller.

The general result is that the strong outside options for a buyer, or weak outside options for a seller, are a major source of buyer power in a bilateral bargaining framework.

### Complications to bargaining power models

Bilateral bargaining typically does not occur in isolation. Even though retail supply contracts are typically bilateral, large retailers often negotiate simultaneously with a large number of suppliers, and suppliers negotiate with more than one retailer. Consequently, bargaining can be influenced by these other simultaneous negotiations, with a commensurate impact on the outside options available to both of the

parties involved in the direct negotiations. For instance, if a retailer was simultaneously negotiating with a number of potential alternative suppliers for a particular product, then this would in general be likely to improve the retailer's outside options and, thereby, its bargaining power with each of the suppliers. Similarly, if a supplier was negotiating with a number of potential alternative buyers, this would in general improve its outside options and its bargaining power.

Bargaining outcomes in retail grocery supply can also be influenced by the degree of downstream competition from other retailers. This will be likely to affect the outside options of both the supplier of the grocery item, and the buyer/retailer.

- For the seller, a significant component of the outside option is the extent to which that supplier can instead place its products on the shelves of competing grocery retailers as an alternative way of reaching the final consumer. The greater the downstream competition, the greater the opportunities will be for the supplier to place its product on another retailer's shelves, which means that there is less chance that the supplier will lose sales by foregoing supply via a specific retailer. This means that a more competitive downstream retail industry will generally give a supplier greater outside options, and therefore greater bargaining power.
- The grocery retailer's typical walk away option is to delist the supplier's product or to refuse to accept a new product. The value of this outside option will depend on the impact the absence of the item from the retailer's shelves will have on final consumers. If a retailer delists a supplier's product, to what extent can this induce customers to switch to an alternative retailer? The more consumers value a specific brand or item etc., the greater the **incentive** will be for consumers to switch retailers. Similarly, the greater the extent of downstream competition, the greater the opportunity is for consumers to switch retailers, which increases the chance of them doing so (all else being equal).

A corollary implication is strong brands may have appreciable countervailing selling power. For instance, it has been observed that ALDI in Australia, which stocks predominantly products under its own in-house labels, nonetheless stocks a small number of very well known branded products (in particular, Vegemite, which is produced by Kraft, and Nescafe, which is produced by Nestle). The reason may be that certain specific brands command such brand loyalty that their absence from the shelves would be reason enough to induce some consumers to change retailers. This would have strong implications for the countervailing power of the suppliers of such goods in respect of bilateral bargaining between these suppliers and retailers.

Factors other than outside options may also influence the conduct and outcome of bilateral bargaining between suppliers and retailers. These factors include:

- **The role of information:** are there information asymmetries regarding the different parties' knowledge of the other parties—for instance, regarding other parties' cost structures? An informational advantage may give rise to an advantage in terms of bargaining power.
- **Coordination (tacit or explicit) among suppliers:** the presence of incentives for suppliers to undercut any supplier collusion (e.g. to obtain a large order from a retailer) may increase buyer bargaining power.<sup>6</sup>

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6 For a formalisation of this notion, see C M Snyder, 'Why do large buyers pay lower prices? Intense supplier competition', *Economics Letters*, vol. 58, 1999, pp. 205–09.

## 14.4 Possible sources of buyer bargaining power

This section examines the possible sources of buyer power that have been analysed in the economic literature and provides a framework for assessing the evidence that has been presented to this inquiry about possible buyer power.

### 14.4.1 Absolute size of buyer

A commonly cited source of buyer bargaining power is the absolute size of the buyer. The typical notion is the larger the buyer, the greater its bargaining power. However, there is also persuasive empirical evidence that mere size alone does not, in and of itself, confer buyer bargaining power, but rather that the bargaining power may be more closely related to the size/value of the relative outside options than it is to the respective sizes of the firms alone.<sup>7</sup>

A commonly cited reason is that a larger firm size may increase the value of the firm's outside options, which will increase the firm's bargaining power (in the context of bargaining models—e.g. the simple model outlined in appendix I). Alternatively, if the larger is a buyer, the lower will be the value of the outside options of the sellers with which it trades (all else being equal).

One proposed reason for the improved outside option value of a larger firm is that the firm may have more attractive alternative sources of supply than a smaller firm, thereby increasing its outside options and its bargaining position. A different way of viewing this is that a larger firm, with its better range of alternative suppliers, may therefore be able to more credibly threaten to find alternative suppliers during negotiations, which will similarly improve its bargaining position.

Closely related to this is the idea that a larger firm might be better positioned to make a credible threat (during negotiations) of producing its own private label products (as an alternative to proprietary branded products) as an outside option. It is argued that a larger buyer may be able to make a more credible threat of such backward integration into its own private label production, which means that a larger buyer may have a better bargaining position (everything else being equal) than a smaller buyer.<sup>8</sup>

It has further been proposed that the presence of large buyers may increase the threat of entry by additional alternative suppliers, and that this may in turn lead to the large buyer being able to make more credible negotiating threats that it will sponsor the entry of such new alternative suppliers.

Finally, it has been proposed that size disparities between a large buyer and a small supplier can bring about differences in bargaining power—for example, if negotiations with the large buyer were to break down, the small supplier could find it difficult to find alternative buyers for the quantities of stock in its possession.<sup>9</sup>

### 14.4.2 Relative dependency on the relationship

A second possible, and potentially important, source of buyer power raised in the economic literature is the relative dependency of two parties on a particular buyer–seller relationship. The idea is that, where

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7 See S F Ellison and C M Snyder, 'Countervailing power in wholesale pharmaceuticals', MIT Department of Economics working paper, no. 01–27, 2001.

8 See, for example, M L Katz, 'The welfare effects of third degree price discrimination in intermediate goods markets', *American Economic Review*, vol. 77, 1987, pp. 154–67; and D T Sheffman and P T Spiller, 'Buyers' strategies, entry barriers, and competition', *Economic Inquiry*, vol. 30, pp. 418–36.

9 See, for example, R Inderst and C Wey, 'Buyer power and supplier incentives', *European Economic Review*, vol. 51, 2007, 647–67.

a buyer and a seller are in a supply bilateral relationship and the relationship is of substantial financial importance to the seller but of lesser importance to the buyer, this will impart bargaining power on the buyer.

This may occur for two separate but interrelated reasons. First, where there is an unequal relative dependency on the relationship, there is likely to be an asymmetry in the respective consequences should either party walk away from the relationship. If the buyer walks away from negotiations, the consequences for the seller would be significant—whereas the consequences for the buyer of the seller walking away would be less significant. Second, because the consequences for the buyer of walking away are not significant, any threat by the buyer to walk away from negotiations would be a credible threat. The interrelationship of these two factors in the case of a relatively dependent seller and a relatively non-dependent buyer would result (all else being equal) in the buyer having greater bargaining power than the seller.

The effect of asymmetric relative dependency on the relationship is captured in an OECD definition of a retailer having buyer power, which states that a:

... retailer is defined to have buyer power if, in relation to at least one supplier, it can credibly threaten to impose a long term opportunity cost (i.e. harmful or withheld benefit) which, were the threat carried out, would be significantly disproportionate to any resulting long term opportunity cost to itself. By disproportionate, we intend a difference in relative rather than absolute opportunity cost, e.g. Retailer A has buyer power over Supplier B if a decision to delist B's product could cause A's profit to decline by 0.1 per cent and B's to decline by 10 per cent.<sup>10</sup>

There are several factors which are helpful in identifying this type of buyer bargaining power. Firstly, the relative shares of economic return for the buyer and seller, which are dependent on the relationship with the other, can be analysed. Dependency in this sense includes both direct and indirect dependence, and extends to that share of return which would be lost if the other party walked away from the relationship. Secondly, how readily a supplier can replace the buyer as a customer, and similarly how easily the buyer can replace the supplier as a source of supply, can be examined.

### 14.4.3 Impact of private labels

If the buyer has its own private labels that compete with the seller's product (or if the buyer can readily create and have manufactured such private label goods), then this is likely to be a further source of buyer power.

This is because if a buyer has private labels that compete with the supplier's products, its outside options are improved, thereby increasing its bargaining power relative to the supplier. Furthermore, even if the buyer does not have private label products that compete with the supplier's goods, the mere credible threat to integrate backwards and produce its own competing products can impart increased relative bargaining power on the buyer (see 14.4.1). Where a buyer already has private label goods in other ranges, this may enhance the credibility of any threat by the buyer to integrate backwards into a range of goods that compete with those of the supplier in question.

The actual impact of private labels on bargaining power is also likely to depend on consumer preference. For instance, if consumers do not view private label products as being close substitutes for a supplier's proprietary branded products, the supplier's bargaining power will not in general be as adversely affected as if consumers viewed the products as close substitutes. Furthermore, and closely

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<sup>10</sup> OECD, *Buyer power of large scale multiproduct retailers*, background paper by the Secretariat, Roundtable on Buying Power, Paris, 1998, para 20.

related to the last point, when consumers show strong brand loyalty to a supplier's products, this generally enhances the supplier's bargaining power when negotiating with grocery retailers buying its products.

The actual impact of private labels on retailers' bargaining power needs to be evaluated on the evidence relating to a particular market. The ACCC notes that there is some empirical economic evidence that private label goods do in general bestow greater bargaining power on retailers.<sup>11</sup>

Private labels and the competitive effects they have in the industry are explored in detail in the chapter 16.

#### 14.4.4 Consumer behaviour

Consumer behaviour is also a possible source of buyer power. One of the constraints on the behaviour of retailers is the ability of consumers to switch to another retailer if their preferred items are not stocked by the retailer.

A key factor in the strength of this constraint on a particular retailer (and a particular item) will be the importance to consumers of the particular item, and how willing and able consumers are to substitute a similar item (e.g. a different brand of the same product, or a private label version).

A consumer whose favourite product is de-listed by their habitual retailer or whose habitual retailer prices higher than competitive retailers may decide that they are better off shopping elsewhere on the basis of a whole range of factors that influence choice of retailers (price, convenience, etc.). In other words, a consumer may engage in 'efficient switching' to another retailer or set of retailers.

However, such efficient switching by consumers may be restrained to some degree by two typical characteristics of consumer behaviour.

Firstly, consumers tend to exhibit one-stop shopping behaviour. For a variety of reasons (including direct costs, such as travel costs and time costs), consumers typically tend to prefer to do their routine shopping at fewer rather than more—and often only one—locations (all else being equal).

Secondly, consumers tend to exhibit some inertia in their shopping behaviour, again for a variety of reasons (including search costs, direct costs, and forces of habit). A consumer's responsiveness to de-listing of items by their preferred retailer may therefore be somewhat dampened.

Furthermore, such efficient switching by consumers in response to price changes and product de-listings may also be limited by information bounds. Supermarkets and large retailers stock a vast range of items. Consumers may not know or be able to process the full range of availabilities and prices at their preferred retailer and its competitors. Indeed, it may be entirely rational for consumers not to obtain the full set of information that would be needed for efficient switching among retailers, given that obtaining, absorbing and processing such a vast amount of data could well be costly in terms of direct costs, time costs and effort. Nonetheless, such a 'boundedly rational' limit on the information that consumers obtain and process may mean that consumers do not efficiently switch between retailers, and remain loyal to retailers even where another retailer offers a better over-all deal, because the consumer does not have all the information regarding better deals at hand.

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<sup>11</sup> For a survey of the evidence, see R Inderst and N Mazzarotto, 'Buyer power in distribution', chapter in the *ABA Antitrust Section Handbook: Issues in competition law and policy* (W D Collins, forthcoming).

## 14.5 Possible consequences of buyer power

This section discusses the possible consequences of buyer power, as they have been discussed in the economic literature, on:

- final retail prices and consumer welfare
- suppliers (generally)
- other (e.g. non-favoured or non-integrated) suppliers
- other retailers.

### 14.5.1 Impact on retail prices and consumers

If a retailer has upstream buyer power, this will typically permit the retailer to buy goods more cheaply. What will be the flow-on consequences of this buyer power on final retail prices (to consumers) and consumer welfare?

Broadly, there are two competing explanations in respect of the impact that buyer power will have on retail consumers.

In the more benign explanation (from a consumer's perspective), retailers pass lower supply prices on to final consumers by way of retail prices. The typical narrative is that the retailer with buyer power upstream can reduce its buying costs (through decreased input prices by bargaining power or by vertical integration, or both), then pass these discounts on (fully or partially) to its retail customers, thereby lowering retail prices, as compared with a situation where the retailer has no buyer power. The lower retail prices confer a net benefit on consumers (that is, consumer surplus is increased) compared with a situation where the retailer does not have market power.<sup>12</sup>

By contrast, in the more malign explanation, the input cost savings are not passed on to consumers but, rather, absorbed by the retailer in the form of increased returns. The typical narrative of this explanation is that the retailer with upstream market power (enabling input cost savings) may also have downstream market power, which enables the retailer to not decrease (and perhaps even increase) the downstream retail price to final consumers. The higher retail price imposes a net cost on consumers (that is, consumer surplus is decreased) compared with the situation where the retailer does not have market power.

Formal economic theory in the area of buyer power and its consequences is still developing, and while it provides some assistance in enabling the relative merits of these two alternative narratives to be analysed, this is not yet conclusive.

One stream of economic models produces results broadly in sympathy with the benign explanation. Certain economic modelling demonstrates that, assuming downstream competition and other plausible assumptions and conditions, a decrease in input prices will be passed on (at least partly) to consumers in the form of lower retail prices, and that this will result in an increase in consumer welfare (consumer surplus).<sup>13</sup> Other modelling shows that, when retail is characterised by a single dominant firm with buyer power, along with a competitive fringe of smaller firms, there will be a similar fall in retail prices.<sup>14</sup>

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12 See P Rey and J Tirole, 'A primer on foreclosure', IDEI working papers 203, Institut d'Économie Industrielle, 2003, Toulouse; Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25.

13 See P Rey and J Tirole, 'A primer on foreclosure', IDEI working papers 203, Institut d'Économie Industrielle, 2003, Toulouse.

14 See Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25.

However, other economic models featuring oligopolistic competition in retail markets produce more ambiguous results, whereby buyer power can lower or raise retail prices, depending on certain further conditions and assumptions. In particular, certain economic models find that retailers with buyer power will only pass upstream cost savings on to consumers if there is sufficient downstream competition among the different retailers.<sup>15</sup>

In the grocery industry, buyer power may be driven substantially by a lack of alternatives available to the supplier to obtain access to consumers for their goods, resulting from the concentrated nature of grocery retailing. This suggests that models featuring downstream oligopolistic competition may be more applicable to the Australian grocery retailing context.

### 14.5.2 Impact on suppliers

If a retailer has upstream buyer power, this will typically permit the retailer to buy goods more cheaply. What will be the flow-on consequences of this buyer power for suppliers?

Allegations that buyer power has a detrimental impact on suppliers are a partial motivation for public interest in grocery retail competition, including this inquiry, and other similar national and other inquiries. A common allegation is that buyer power results in suppliers being paid lower prices than they would receive otherwise. Other typical complaints in relation to misuse of buyer power by retailers in their dealings with suppliers include pressure on suppliers to give ‘unjustified discounts’, demands for help against rival retailers, loss-leading behaviour, and retailers charging shelf slotting or listing fees.<sup>16</sup>

The economic analysis of buyer power broadly supports that such reduction in the price paid to upstream sellers may occur.

Where the item is traded in a wholesale market setting, a powerful buyer can reduce its demand and thereby reduce the market price at which the good is traded by all buyers and sellers (see appendix I). Where the item is traded in a series of bilateral buyer-seller relationships, a buyer who has greater bargaining power than the corresponding seller may be able to capture most or all of the joint surplus arising out of the bilateral supply relationship (see section 14.3 and appendix I).

It was noted in 14.3 that bilateral bargaining buyer power may arise in particular where a buyer has significantly better outside options than the seller (the absolute sizes of the buyer and seller, their relative dependency on the relationship, their relative financial fragility and consumer behaviour may also influence the relative bargaining powers of the buyer and seller). A typical situation giving rise to asymmetric bargaining power in grocery retail may be where the supplier has no (or poor) alternative channels through which to supply its product. This situation is more likely to occur (all else being equal) where there is weak or no competition in a local retail market.

### 14.5.3 Impact on other suppliers and supply prices—vertical integration

Vertical integration (i.e. backward integration or the production of their own private label products) by large buyers may be harmful to suppliers that are independent of the large buyer. Such backward integration—or a credible threat to do so—by the large buyer, and the associated foreclosure (or threat thereof) of the supplier by the large buyer, will generally improve a large buyer’s bargaining position, which enables the large buyer to obtain a lower supply price and/or better other terms and conditions from the independent supplier.

<sup>15</sup> See T von Ungern-Sternberg, ‘Countervailing power revisited’, *International Journal of Industrial Organization*, 14, 1996, pp. 507–19; P Dobson and M Waterson, ‘Countervailing power and consumer prices’, *Economic Journal*, 107, 1997, pp. 418–30.

<sup>16</sup> OECD, ‘Buying power of multiproduct retailers’, series of roundtables on competition policy, DAF/CLP(99) 21, p. 18.

Further, such backward integration and/or foreclosure may in the longer term also have an impact on the structure and costs of the upstream supply market. If independent suppliers exit the upstream market (in response to reduced sales and/or prices), this may ultimately cause an increase in the upstream costs of production. This in turn (all else being equal) may lead to an increase in final retail prices and a consequent decrease in consumer prices.<sup>17</sup>

#### 14.5.4 Impact on suppliers' incentives to invest and innovate

A further possible consequence of buyer power is that it may dampen the incentives of upstream buyers to invest and innovate, although there are also powerful economic arguments to the contrary<sup>18</sup>. The economic literature is not conclusive on this point.

The economic argument in favour of this proposition (that buyer power dampens upstream innovation) is essentially that of the classic 'hold-up' problem. If a large buyer has strong bargaining power relative to its suppliers, then it can capture a large share of any future joint surpluses arising out of its bilateral supply relationships. Suppliers, in turn, may 'respond by under-investing in innovation or production'<sup>19</sup> because they foresee that they will not be able to capture an adequate portion of the total return on the investment that they need to make to fulfil the supply order. Because they will not be able to capture adequate returns, they do not make the investment in the first place. This effect is said to lead, over a sector, to under-investment in productive capacity and innovation.

One contrary view is powerful buyers, rather than causing a hold-up problem, may instead be able to help overcome hold-up problems. An argument is that large buyers may have strong incentives to develop long-term relationships with suppliers and to co-sponsor investments with these long-term suppliers, and that this may in fact enhance the incentives of such suppliers to invest and innovate.

A further contrary view is that, if there are few large buyers, this may reduce transaction costs and coordination problems in upstream markets (compared to if there were many small buyers). The argument is that this may enable more efficient contracting in the supply relationship and, in particular, may enhance incentives for and prospects of long-term contracting, which would enhance the incentives for those suppliers to invest and innovate.

A final contrary argument is that the presence of a powerful buyer may also increase the incentives for suppliers to invest and innovate in that such investment may increase the ability of those sellers to sell their product through alternative buyers.<sup>20</sup>

#### Incentive to innovate—impact on product variety

If the presence of buyer power has an impact on incentives to invest and innovate, this may in turn have an impact on the breadth of product variety produced in upstream markets (and available to retail consumers downstream). A reduction in product variety is generally considered to cause a reduction (all else being equal) in consumer welfare, as it decreases the choice of products from which consumers can select.

Economic analysis has demonstrated that where a monopoly manufacturer sells a range of differentiated products through a large retailer and a number of small retailers, an increase in the buyer

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17 See C C de Fontenay and J S Gans, 'Vertical integration in the presence of upstream competition', *RAND Journal of Economics*, 36(3), 2004, pp. 544–72.

18 See R Inderst, and C Wey, 'Buyer power and supplier incentives', *European Economic Review*, vol. 51, 2007, pp. 647–67.

19 See Federal Trade Commission, Report on the Federal Trade Commission workshop on slotting allowances and other marketing practices in the grocery industry, report by the Federal Trade Commission staff, Washington, DC, 2001.

20 See R Inderst and C Wey, 'Buyer power and supplier incentives', *European Economic Review*, vol. 51, 2007, pp. 647–67.

power of the large retailer can reduce the variety of products that are manufactured, thereby tending to reduce consumer welfare (all else being equal). Simultaneously this can reduce the retail price paid by consumers, thereby tending to increase consumer welfare (all else being equal).<sup>21</sup> The net impact on consumer welfare depends on which effect outweighs the other, and the formal modelling in question demonstrates that it is possible that the decrease in welfare from loss of product variety can outweigh the welfare enhancing impact of lower prices.

However, the formal economic analysis in this area is not conclusive, and the actual impact on product variety and consumer welfare in any set of circumstances will need to be determined in light of the empirical evidence connected with the particular circumstances.

### 14.5.5 Impact on other retailers

A retailer buyer with buyer power may also have an impact on other competing retailers.

Two broad issues emerge from the economic literature. Firstly, the large retailer's buyer power may affect supply prices paid by other retailers. Secondly, the large retailer's buyer power may, over time, affect retail market structure.

#### Impact on supply prices paid by other retailers

A large retailer with buyer power may be able to use this to obtain lower input prices than it might otherwise be able to obtain without buyer power. This effect may in turn affect input prices that other competing retailers pay for their inputs. But will the other retailers face increased or decreased input prices as a result of the large retailer's buyer power?

The economic literature on this subject is still quite small and not yet clear, and there is in fact a conflict in the results arising from different analytical models that have been proposed, with certain analytical models proposing the result that other retailers pay lower input prices because of the large retailer's buyer power. Other models propose the opposite result—that other retailers pay higher input prices.

In a simple textbook monopsony power framework, the result appears quite clear that other retailers will also pay lower input prices. In this framework, buyers and sellers interact in the context of a single wholesale market, and the input is traded at a single wholesale price. The large buyer can obtain a lower input price by withholding demand. The other retailers also pay the same wholesale price for the input, so that the other retailers benefit from the same decreased input price.

However, as discussed in section 14.3 and appendix I, the monopsony power framework is unlikely to be the appropriate framework for analysis of buyer power in most retail input markets. The clear results from this simple framework cannot be relied upon to any significant extent.

Some papers within the bilateral bargaining literature (which is likely to be more appropriate for analysing grocery supply markets—see section 14.3 and appendix I) similarly conclude the smaller competitive fringe retailers will benefit from a lower supply price in a bargaining framework. One recent paper shows that, where there is an increase in the bargaining power of a single large retailer, upstream suppliers may find it strategically optimal to also set a lower wholesale price for the competitive fringe.<sup>22</sup> Another recent paper shows that if large retailers with buyer power compete more aggressively in downstream retail markets in consequence of obtaining a lower input price, then this may reduce the downstream demand for products on sale by the smaller retailers, which will in turn reduce their

21 See Z Chen, 'Countervailing power and product diversity', mimeo, <http://ideas.repec.org/p/ecm/hawm04/279.html>; and P Battigalli, C Fumagalli and M Polo, 'Buyer power and quality improvement', CEPR discussion papers 5814, CEPR, discussion papers, 2007.

22 See Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25.

upstream demand for inputs, which may in turn lead to the smaller retailers also paying a lower retail price.<sup>23</sup>

Another group of papers, however, concludes that a large retailer's buyer power will instead force up the input prices paid by other competing retailers. Among these is a subgroup of papers that argues for the existence of a supposed 'waterbed effect', which pushes up the price paid by other retailers. Under this proposed waterbed effect, an increase in buyer power that lowers the large buyer's input price would lead suppliers to seek to recover lost profits by charging higher prices to other buyers that do not have the same level of bargaining power.

A typical explanation for this is a cost shifting narrative. This explanation relies on suppliers incurring certain fixed costs. If the suppliers recover fewer of these fixed costs from the large buyer (which forced their input price down by bargaining power) or none of them if the powerful buyer negotiates to pay marginal costs, according to the argument the suppliers must recover more of these fixed costs from other buyers. It is argued that the suppliers must shift more or all of their fixed costs onto smaller/weaker buyers, thereby increasing the total price paid by those weaker buyers.<sup>24</sup>

Another mechanism by which, it is argued, this effect may occur is through a change in the upstream market structure. In this explanation, if suppliers' profits are eroded by a powerful buyer negotiating lower input prices, this may induce smaller or weaker suppliers to merge or exit the industry. This in turn may weaken the bargaining power of the weaker buyers, as their best outside option bargaining positions deteriorate if there are fewer potential suppliers. This weaker bargaining position then leads to them having to accept higher input prices.

This proposed waterbed effect has had a certain influence in the thinking of competition authorities. For example, the UK Competition Commission has considered that such an effect might occur in the private healthcare market as a result of a merger in that industry<sup>25</sup>, and it has stated in the context of investigating prospective supermarket mergers that:

The exercise of buyer power by the merged entity would have adverse effects on other, smaller, grocery retailers through the 'waterbed' effect—that is, suppliers having to charge more to smaller customers if large retailers force through price reductions which would otherwise leave suppliers insufficiently profitable ...<sup>26</sup>

But the existence (and if it exists, the relative importance) of such a waterbed effect is far from universally accepted. A common objection is that this sort of cost-shifting violates standard axioms of profit maximisation—if the supplier is able to charge higher prices of the smaller retailers after the decrease in price charged of the powerful buyer, why didn't they do so before? A second objection is that a number of the influential economic models of buyer power predict the opposite result—that is, that a decrease in the price paid by the powerful buyer will result in the smaller competing buyers also paying a reduced price.<sup>27</sup>

Further, even if a waterbed type effect exists and results in weaker retailers paying higher input prices, it is far from clear from the economic modelling what the impact will be on downstream prices. This second question is a separate—even if related—question, the answer to which will depend partly on the state of competition in the downstream retail sector.

23 See S P King, 'Does buyer power benefit outsiders?', mimeo, 2008.

24 See, for example, A Majumdar, 'Waterbed effects and buyer mergers', CCP working paper 05–7, University of East Anglia, 2005.

25 Competition Commission, Supermarkets: a report on the supply of groceries from multiple stores in the United Kingdom, Cm 4842, HMSO, 2000, p. 2.180b.

26 Competition Commission, Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc, Cm5950, HMSO, 2003, p. 2.218.

27 See, for example, Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25; and S P King, 'Does buyer power benefit outsiders?', mimeo, 2008.

However, competitive harm to other buyers/retailers as a result of a powerful retailer's buyer power can also occur through other channels that do not require the existence of a waterbed effect.

One possible effect is where a powerful buyer also has a 'first mover advantage' in retailing—that is, it establishes itself in the retail sector before its competitors. Economic models analysing this situation have concluded that such a first mover advantage in retail supply markets can benefit the powerful buyer while leaving other buyers worse off.<sup>28</sup>

Others have proposed that aggressive loss-leader pricing by large retailers can inflict competitive damage on smaller, weaker retailers. However, there are also counter arguments that dispute the extent or existence of such effects.

Because of the lack of clarity and conclusiveness in the economic literature on this issue, the actual impact on other retailers of a large retailer's buyer power will need to be assessed on the basis of the particular factual evidence.

There is some empirical evidence that larger buyers tend to pay lower upstream input prices than smaller retail buyers.<sup>29</sup> However, lower upstream prices paid by a large retailer do not in and of themselves necessarily mean that these prices are lower because the large buyer is exercising some degree of undue buyer power. Variations in price can also reflect genuine cost differences. It may, for example, be that there are economies in supplying larger orders for larger retailers. Further, a large chain may also be able to generate efficiencies through, for example, more efficient supply and purchasing strategies. Thus lower input prices do not necessarily lead to the conclusion that there is a market power or anti-competitive reason for these cost differences. If there are cost differences, it is a matter for an inquiry to decide, on the basis of the evidence, the reasons for the differential.

### Impact over time on retail market structure

The second issue regarding the impact on other retailers is the effect that buyer power may have over time on retail market structures.

A powerful buyer may be able to obtain lower input prices from suppliers, which may in turn be passed on, fully or partially, to retail consumers in the form of lower retail prices.

According to one school of argument, this may give rise to virtuous circles, whereby the lower price retailers expand their sales further, thus enabling them to obtain even lower input prices from suppliers, which will be passed on to consumers in the form of even lower retail prices, and so forth, to the consumer's expanding benefit in the form of retail prices that are continually and progressively ratcheted down.

The common counter-argument to this point of view is what might be termed the vicious circle proposition. According to this view, virtuous circles of continually decreasing retail prices rely crucially on the assumption that smaller/weaker retailers will not exit the retail market. According to this argument, this is an unrealistic assumption, as ever-decreasing prices will progressively push out retailers, starting with the weakest—for example, those with the lowest retail margins. Following this argument further, as weaker retailers are progressively pushed from the market, the remaining retailers will benefit from a corresponding increase in downstream market concentration and decrease in competition, which may lead to higher prices in the long run and even progressively increasing prices if

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28 See, for example, F Mathewson and R Winter, 'Buyer groups', *International Journal of Industrial Organization*, vol. 15, 1996, pp. 137–64; J S Gans and S P King, 'Exclusionary contracts and competition with large buyers', *International Journal of Industrial Organization*, vol. 20, 2002, pp. 1363–81.

29 Competition Commission, *The supply of groceries in the UK market investigation*, 2008, paras 5.19–5.43.

weaker retailers are pushed out of the market (the proposed vicious circle).<sup>30</sup>

There are, however, counter-objections to such vicious circle arguments. Firstly, it is argued that such models do not account for competition that could arise from other sources (for example, from entry), or from expansion by an existing smaller player to occupy a market position characterised by greater product differentiation.

The economic literature is, as with other relevant branches of the economic literature, conflicted and uncertain in its conclusions on this. The longer term impact of buyer power on retail market structures will need to be determined based on the empirical evidence arising out of the relevant retail market.

## 14.6 Cases on buyer power under section 46 of the Trade Practices Act

### 14.6.1 ACCC v Safeway

In 2001 the ACCC began proceedings against Australian Safeway Stores Pty Ltd (Safeway)<sup>31</sup>, a member of the Woolworths Limited Group, for breaches of ss. 45(2)(a)(ii), 46, 47 and 48 of the Trade Practices Act.

The ACCC alleged Safeway had a policy that, if bread products of a manufacturer were being sold on special by another retailer (other than Coles or Franklins) in the vicinity of a Safeway store at a price under what was being charged at the Safeway store, all the manufacturer's bread products would be removed from sale at that Safeway store and other nearby Safeway stores until the retailer ceased selling the manufacturer's products at the special price.

The ACCC also alleged that Safeway's conduct attempted to punish bread manufacturers Tip Top, Sunicrust and Buttercup for selling bread to independent stores at prices that enabled them to retail at less than the prices at which Safeway was selling the bread. Further, the ACCC alleged that by the implementation of the so-called 'deleting' policy—that is, ceasing to stock, display or sell the bread product—the bread manufacturers were discouraged from both supplying bread to retailers at prices which enabled them to discount the bread and from supplying bread to retailers that were likely to sell the bread at prices cheaper than Safeway.

Safeway denied it had such a policy and instead argued its conduct was pro-competitive rather than punitive. Safeway said it would ask the bread manufacturer for a 'case deal'. This involved requesting a cost price equal to that of Safeway's competitors, allowing Safeway to sell its bread at a similar price to its competitors who were offering the discounted price. Safeway argued that the bread manufacturers had refused the case deal and that these deletions were a result of their refusal. However, evidence during the trial showed that these case deals were only sought in five of the nine instances of product deletion.

The case was heard in the first instance by Justice Goldberg who held that the alleged contraventions of ss. 45, 46, 47 and 48 had not been made out. In relation to s. 46, Justice Goldberg found that Safeway had a substantial degree of market power in the wholesale market for the acquisition of bread but had not taken advantage of that market power because there was no connection between their market power and the relevant conduct.<sup>32</sup>

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30 See, for example, R Inderst, 'Leveraging buyer power', *International Journal of Industrial Organization*, vol. 25, 2007, pp. 908–24.

31 Australian Competition and Consumer Commission v Australian Safeway Stores Pty Ltd (N. 3) (2001) 119 FCR 1.

32 ACCC v Australian Safeway Stores Pty Ltd (No 3) (2001) 119 FCR 1, 258.

The reality of a competitive wholesale market in which Safeway did not have substantial market power would be that Safeway would still have alternative sources of supply available if a plant baker refused to stop selling bread to an independent store and Safeway stopped buying that plant baker's bread.<sup>33</sup>

On appeal in 2003, the Full Federal Court found that four agreements entered into by Woolworths with liquor license applicants contravened s 45 of the Act. The court found that Goldberg J had erred in finding that Safeway had not taken advantage of its substantial market power.<sup>34</sup> Heerey and Sackville JJ, in their joint decision, held there would have been no purpose or benefit for Safeway to delete the bread products from its stocks in a competitive market and applied the decision in *Melway*<sup>35</sup> in determining that:

Safeway's conduct in the four instances was therefore *materially facilitated* by the existence of its market power even though that same conduct would not have been 'absolutely impossible' without that power.<sup>36</sup> [Emphasis added.]

Special leave to appeal to the High Court was refused in 2004.<sup>37</sup> On 31 January 2006, on reversion from the Full Federal Court, Goldberg J imposed on Safeway a penalty of \$8.9 million.

## 14.7 Conclusions

This inquiry broadly prefers a bilateral bargaining power model as the appropriate analytical framework to analyse buyer power in the grocery retail industry, in preference to a monopsony power framework. This is because the bilateral bargaining model more closely fits the actual structural features of grocery supply markets (a series of bilateral relationships, rather than wholesale markets), and better predicts empirical outcomes of grocery retail supply (decreases in price often not accompanied by decreases in quantity).

Buyer power may have an impact on any or all of consumer welfare, other competing retailers, and suppliers to the buyer, as outlined in this chapter. There may also be an impact on related aspects such as supplier market structures, and product variety, as discussed above in this chapter.

However, the formal economic theory of buyer power (especially in relation to bilateral bargaining power) is still developing, and the exact nature of the impact of buyer power is in some respects still not clear from formal economics. For instance, it is not clear a priori what will be the impact of buyer power on downstream retail customers. Retailers may pass on upstream savings due to buyer power, thereby benefiting consumers, or they may not. Buyer power can not be said to be per se either enhancing or destructive of downstream competition or final consumer welfare. Similarly, buyer power that reduces a large retailer's input prices may also result in decreased input prices for other retailers, or it may result in increased prices to competing retailers (e.g. by way of a waterbed effect). In consequence, judgments regarding the impact of buyer power in the hands of large retailers must still remain (to some extent at least) an empirical judgement based on the evidence arising out of specific factual situations.

The evidence that has been presented to this inquiry about buyer power is considered in the next chapter.

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33 ACCC v Australian Safeway Stores Pty Ltd (No. 3) (2001) 119 FCR 1, 259.

34 Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores Pty Ltd (2003) 129 FCR 339.

35 Melway Publishing Pty Ltd v Robert Hicks Pty Ltd t/as Auto Fashions Australia (2001) 205 CLR 1, 23.

36 ACCC v Australian Safeway Stores Pty Ltd (2003) 129 FCR 339, 409.

37 Both Safeway and the ACCC made applications seeking special leave to appeal to the High Court of Australia on various aspects of the Full Court decision. Safeway sought to appeal against the findings of ss. 45 and 46, and the ACCC sought to appeal the finding that Safeway had not misused its market power in five of the nine instances alleged.

# 15 Evidence of buyer power

## Key points

- The major supermarket chains (MSCs) and Metcash have significant buyer power in packaged groceries because suppliers of packaged groceries effectively have little option other than to deal with those companies.
- Suppliers of key brands of packaged groceries have countervailing power in relation to those brands. However, this countervailing power is generally not sufficient to offset buyer power across the supplier's entire range.
- The greater number of options available to sellers of fresh produce and meat—which include export, food service and sale into the wholesale markets—limit the MSCs' buyer power in relation to those products overall.
- The MSCs may be able to exercise significant buyer power in relation to a particular seller but the extent to which they are able to do so is dependent on the outside options available to that seller.

## Effect of buyer power

- The inquiry was provided with little evidence to substantiate anecdotal allegations of buyer power being exercised in an anti-competitive or unconscionable manner rather than simply to drive a bargain that was harder than the supplier would have preferred. Having said that, there were some complaints of buyer power being exercised where the complainant appeared to be genuinely concerned about retribution if details were provided to the ACCC and investigated.
- In relation to fresh produce, there is no credible evidence that MSCs (or anyone else) can manipulate wholesale prices to suppress prices below competitive levels.
- Farm gate prices are determined by the supply and demand conditions prevailing in the relevant market, rather than by buyer power. In many instances, farm gate prices are heavily influenced by supply and demand in world markets.
- MSCs generally buy products on better trading terms than other buyers. This is often because of the MSCs' stronger buyer power. However, suppliers consider that the MSCs are also better able to execute agreed promotional activities and this is reflected in suppliers' willingness to offer higher discounts to the MSCs.
- There is little evidence that incentives to innovate are being impacted upon adversely by buyer power.
- Competition is not sufficiently strong at the retail level to ensure that consumers always benefit from buyer power in the form of lower retail prices.

## 15.1 Introduction

There is considerable community concern, particularly in relation to fresh produce, that the MSCs are able to, and do, force down the prices that they pay to suppliers below the levels that would prevail in a competitive market. Such circumstances may arise if MSCs have buyer power, the exercise of which enables the MSCs to achieve supply terms that they could not achieve in a more competitive market. Community concern is often exacerbated by the apparently large differences between the

prices that suppliers receive for their produce and the retail price that consumers ultimately pay, leading to suspicions that the MSCs are exploiting not only suppliers but consumers as well. In recognition of these concerns, the ACCC has examined a number of fresh produce items in more detail. The results of these case studies were presented in chapter 12.

This chapter examines the evidence that has been presented to the grocery inquiry that may indicate the presence of buyer power. This evidence is evaluated using the framework that was set out in chapter 14.

Community concerns about buyer power are reflected in anecdotal claims that MSCs' buyer power is having a detrimental impact on sellers. Concerns were also raised that fear of buyers' retribution is preventing those sellers from coming forward and substantiating those claims. For instance, the National Association of Retail Grocers of Australia (NARGA) submitted:

Consider the situation of a major national grocery supplier, dealing with two customers taking 45 per cent and 35 per cent of his production respectively. Unless that manufacturer is prepared to lose 45 to 35 per cent of his sales or both, his ability or willingness to resist intimidation or risk retribution from either customer is virtually non-existent.<sup>1</sup>

The South Australian Farmers Federation expressed the problem as follows:

The reasons why growers won't speak out is that they are afraid of the repercussions of speaking out and they rely on the marketplace to work for them and therefore to ostracise themselves against that marketplace is in large part seen as not being in their best interests and so they come to our organisation and say, fix it. It's very difficult, however, to get individuals with anecdotal evidence to come forward under those circumstances because of the fear that surrounds it.<sup>2</sup>

Grow SA, Growcom and the National Farmers Federation expressed similar views.<sup>3</sup>

The Horticulture Australia Council, which claims to represent over 97 per cent of Australia's horticulture industry, gave an indication of the apparent magnitude of the concerns in its submission:

A recent survey of members agreed (85%) that growers were often unwilling to raise issues with major retailers and wholesalers for fear of retribution.<sup>4</sup>

Despite these concerns, the Produce and Grocery Industry Code Administration Committee told the inquiry:

From evidence that we have received from the Ombudsman there is anecdotal evidence of what you say in terms of fear of retribution but the Ombudsman has consistently reported to us that there has never been any actual evidence of that coming before the Ombudsman. Nor has there been any claim based on victimisation.<sup>5</sup>

Recognising that existing administrative arrangements may be inadequate to deal with suppliers' concerns, the ACCC placed a high priority in giving suppliers the opportunity to raise their concerns either publicly or in confidence during the inquiry. Every supplier who provided evidence at the inquiry's public hearings was summonsed to appear so that buyers could not draw any conclusions about a supplier's willingness to provide information to the inquiry. In addition, much of the evidence given to this inquiry by suppliers was provided on a confidential basis.

Despite this, there was very little in the way of specific evidence of harsh or unconscionable conduct by the MSCs, or specific incidents of apparent abuse of their market position by the MSCs. In fact, many

1 NARGA, submission no. 129, p. 2.

2 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 4.

3 See Grow SA, submission no. 112; Growcom, submission no. 6; ACCC, public hearing transcript, Canberra, 30 April 2008, p. 5.

4 Horticulture Australia Council, submission no. 63, p. 5.

5 ACCC, public hearing transcript, Melbourne, 30 May 2008, p. 6.

growers and suppliers summonsed to attend the hearings by the ACCC provided positive reports about the conduct of the MSCs, which would not normally be brought to the public's attention.

### 15.1.1 General comments on buyer power from evidence

The evidence presented to this inquiry on buyer power focussed on the MSCs and Metcash, with most emphasis on the MSCs. Much of this evidence was conflicting.

On the one hand, suppliers generally consider that the MSCs and Metcash have buyer power.

For example, the Australian Food and Grocery Council (AFGC), which represents 150 companies in the packaged food, drink and grocery products industry, submitted:

Undoubtedly the market power of the retailers and wholesalers has increased, in a market among the most concentrated in the world. As a result, there is substantial and increasing buying power of retailers and wholesalers in the Australian grocery sector.<sup>6</sup>

Commenting directly about Woolworths' buyer power, the AFGC continued:

Woolworths' move into the New Zealand market has increased its buying power for goods from suppliers who service both markets from Australia.<sup>7</sup>

The Australian Beef Association (ABA) submitted:

The supermarket duopsony has used its buying power to pressure wholesaler/processors to lower their prices and in-turn processors have used their relative market power to lower the price of livestock [beef]...While the supermarket duopsony is allowed to exercise unrestrained market power, Australian farmers will not be able to negotiate prices that reflect the cost of production.<sup>8</sup>

The Australian Honey Bee Industry Council's (AHBIC) views are similar to those of the AFGC and the ABA:

The AHBIC submits that through a variety of mechanisms the effective duopsony in Australian markets for the supply of inputs to the wholesale and retail levels of the grocery industry has been able to secure and exercise buyer power against suppliers. The effect of the exercise of buyer power by the MSCs against honey product suppliers has been to transfer rents, in this case quasi-rents, from honey product suppliers to the MSCs.<sup>9</sup>

George Weston Foods (GWF) provided a specific example of buyer power in the small goods industry:

The strong countervailing power of the MSCs is well documented. In the context of the smallgoods industry, the IBIS World Risk Report noted:

One of the biggest threats facing the profitability of the industry is the ongoing consolidation of the industry's retail foods client base. The continuing reduction in the number of retail buyers, the growth of giant supermarket chains and the use of category management practices is weakening the negotiating strength of the industry's players in supply contracts. The uptake of global supply strategies by the large supermarkets has also been one of the most significant issues facing the Australian Bacon, Ham and Smallgoods manufacturers.<sup>10</sup>

Another supplier told the inquiry confidentially:

I feel there's a lot of power at the buyer level. There's no doubt that I've never struck a national sales manager that hasn't basically lived in fear of what the buyer might do.

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6 Australian Food and Grocery Council, submission no. 73, p. 2.

7 Australian Food and Grocery Council, submission no. 73, p. 6.

8 ABA, submission no. 146, p. 6.

9 Australian Honey Bee Industry Council, submission no. 59, p. 10.

10 George Weston Foods, submission no. 138, p. 8.

Metcash implied that it does not have buyer power but that the MSCs do. Metcash submitted:

In general, Metcash is viewed as a 'third force' that dilutes the bargaining power of the major chains and strengthens the bargaining position of suppliers in the market.<sup>11</sup>

Woolworths agreed that its trading terms with suppliers reflect its strong bargaining power.<sup>12</sup> However, Coles submitted that suppliers often have countervailing power that offsets any buyer power it may otherwise have:

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.<sup>13</sup>

GWF disagreed with Coles' view, submitting:

Any market power that a supplier has is significantly diminished by the countervailing power of the MSCs who effectively control the process. A supplier is not in a position to charge more or provide less as the consequences of such a challenge to the MSCs would be profoundly detrimental.<sup>14</sup>

Some of the evidence discussed above, such as that from the AFGC and GWF, suggests that retail buying power is increasing over time to the detriment of suppliers. In addition, the inquiry heard confidential evidence from a supplier that Woolworths' negotiating position is becoming stronger as its market share increases, and that suppliers had more bargaining power prior to the sale of Franklins in 2001. In contrast, another supplier told the inquiry in confidence:

The MSCs are hard negotiators—they're very professional in their business dealings. But I wouldn't say it's gotten worse, and nor would I say it's unduly hard.

Along similar lines, Coles explained:

The relationship with suppliers is premised on the need to ensure an ongoing supply of quality products that meet consumers' needs and preferences. To achieve this, the supplier relationship must be open, fair and ensure a reasonable, mutually beneficial return. While it is not unusual for there to be some commercial tension in negotiations between suppliers and resellers, it is not in Coles' long term commercial interest to undermine these relationships by setting out to achieve one-sided outcomes. The vast majority of Coles' suppliers continue to value the relationship – some have been suppliers to Coles for more than 20 years.<sup>15</sup>

As outlined above, the evidence to the Inquiry as to the extent of the MSCs' buyer power and whether it is increasing, was varied. The following sections explore in more detail specific evidence that has assisted the ACCC form its views about the existence or otherwise of buyer power, and its consequent effect on competition and consumers.

## 15.2 Outside options

As explained in chapter 14, the outside options concept is critical to an assessment of buyer power in a bilateral bargaining context. A buyer's or seller's outside option(s) is simply the best outcome that either could achieve by walking away from negotiations relating to the supply of a product from the seller to the buyer. The extent of a buyer's power in any given transaction will depend crucially on the quality of the seller's outside option(s).

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11 Metcash, submission no. 217, p. 7.

12 ACCC, public hearing transcript, Melbourne, 19 May 2008, pp. 32–33.

13 Coles, submission no. 225, p. 32.

14 George Weston Foods, submission no. 138, p. 12.

15 Coles, submission no. 157, p. 5.

Supply to other domestic or overseas retailers may be a viable outside option for some suppliers. For suppliers of fresh produce and meat it is clear that in the short or medium term a number of outside options are available. These include export, the wholesale markets, food service and food manufacturing.<sup>16</sup>

The inquiry has heard evidence that the outside options available to suppliers of packaged groceries are generally more limited than those available to suppliers of fresh produce. Hence this section will consider the outside options available to buyers and sellers in each of those sectors in turn.

### 15.2.1 Packaged groceries—sellers' outside options

In the context of the supply of packaged groceries, a seller may have a range of outside options, including export to overseas customers, supply to other retailers or supply through other distribution channels such as food trade or direct supply to customers.

Limited evidence was provided to the inquiry about the potential for suppliers to supply directly to customers or through other distribution channels.

The ACCC is aware that some suppliers of packaged groceries currently export to overseas countries. Generally, however, export sales are a small share of revenue and it is not clear whether export volumes could be expanded rapidly to replace volumes lost by walking away from a large retail grocery buyer. Nevertheless, the inquiry heard confidential evidence from a supplier that is pursuing export markets in response to its perceptions of domestic retail buyer power.

Therefore, as the inquiry has been told, for many suppliers of packaged groceries, supply to other retailers remains the main outside option available.<sup>17</sup> The inquiry has heard evidence that supermarkets account for the vast majority of purchases of packaged groceries such as biscuits, snacks and soft drinks.<sup>18</sup> In this regard, the evidence indicates that many suppliers of packaged groceries cannot afford to walk away from negotiations with Woolworths or Coles as their outside options to sell their products are limited.

For instance, suppliers have suggested in confidential evidence to the inquiry that they do not have the option of walking away from negotiations with the MSCs because the MSCs typically account for such a large share of the supplier's sales that those lost volumes could not be made up entirely by placing the product in alternative distribution channels, particularly in the short run. A supplier told the inquiry in confidence that it could not afford to lose 100 per cent of its business with one of the MSCs because it would take time to replace the lost volume with increased sales through other retailers. Suppliers told the inquiry that a decision to walk away from an MSC would have a substantial impact on a supplier's operating profit, not only because of lost volumes but also because of the lost promotional opportunities that a relationship with an MSC provides.

The ACCC considers that for most suppliers of packaged groceries the outside options available are largely restricted to supply to other grocery retailers.

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16 See, for example, ACCC, public hearing transcript, Perth, 22 April 2008; ACCC, public hearing transcript, Canberra, 8 April 2008; ACCC, public hearing transcript, Canberra, 9 April 2008; ACCC, public hearing transcript, Brisbane, 3 April 2008; George Weston Foods, submission no. 138; and ACCC, public hearing transcript, Port Lincoln, 29 April 2008, p. 4.

17 Metcash, submission no. 181, p. 12.

18 Metcash, submission no. 181, p. 25, quoting ACNeilsen Shopper Trends, 2008.

## 15.2.2 Fresh produce—sellers' outside options

The evidence presented to the inquiry suggests suppliers of fresh produce, such as meat and fruit and vegetables, generally have more valuable outside options than most suppliers of packaged grocery products. In these cases, buyer power may be weaker.

For some suppliers of fresh produce, the outside option of supplying export markets rather than domestic retail markets is likely to be a viable alternative that enhances the seller's negotiating position. For instance, Coles told the inquiry:

Some locally sourced product, such as beef, are produced for export as well as 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.<sup>19</sup>

However, the ACCC understands that for some fresh produce, such as bananas and bread, there are limited or no export opportunities because of the perishability of the product.<sup>20</sup>

Furthermore, export markets may be an imperfect substitute for domestic supply because of the lead times required to switch from domestic to export markets. In addition, substantial investment in plant and equipment to meet export quality specifications may be required.

The view that the buyer power of grocery retailers and wholesalers is generally weaker for purchases of fresh produce compared with packaged groceries is consistent with evidence from Coles, which told the inquiry:

From Coles' perspective, we recognise that growers do have options and will increasingly develop them. While Coles considers 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.<sup>21</sup>

### Fruit and vegetables

Fruit and vegetable growers often have a range of outside options other than supply to domestic retail stores. These options may include supply to food processors, or export of fresh produce overseas.

For instance, the Australian Government Department of Agriculture, Fisheries and Forestry (DAFF) has estimated that in 2007, 55 per cent of domestic production of fruit and vegetables was sold as fresh produce, 36 per cent underwent further processing (canning, juicing etc.) and 9 per cent was exported.<sup>22</sup> IBISWorld estimated that 40 per cent of vegetables in June 2008 and 26 per cent of apples and pears in December 2007 were processed following harvesting.<sup>23</sup>

Processing of fruit and vegetables predominantly consists of manufacturing fruit and vegetable juice, or canned, preserved, frozen or dried product. Fruit and vegetables are also key inputs into many products such as sauces, jams, prepared meals and snacks. Certain products, such as potatoes, often tend to be used in processing. Processors generally compete with imported processed products and they also export their products.

<sup>19</sup> Coles, submission no. 225, p. 32.

<sup>20</sup> George Weston Foods, submission no. 138, p. 11.

<sup>21</sup> Coles, submission no. 225, p. 12.

<sup>22</sup> S Spencer and M Kneebone, *FoodMap: a comparative analysis of Australian food distribution channels*, Australian Government Department of Agriculture, Fisheries and Forestry, Canberra, 2007.

<sup>23</sup> IBISWorld industry report A0113, *Vegetable growing in Australia*, June 2008; IBISWorld industry report A0115, *Apple and pear growing in Australia*, December 2007.

There are also significant quantities of fresh fruit and vegetables which are exported. Exporters either contract directly with farmers or purchase from wholesalers in wholesale markets.

The ACCC understands that there are some restrictions on a grower's ability to switch between these distribution channels in the short term because of, amongst other things, differences in product specifications. For instance, the fruit and vegetables sold as fresh produce are generally of a higher grade than those used in processing, and they therefore demand a higher market price. Furthermore, the perishability of some produce such as bananas means that exports are not a viable alternative. Nevertheless, over time growers generally have some ability to switch from one distribution channel to another in response to profit opportunities.

Furthermore, for many types of fresh produce, direct supply to retailers is only one of several ways to get the produce to final domestic customers. This inquiry has heard that between 40 and 60 per cent of fresh fruit and vegetables are sold through the MSCs. The remaining volumes (also between 40 and 60 per cent) are sold through wholesale markets and to food service.

Consistent with these statistics, the inquiry was told that suppliers of fresh fruit and vegetables are often able to place their product on wholesale or export markets if they walk away from negotiations with Woolworths, Coles or Metcash.

Apple & Pear Australia Ltd submitted:

Apple and pear growers/producers mostly sell to a range of buyers including through the MSCs and the wholesale markets...In the absence of direct supply through MSCs, suppliers can sell through the wholesale markets or export.<sup>24</sup>

Similarly, R Ceravolo and Co. agreed with the proposition put by the ACCC in public hearings that there are realistic alternatives, including supply to wholesale markets, to supplying directly to Coles.<sup>25</sup>

In response to a question from the ACCC at a public hearing about viable alternatives if the MSCs reduced their demand, the Costa Group responded:

Yes, Aldi are a very big customer now, and, you know, the independents are certainly, collectively, are very large, and there is a number of large retailers out there. It's more a point of what business are you going to be in. I mean, we're located in growing regions; that is what our business is, but we could go and take a position in any or all of the wholesale markets at the same time, and have closer access to the independent retailers that are around the country, so there are options.<sup>26</sup>

## Meat

Meat and Livestock Australia estimates that 35 per cent of domestic production of beef in 2007 was consumed domestically with the remainder exported. However, the inquiry has heard that differences in specifications can make it difficult for producers to switch rapidly from domestic to export markets. Furthermore, there are very few exports of poultry.

As with fruit and vegetables, suppliers of meat to the domestic market have a number of alternative supply channels including retail grocery, butchers and food service. For instance, the inquiry had heard a range of estimates (from 26 to 31 per cent) of butchers' share of domestic fresh meat sales. DAFF estimates that butchers' share of poultry is lower, at around 18 per cent.

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<sup>24</sup> Apple & Pear Australia Ltd, submission no. 80.

<sup>25</sup> R Ceravolo and Co., public hearing transcript, Adelaide, 28 April 2008, p. 62.

<sup>26</sup> Costa Group, public hearing transcript, Melbourne, 15 May 2008, p. 50.

## Milk and eggs

Based on the 'milk equivalents' measure produced by Dairy Australia, exports of Australian milk have been growing steadily—up from around 30 per cent of annual milk production in 1990-91 to around 50 per cent of annual milk production in 2006-07.<sup>27</sup> Of the domestic milk supply, around 45 per cent is estimated to be supplied to the food service sector and for industrial purposes with the remainder being used to produce retail products such as fresh milk, cheese and dairy spreads.<sup>28</sup>

Food service also accounts for around half of total egg supply.

## Sellers' views of relationship with MSCs

The ACCC considers that suppliers of fresh produce have a range of outside options other than supply through an MSC. Consequently, the ACCC considers it would generally be easier for a supplier of fresh produce to walk away from negotiations with an MSC in response to an attempted exercise of buyer power than a supplier of dry grocery products.

Despite this, when asked at the public hearing why it did not deal with Woolworths, R Ceravolo and Co., which had been a supplier to Coles for around 40 years, responded:

I suppose we've started with Coles so many years ago and we've been always loyal with them and I think they've tried to be as loyal as they can back with us.<sup>29</sup>

Similarly, while recognising its outside options, the Costa Group, which supplies mainly to the MSCs, told the inquiry:

We're pretty comfortable with where we're at at the moment.<sup>30</sup>

Australian Pork Ltd submitted more generally that producers have a tendency to blame the MSCs for low producer prices; however, a relationship with an MSC can help growers achieve efficiencies:

Pork producers have long complained that their prices are low and have in part attributed this to supermarket dominance. The arguments, however, cannot be viewed so simplistically since grocery pricing is complex and factors such as producer risk management strategies, supply chain engagement, industry structure, drought and international developments all play a part and are interdependent.

Certainly over time the engagement by national retailers with sole producers, producer groups and vertically integrated producers have provided efficiency improvements in supply chain management, with some corresponding effect on quality and price.<sup>31</sup>

Overall, the ACCC considers that the evidence presented to the inquiry, including the lack of substantiating evidence of any abuse of buyer power, does not support assertions that the MSCs conduct in their relationships with suppliers of fresh produce is oppressive.

## 15.2.3 Buyers' outside options

Buyers may also have a range of outside options, such as obtaining the product from other suppliers, including imports. The ACCC considers that the value of these options is likely to vary from product to product and will depend in part on the strength of the product's brand and the extent of product differentiation. The inquiry has heard confidential evidence that there are a number of 'must have'

27 Based on the milk equivalents measure produced by Dairy Australia. This measure looks at the milk content of all exported dairy products (e.g. butter, cheese, milk powder) as a percentage of total domestic milk production.

28 S Spencer, and M Kneebone, *FoodMap: a comparative analysis of Australian food distribution channels*, DAFF, Canberra, 2007.

29 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 62.

30 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 50.

31 Australian Pork Ltd, submission no. 147, p. 3.

products that consumers expect to find on supermarket shelves that have very high levels of brand loyalty. The ACCC considers that suppliers of those brands are likely to have significant bargaining power, at least in relation to those products. Furthermore, for those brands, the value of the buyer's outside option is likely to be relatively low. A supplier told the inquiry in confidence:

... there's definitely differences. So in some products we would have lesser brands that we would be struggling to hold in range. But then, conversely we have very strong brands as well. So it's a balancing act.

The ACCC considers that suppliers of key brands will have countervailing power in relation to those brands. However, the evidence presented to this inquiry indicates that this countervailing power does not extend across the supplier's entire range of products and brands. As sales of that 'must have' brand or product will generally only be a portion of the supplier's total sales, the buyer is likely to retain the balance of negotiating strength.

Buyers' outside options in relation to sourcing of generic and private label products are likely to be high, except in the limited circumstances where there is only one possible supplier of the product. This is because consumers typically do not know who the manufacturer of a generic or private label product is. This makes it relatively easy for the buyer to switch sellers without consumers being aware of the change, providing quality specifications do not change. Thus the buyer could credibly threaten to walk away from negotiations if the supplier does not offer more favourable terms.

This is consistent with the view expressed by a supplier in confidence on the supply of generics:

Given the size and importance of the chain store channel, even the threat of these chains re-tendering their supply arrangements is often sufficient to ensure that their price and delivery demands are met.

## Imports

Horticulture Australia Ltd (HAL) submitted that imports of fresh fruit and vegetables represent between three and four per cent of industry value.<sup>32</sup> The main fruit products that are imported include avocados, kiwifruit, oranges, cherries and grapes. The main vegetables are garlic, capsicum, asparagus, onions, tomatoes, peas, mushrooms and beans.<sup>33</sup> HAL expects that this figure may increase as remaining trade barriers, other than quarantine restrictions, are removed.<sup>34</sup>

HAL submitted that imports of fresh fruit and vegetables typically occur when:

- the product is not available in Australia
- the product is available in Australia but not in the required volumes
- the price of the domestic product is higher than consumers are willing to pay.<sup>35</sup>

Coles submitted that Australia's quarantine restrictions place limits on the extent to which imports can be considered a viable outside option to domestic supply:

Over 95% of fresh items need to be sourced locally for quality, freshness and quarantine reasons. This limits Coles' options with respect to sourcing those items from overseas suppliers and means we must deal with local suppliers. But those local suppliers may be able to sell internationally to countries which do not have corresponding quarantine requirements.<sup>36</sup>

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32 Horticulture Australia Ltd, submission no. 92, p. 103.

33 Horticulture Australia Ltd submission no 92, p. 102.

34 *ibid.*, pp. 103-104.

35 *ibid.*, p. 103.

36 Coles, submission no. 225, p. 32.

Imports are often a viable alternative to domestic supply of certain packaged groceries, particularly for private label and generics, and thus may enable the buyer to credibly threaten to import if a deal cannot be reached with a supplier.

GWF told the inquiry:

The uptake of global supply strategies by the MSCs has been one of the most significant issues facing suppliers. Whether a retailer is in a position to threaten import of products in preference to local brands largely depends on the product in question. Bread, for example, because of its short shelf life is not subject to these sorts of threats. Similarly, despite relaxation of historical quarantine restrictions, the quantities of imported smallgoods products are still very small. Generally, however, retailers are able to and do source products worldwide.<sup>37</sup>

Further, the Apple and Pear Association of Australia told the inquiry in response to a question about whether imports have led to a change in bargaining:

...the development of offshore processors, the Chinese and the South Africans, especially the South Africans, the Chileans and the Argentineans and so forth, where they've been able to leverage off the home brand shift through major retailers especially, and that created - there is no question they've created a lot of hardship for processors and suppliers in this country for the home market. There is no doubt about that.<sup>38</sup>

Overall, however, domestic suppliers of branded packaged groceries did not raise actual or potential import competition as a major concern for them in relation to their negotiations with domestic grocery retailers.

## 15.3 Retailers' absolute size

As explained in chapter 14, it is often the case that the larger the buyer in absolute terms, the greater will be its bargaining power. This could be because the value of the company's outside options increases with company size as a large company has more viable alternative sources of supply than a smaller retailer. If so, the large companies' ability to credibly threaten to withdraw from supply negotiations, including by threatening backwards integration into private labels, would be enhanced. Alternatively, a larger company may be more able to credibly threaten to sponsor the entry of new alternative suppliers than a smaller buyer.

Woolworths, Coles and Metcash are each large companies in absolute terms. NARGA told the inquiry that, in this regard, Woolworths and Coles are among the top 30 retailers in the world.<sup>39</sup> Furthermore, each of those 30 companies is large in relative terms. These factors are consistent with each of these buyers having a degree of buyer power.

In relation to agricultural producers, the AHBIC submitted:

As the retail market share of the MSCs has increased, agricultural producers have become more heavily dependent on trading with the MSCs for their livelihoods. This dependence has provided the MSCs with significant bargaining power over agricultural producers which in turn has enabled the MSCs to set the terms and conditions of trade heavily in their favour. This situation has been exacerbated because not only are MSCs customers of individual agricultural producers but they are also their competitors and suppliers. The MSCs are the customers of agricultural producers in

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<sup>37</sup> George Weston Foods, submission no. 138, pp. 9–10.

<sup>38</sup> ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 14.

<sup>39</sup> NARGA, submission no. 129, p. 1.

that they purchase their products for resale for final end consumers. Due to the large retail market share enjoyed by the MSCs in grocery retailing, an agricultural producer is readily compelled to do business with MSCs as there is little prospect of making up for lost sales elsewhere due to the highly concentrated nature of Australia's grocery industry at the wholesale and retail levels. This provides the MSCs with enormous bargaining power not just against agricultural producers but against all grocery product suppliers.<sup>40</sup>

Nevertheless, Coles contended that it often negotiates with suppliers who have a degree of seller power:

While Coles has thousands of suppliers, the number of major food processors, across key food categories such as dairy, meat and grocery, consists of a small number of large suppliers. The most popular consumer grocery brands, which make up the bulk of packaged food and groceries in supermarkets, continues to be led by a small number of international food processors and manufacturers. They are often larger than Coles or command substantial market share in the food categories they supply Coles and its competitors.<sup>41</sup>

Metcash agreed, submitting:

There is some evidence to suggest that the market for suppliers is relatively concentrated. The 20 largest food and soft drink manufacturers in Australia account for almost 50% of total industry turnover. In some product categories, the largest two suppliers own or share over 50% of the market.<sup>42</sup>

Coles suggested that its buyer power enables it to extract lower prices from powerful sellers, to the benefit of consumers:

There's no doubt some competitive tension in there, we don't apologise for that. We're dealing with some of the largest FMCG companies in the world so we don't apologise for extracting a better price for our customers.<sup>43</sup>

## 15.4 Relative dependency on the relationship

Buyer power is more likely to arise if the relationship is of substantial financial importance to the seller but of lesser importance to the buyer. This is because there is likely to be an asymmetry in the consequences of either party walking away from the negotiations. If the buyer walks away, the consequences for the seller would be significant whereas the consequences for the buyer of the seller walking away would be less significant. Secondly, as the financial consequences for the buyer of walking away from the negotiations are not significant, any threat by the buyer to walk away would be credible. The interrelationship of these two factors would generally increase the buyer's bargaining power.

As noted above, a buyer's or seller's ability to walk away from negotiations depends to a large extent on each party's outside options. To reiterate, the ACCC considers that most suppliers of packaged groceries have little option other than to reach an agreement for supply to the MSCs and Metcash. In contrast, most suppliers of fresh produce have a range of outside options that might reduce their relative dependence on the relationship with an MSC.

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40 Australian Honey Bee Industry Council, submission no. 59, p. 8.

41 Coles, submission no. 157, p. 12.

42 Metcash, submission no. 181, p. 51.

43 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 59.

Nevertheless, in relation to the relative financial importance of the relationship to sellers and buyers, the evidence presented to this inquiry indicates that most suppliers are relatively more dependent on buyers than buyers are on individual sellers. For instance, the AFGC submitted:

For most AFGC member companies, sales of packaged food and grocery products to grocery wholesalers and retailers account for the majority of their sales<sup>44</sup>

and

Suppliers seeking to have competitive economies of scale must have a business relationship with all major retailers and wholesalers.<sup>45</sup>

The AFGC's submission was supported by confidential information obtained by the ACCC from suppliers of packaged groceries.

Similarly, the Queensland Citrus Growers told the inquiry:

MSCs can clearly negotiate a better deal with suppliers than their competitors. In particular, they are able to pay less and demand more from a supplier on the basis that the wholesaler may be reliant on the MSC for a substantial proportion of his business across a range of products.<sup>46</sup>

Assisting this view, Coles submitted in confidence:

'... over 50 per cent of its SKUs on the shelf are sourced from small suppliers, who are those suppliers with total sales of less than approximately \$10m/pa (where total sales is [sic] sales of all of the supplier's products in Coles stores).' Many of these products are vital to Coles providing a range of product to its customers in varying price categories.<sup>47</sup>

The ACCC notes Coles' submission. However, while it may be the case that, in aggregate, Coles is relatively dependent on its small suppliers, the ACCC considers it unlikely that Coles is relatively more dependent on the relationship with **individual** small suppliers than the small suppliers themselves are. Furthermore, even though some of these suppliers are large in absolute and relative terms in relation to the domestic retailers, the ACCC's consideration of outside options suggests that even large suppliers are likely to be relatively more dependent on the buyer-seller relationship than are retailers.

## 15.5 Retailers' gatekeeper role

Retailers have a gatekeeper role between suppliers and final customers as a result of their ability to control access to supermarket shelves, dictate product placement on those shelves and set retail prices. Supermarket shelf space is a valuable and finite resource in the grocery retailing industry. Decisions regarding the allocation of shelf space and the planning of stores have significant implications for the viability and profitability of both suppliers and supermarkets.

A retailer's gatekeeper role may contribute to its buyer power by enabling the retailer to credibly threaten to de-list a product unless a supplier offers more favourable terms and conditions. Alternatively, a retailer may credibly threaten to not list a new product unless the supplier agrees to pay new product listing fees and other charges to keep the product on the shelf.

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44 Australian Food and Grocery Council, submission no. 73, p. 1.

45 Australian Food and Grocery Council, submission no. 73, p. 2.

46 Queensland Citrus Growers Inc., submission no. 49, p. 7.

47 Coles, confidential submission, May 2008, cited with the consent of Coles.

## 15.5.1 Category reviews

Given the differing structure and format of supermarket retailers in Australia, retailers' decisions vary regarding ranging, shelf space allocation and the development of plan-o-grams. Plan-o-grams are the diagrammatic illustration of where ranged products will be placed on retail shelves, the amount of space that will be allocated to each and how many faces or exposures each product will have to the aisle. Generally, the more profitable, higher margin products are placed in prime shelf space, which is the space between eye and hip level.

Woolworths and Coles are similar in their approach to ranging and the allocation of shelf space for products. For both MSCs, ranging and shelf space allocation is determined as part of the category review process.

Woolworths' categories are generally reviewed annually or biannually.<sup>48</sup> In some categories there are additional minor reviews, which, according to Woolworths, 'generally result in minimal or no range changes with the majority of new lines being introduced during major reviews.'<sup>49</sup>

According to Woolworths, category reviews provide suppliers in that category with the opportunity to put forward any new products. The performance of existing lines is also reviewed.<sup>50</sup> Reviews may result in the introduction of a new line, continuation of a line, deletion or the removal of a line from sale, or downgrade of a product. Deletion (or de-listing) refers to a product no longer being ranged and therefore no longer being available through the retailer, while downgrading refers to a product being given a poorer shelf space allocation or no longer being available in some stores. Ranging decisions are based, in part, on hurdle rates, which set the minimum number of units to be sold and the rate of return that the retailer expects to receive. Decisions are informed by scan data, which is collected at supermarket checkouts and processed by companies such as Aztec and ACNielsen. The scan data provides suppliers and retailers with sales data for products sold in each category, and provides a basis for assessing whether the products are meeting category sales and margin targets.

### Category captains

The inquiry was told that key suppliers in each category are sometimes invited to provide input into category reviews by sharing their knowledge of consumer behaviour and global product trends with retailers. These suppliers are known as category captains. For instance, Coles told the inquiry that, as part of its agreement with Coles, a category captain will agree to provide insights, information on global developments in the relevant category and 12 months notice of new product developments.<sup>51</sup>

## 15.5.2 Threat of de-listing

As part of category reviews, MSCs decide which new products will be listed in a category and which existing products will be deleted from the category.

Each of the retailers has a number of criteria that a product must meet in order to be placed on the retailer's shelves. These generally include sales and profit potential (including ability to meet target performance criteria).

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48 See [www.woolworths.com.au/resources/vguide\\_cds09%201.1.xls](http://www.woolworths.com.au/resources/vguide_cds09%201.1.xls), accessed 18 June 2008.

49 *ibid.*

50 See [www.woolworths.com.au/resources/vguide\\_vendorguide190508.pdf](http://www.woolworths.com.au/resources/vguide_vendorguide190508.pdf), accessed 2 July 2008.

51 Coles response to s. 95ZK Notice, cited with the consent of Coles.

If a retailer has buyer power, it may be able to credibly threaten to de-list a product unless the supplier offers more favourable terms and conditions. Furthermore, retailers may de-list an otherwise well performing product in order to make shelf space available for its own private label products.

Metcash expressed the issues as follows:

The MSCs can credibly threaten the de-listing of products and/or ranges of suppliers either as a ranging strategy or to favour their private label brands. In a highly concentrated market, the de-listing of products by the MSCs could result in suppliers exiting the market, thus further intensifying the level of market concentration.<sup>52</sup>

In addition, GWF told the inquiry:

For all of GWF's products, the threat of de-listing is certainly credible. Any such threat has to be weighed against the requirement for retailers to provide a comprehensive range which includes consumer preferred brands. While for a percentage of consumers private label products are a relevant choice, a more limited range may have the effect of driving consumers elsewhere.<sup>53</sup>

The inquiry was provided with little evidence that retailers misuse buyer power in relation to the deletion process. The evidence indicates that MSCs typically give suppliers advance notice of four to six weeks that a product is at risk of deletion. During that time, the supplier generally has the opportunity to try to improve the performance of the product. The supplier may attempt to improve the product's pricing by offering an additional case deal, increasing promotional activity or increasing advertising in external media.

The inquiry gathered confidential evidence from the MSCs on recent product deletions and the reasons for those deletions. In some instances, deletion was instigated by the supplier or related to the supplier's inability to meet quality requirements. However, the majority of deletions related to poor sales performance. In several cases, a deleted product was replaced by a new product from the same supplier.

The ACCC does not consider that the giving of advance notice of the potential deletion of an underperforming product necessarily represents a 'threat' that is consistent with the exercise of buyer power rather than normal business practice. Similarly, a supplier's offer to increase promotional support to a failing product in an attempt to increase sales and prevent deletion is consistent with competitive behaviour and not necessarily indicative of behaviour caused by buyer power.

A key issue, however, is the extent to which buyers accept this additional promotional support and pass it through to retail prices rather than retain it as higher margins. Generally, the ACCC is not satisfied that retail competition is sufficiently strong to ensure that consumers always benefit from any increased promotional support paid by suppliers to defend weak products from deletion.

The inquiry heard evidence that, on occasion, the MSCs attempt to recover some of the costs of product deletion, including the cost of marking down the product to clear stock from the supplier even though the ownership of the product has already passed to the MSC under previously agreed supply terms. The MSCs leverage the need for a supplier to maintain a distribution channel into a request for payments, which amounts to a unilateral variation of the supply terms. The ACCC considers that such practices are consistent with buyer power and lead to an inappropriate risk allocation in some circumstances.

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<sup>52</sup> Metcash, submission no. 181, p. 51.

<sup>53</sup> George Weston Foods, submission no. 138, pp. 9-10.

### 15.5.3 Fees and charges for accessing shelf space

The MSCs enter into a range of commercial arrangements with suppliers, including payments essentially in return for gaining access to retail shelf space, particularly for new products. The ACCC has formed this view even though some retailers told the inquiry that they do not charge new product listing fees—that is, fees for new products to access retail shelf space.

FoodWorks told the inquiry that it does not charge slotting fees, but contended that the MSCs do:

It is generally understood that unless a supplier pays the slotting fee (by whatever name that might be given) to the MSC, the products do not get on the shelf. FoodWorks does not have ranging fees.

This [payment of slotting fees to MSCs] generally means the larger suppliers get ‘ranged’ as they have the better ability to pay. This leads to less competition at supplier level as smaller players disappear. Most retailers will seek to utilise their shelf space and gondola ends to secure a range of promotional fees from suppliers at various times through the year (eg Easter eggs) however this is different to whether the products are ranged at all.<sup>54</sup>

In response to FoodWorks’ assertion, Coles countered:

Contrary to some assertions, Coles does not consider that it charges slotting fees to suppliers in order for them to access shelf space (see Foodworks submission). Coles wants 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.<sup>55</sup>

Woolworths told the inquiry:

In relation to access to shelf space, Woolworths Supermarkets does not charge new line fees, slotting fees, ‘pay to stay’ fees or any other kind of fee to suppliers. All payments received from suppliers are referable to sales generating activities.<sup>56</sup>

Similarly, ALDI submitted:

In dealing with suppliers, we do not charge them slotting, or any other fees, in order for them to obtain product exposure. We consider such arrangements to be inconsistent with our low cost approach and incompatible with supplying our own exclusive brand products. Ultimately the customer will carry the cost of slotting fees in the form of higher prices and they may also miss the opportunity to obtain the best value product. With slotting fees and other supplier funded promotional activity, customers are not offered the best product but the product that is able to pay for placement.<sup>57</sup>

Metcash told the inquiry that it does not charge slotting fees but may charge a listing fee for new products:

Metcash as a non-vertically integrated wholesaler cannot guarantee the shelf placement of products by independent grocery retailers. Therefore, it does not charge slotting fees to suppliers. However, when Metcash negotiates the introduction of new products with a supplier, it may charge a listing fee and negotiate some form of support for this product – either through introductory promotions and/or other allowances – in the first 6 – 12 months after new product introduction. Adequate support is vital for the success and viability of new products, and as such the listing fee does not represent the existence of market power, but are instead a part of the normal negotiations and joint planning between grocery suppliers and wholesalers/retailers.<sup>58</sup>

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54 FoodWorks, submission no. 90, p. 34.

55 Coles, submission no. 225, p. 19.

56 Woolworths response to s 95ZK notice, cited with the consent of Woolworths.

57 ALDI, submission no. 81, p. 13.

58 Metcash, submission no. 181, p. 51.

GWF told the inquiry:

Slotting fees reflect the competitive importance of particular in-store locations and are generally higher for new products. They are not payable on all products and may not be distinct fees but incorporated into trading terms.<sup>59</sup>

Industry associations also provided evidence on this topic, including the AFGC:

The AFGC understands that such fees are common with retailers elsewhere in the world and reflect the competitive importance of particular instore locations. Such fees are likely to be higher for new products as retailers seek higher margins to cover additional costs and risks, but in so doing, they may well be an impediment to innovation or lead to the de-listing of lower margin products. They are accordingly likely to be part of performance based business plans, as individual suppliers may advise.

Slotting fees also reflect the power of retailers to control what products are on their shelves and where. It is a reality that retailers have reduced the number of products or product variants in particular categories in recent years as they seek to minimise supply chain and administration costs and accommodate new private label (and other) products. The limitations on the exercise of such power are the strength of the brands and the reaction of consumers who can and do go elsewhere if their preferred brand is no longer available.<sup>60</sup>

Meanwhile, NARGA contended:

Evidence exists of slotting fees that are so high that some manufacturers cannot do business with the MSCs. That is why small companies go to independents to start their business. There are numerous examples of this.<sup>61</sup>

Similarly, the AHBIC told the inquiry:

The MSCs also exert bargaining power over product suppliers through their role as the suppliers of shelf space and advertising to the producer. Producer brands not only have to compete against other branded products and the own-label products of the MSCs, they also have to compete for limited shelf space. This has further enhanced the bargaining position of the MSCs requiring the payment of listing fees for producer branded products in order to secure limited shelf space.<sup>62</sup>

Confidential information provided to this inquiry confirms that explicit payments associated with new product introductions are payable by some suppliers to some retailers. In addition, the inquiry was told in confidence:

In some instances, fees that may otherwise be physically paid by a supplier to the retailer are instead provided by the supplier to the retailer as discounts, allowances or rebates. These ordinarily form part of the terms of trade between the supplier and retailer. They are deducted off invoice by the supplier or off remittance by the retailer to simplify the fee charging process. In other words, rather than the supplier physically paying certain fees to the retailer, these amounts are instead deducted as a percentage from amounts payable to the supplier.

Confidential information provided to the inquiry indicates new product fees are sometimes justified on the basis of recovering the cost of adding new products to the retailer's range, including the addition of fixtures and the cost of marking down deleted lines. The inquiry was also told in confidence that payments for new products are also used to provide additional support to new products.

Confidential evidence presented to this inquiry also indicates that some suppliers of strong brands are able to negotiate more favourable shelf space arrangements than other suppliers. The inquiry was told,

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59 George Weston Foods, submission no. 138, pp. 8-9.

60 Australian Food and Grocery Council, submission no. 78, p. 8.

61 NARGA, submission no. 129, response to Q51, p. 65.

62 Australian Honey Bee Industry Council, submission no. 59, p. 10.

however, that any such arrangements do not guarantee that a supplier's products will not be deleted from the category.

In addition, as noted below, category average margins may also be utilised by MSCs as a benchmark in providing access to more favourable shelf space for products that meet or exceed the category average margin.

#### 15.5.4 ACCC's views

The ACCC considers that the impact of shelf space fees on competition is ambiguous. On the one hand, such fees may enhance efficiency if they:

- Provide an efficient means of allocating scarce shelf space among competing products. In this scenario, new product listing fees are a form of rationing scarce shelf space with suppliers who are willing to pay the highest fees to gain access to the shelf space. Willingness to pay new product fees may also signal the supplier's confidence that the new product will be a success, thus increasing the chance that the products that are most likely to succeed will gain access to retail shelves.
- Reflect the retail costs of new product introduction. Retailers incur costs in evaluating new products and adding new products to their plan-o-grams and inventory systems. New product fees may be an efficient way to recoup the cost of new product evaluation and introduction.

On the other hand, such fees have the potential to be anti-competitive if they lead to the exclusion of suppliers and a weakening of competition at the supply level. This might arise if shelf space fees raise entry costs and disadvantage small suppliers.

The evidence presented to this inquiry is consistent with both efficiency and anti-competitive rationales for shelf space fees. The supply agreements provided to this inquiry on a confidential basis show that not all suppliers pay fees for new product introduction. This evidence is inconsistent with assertions that such fees seek to recover the costs of new product introduction and are thus efficient. Instead, it may be that such fees are mechanisms for buyers to extract additional payments from suppliers who do not have significant countervailing power.

Furthermore, the evidence indicates that some suppliers are able to negotiate more favourable shelf space locations. Such arrangements may have an efficiency basis and make it easier for consumers to find the leading products they wish to purchase. However, the arrangements may also reinforce existing brand strength by making it harder for weaker brands to attract consumers' attention and thus compete with leading, or more profitable, brands.

However, contrary to NARGA's assertions, the ACCC has not been presented with evidence of shelf space fees that are so high that some manufacturers, presumably smaller ones, cannot do business with the MSCs. Instead, the inquiry has heard of several small suppliers who have expanded their operations through their dealings with the MSCs. In addition, as noted, above, Coles told the ACCC that over half of the stock keeping units (SKUs) in its stores are supplied from small suppliers.

The ACCC considers that there is an efficiency rationale for the payment of shelf space fees as a way of allocating scarce shelf space among competing products. Furthermore, shelf space fees may be an efficient way to recover the costs of introducing new products. However, the evidence suggests that the nature and level of such fees is such that they appear to be determined at least in part by the buyer's bargaining power and hence buyer power.

## 15.6 Trading terms

If the MSCs had buyer power, it would be expected that an exercise of such power would be visible during their negotiations with suppliers. The following section examines trading terms between the retailers and suppliers to determine whether there is any evidence of the MSCs using their buyer power in these negotiations.

### 15.6.1 What are trading terms?

The supplier-retailer/wholesaler relationship is governed by negotiated trading terms. Trading terms are negotiated for dry groceries (usually proprietary products; however, in some cases also private label products) and fresh produce. These terms set out the conditions on which goods will be supplied by the supplier to a retailer or wholesaler.

Trading terms cover a range of topics including the rejection of stock, specifications of stock to be provided, how stock will be delivered to the retailer, insurance requirements and dispute-resolution procedures. The trading terms also include clauses setting the cost of the product to the retailer and rebates or other discounts provided to the retailer or wholesaler by the supplier.

The ACCC has used its information-gathering powers to obtain copies of trading terms between a number of suppliers and retailers over periods of several years.

Given the number of products stocked at any one time by the MSCs, which run into the tens of thousands, the ACCC has been unable to examine all supply terms in place with all suppliers. The ACCC has attempted to obtain a general cross-section of trading terms across dry groceries and fresh produce including fruit and vegetables, fish and meat; from major suppliers and manufacturers to smaller suppliers and manufacturers in the market place; branded products as well as private label. As a result, the ACCC believes that the trading terms which it has examined are indicative of trading terms between suppliers and retailers more generally.

### Business plans

The Australia Food and Grocery Council submitted that the relationship between suppliers and retailers is becoming more sophisticated and instead of merely relying on trading terms, suppliers have business plans that 'recognise the mutual commercial goals of trading partners and the efficiencies inherent in individual trading relationships'.<sup>63</sup> The ACCC considers that while this may be the case for some larger suppliers, a significant number of smaller suppliers do not have business plans with the retailers and are left to solely negotiate on a trading term basis.

### ALDI

The ACCC has obtained copies of documents relating to the relationship between suppliers and ALDI. These documents show that ALDI's strategy in negotiating with suppliers is different to that of the other retailers and major wholesalers in the industry. ALDI does not negotiate rebates, discounts or allowances with suppliers.<sup>64</sup> Further, it provides payment to all suppliers within 30 days net.<sup>65</sup> For these reasons, much of the discussion below does not apply to suppliers' negotiations with ALDI.

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63 Australian Food and Grocery Council, submission no. 73, p. 2.

64 ALDI, submission no. 81, p. 15.

65 *ibid.*

## 15.6.2 Negotiation of purchase price

### Dry packaged groceries

Suppliers and retailers have indicated to the ACCC that trading terms are fiercely negotiated between the retailer and the supplier. Trading terms for dry groceries appear to be generally negotiated for a defined period of between 12 months and two years (however, there are examples of terms being negotiated for substantially longer periods). Despite an end date often being provided on the agreement, the terms are usually stated to continue 'until further notice'. That is, until the terms are renegotiated between the parties, which can result in trading terms remaining in place for substantial periods of time.

Documentation obtained by the ACCC also indicates that trading terms can be renegotiated during the initial contract period, although this appears to occur rarely. Where renegotiations have occurred it appears that they have occurred for various reasons including changes to the retailers' warehousing practices.

The starting point for any negotiation on price for dry packaged groceries is the suppliers 'wholesale list price'. Prior to trading term negotiations, each supplier publishes a list price setting out the price of a particular unit (e.g. a case) of each of the grocery products it produces. The price paid by the retailer based on this list would then simply equate to the number of units of product required multiplied by the wholesale list price.

The wholesale list price is provided to all retailers who either already sell the products or could potentially stock the products. Suppliers have indicated to the ACCC that the same list price is provided to all retailers. Suppliers are required to confirm that they are providing individual retailers and wholesalers with the best price available in the market. In this way, all retailers and wholesalers have the same starting point for their negotiations on price. However, wholesale list prices are just that, a starting point for negotiations.

Generally, the wholesale list price is contained in a separate document to the trading terms.

The wholesale list price (for a supplier's proprietary products) may be changed by the supplier during the term of the agreement with the retailer. Suppliers have indicated that they provide the retailers usually with at least one month's notice of any proposed change to wholesale price. Suppliers must also provide an explanation as to why the change in list price is required. Evidence provided to the ACCC indicates that the retailers will normally agree to such price changes, especially where there are exceptional circumstances, such as in the case of large unforeseen increases in input costs (e.g. the significant recent increases in the cost of grain as a result of a number of local and international factors).

Producers of private label products, who are generally selected by tender, are not usually able to change their supply price during the period of the agreement. Retailers expect that private label product suppliers will have taken into consideration likely input cost rises in the tender price.

### Fresh produce

The ACCC understands that trading terms are also negotiated on a range of fresh produce supplied to the retailers. These terms may be negotiated in a contract similar to that for dry packaged groceries (for products such as poultry), or on an individual basis at the time of a particular order (this seems to be more common in the fruit and vegetable growing industries where price varies more frequently).

Price negotiations are slightly more complicated for fresh produce than for dry packaged groceries. Fresh produce prices are more likely to vary during the periods of supply as a result of changing market conditions. The ACCC understands that in the week before delivery of the fresh fruit and vegetables, price and volume is discussed between the supplier and retailer and a reasonably firm price is agreed. This price is then usually fixed for the week, but can be renegotiated if market conditions change prior to dispatch of the product. The price may be changed at the instigation of the retailer or supplier depending upon conditions in the market place. In this way, growers and wholesalers of fresh produce are able to ensure that their starting price takes current market fluctuations into consideration. For livestock, a representative price may be negotiated some time out from purchase; however, a firm price will be provided closer to the sale date as a result of changes in market conditions or the quality of the livestock.

### 15.6.3 Rebates and allowances

#### What are rebates and allowances?

Trading terms often include a number of rebates and allowances. These are negotiated between the parties and come off the list price in the case of dry groceries or negotiated price in the case of fresh produce. The rebates and allowances ultimately act as discounts and lower the price paid for the goods by the retailer or wholesaler. Rebates and allowances may be 'off invoice' or taken off the price of the goods before they are invoiced to the retailer/wholesaler, or they may be 'off remittance' where the retailer deducts them from the invoice price before payment. Rebates and allowances may be calculated as a percentage, or alternatively a specific dollar amount. The majority of rebates examined were calculated on a percentage basis, although cent per litre rebates are frequently used for products such as milk.

The rebates and allowances negotiated encompass price reductions for reasons such as large volume purchases; ullage, which provides some recompense for goods that may be damaged during transport and therefore rendered unsaleable; settlement discounts, which are for payment within a specified period; and warehousing allowances, where products are delivered to a retailer or wholesaler's distribution centre rather than delivered direct to store (to take into account the funds required to warehouse and distribute products on behalf of the supplier).

In addition to such rebates, suppliers and retailers will also often negotiate a promotional schedule for the products. Suppliers will either fully or partly fund these temporary reductions in price by providing additional rebates to retailers. In exchange, retailers will run a promotional program agreed with the supplier, which may include store displays and particular forms of advertising.

A small proportion of the rebates and allowances may be common to most retailers and wholesalers. The remainder of the rebates and allowances negotiated between the parties differ depending upon the supplier and retailer/wholesaler involved.

#### Factors influencing the negotiation of rebates and allowances

The ACCC has received evidence that indicates that during rebate negotiations suppliers take into consideration factors such as the category average margins required by retailers in their category of product, the complexity of distribution of the product and whether that distribution is being undertaken by the supplier or the retailer, and support that may be afforded to the supplier as a result of providing a specific rebate, such as increased promotional activity or acceptance as a 'preferred supplier' or other similar status.

As a result, trading terms do not simply encompass the different volumes of products purchased by various retailers and wholesalers. As GWF submitted:

While volume is an important consideration, the volume of purchases does not in and of itself determine whether customers are 'like customers'. What is at issue, and suppliers are paying for, is the level of support that the retailer provides to the supplier. This varies dramatically from customer to customer and is not solely dependant on volume.<sup>66</sup>

As a result, a smaller store buying the same amounts of product from GWF as one of the MSCs, may still have different (and potentially less favourable) trading terms to the MSCs depending upon the level of support provided to the supplier.

Ultimately, rebates and allowances assist retailers and wholesalers to reduce the price paid for stock. This in turn, in a competitive environment, should lead to the reduction of prices paid by consumers (and in the case of wholesalers, being on-sold to retailers). In a less competitive environment, where there are less incentives for retailers to pass on the reduced costs, rebates and allowances may allow retailers to increase their margins at the expense of suppliers with little benefit to consumers.

## 15.6.4 Have trading terms changed over time?

### Difficulties encountered in examining trading terms

Due to the complex nature of the pricing and rebate structures set out in the trading terms, it is difficult to precisely calculate what retailers are paying for various goods. It is therefore difficult to determine precisely what effect any changes to trading terms have had over the ultimate price at which retailers and wholesalers are able to purchase products. The difficulties encountered by the ACCC in examining and comparing trading terms were:

- In addition to rebates and allowances, suppliers will often assist retailers by providing further funding to reduce prices for promotion (funding either a proportion or the entirety of the promotion), on top of the rebates and allowances already provided. Without examining the timing of promotions and the level of supplier support, it is difficult to precisely determine how much increased or decreased trading terms are affecting retailers' purchase price.
- Due to the nature of rebates—which are designed to compensate retailers for various factors related to the supply, distribution and retailing of the products, and the inherent differences in the models operated by retailers, wholesalers and suppliers—it is difficult to compare trading terms between retailers; and for the one retailer, between individual suppliers.
- Reasons for the changes in trading terms are not always readily apparent from the documentation provided to the ACCC. It is difficult to identify, for particular individual increases or decreases in trading terms, the reasons behind those changes and whether it indicates solely an exercise of buyer power on the retailer's behalf or other external factors.
- It is not only the price and rebate structure which has the potential to affect growers and producers. While price is an important factor, retailers may also attempt to obtain additional contractual benefits such as longer settlement terms, clauses which require suppliers to provide the product to the retailer at the best available price in the market, or the shifting of financial risks or costs associated with the supply of the product back to suppliers.

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<sup>66</sup> George Weston Foods, submission no. 138, p. 7.

## Pricing and rebate structures

Documents obtained from both retailers and suppliers under the ACCC's information-gathering powers dating back to 2002 indicate that generally, rebates provided to the MSCs have increased slightly in the retailer's favour since this time. Of the documents examined, 59 per cent of the trading terms demonstrated overall increased rebates over the period.

Leaving aside this general trend, it should be noted that there were some occasions where the level of rebates provided to the retailers actually decreased over the period. Of the trading terms examined, 16.5 per cent had rebates that had fallen between 2002 and 2008. In some cases, this decrease was due to an increase in settlement terms and either a decrease or removal of a rebate allocated for payment within a specific shorter timeframe.

There were also a number of products on which the rebates offered remained static over the entire period. Trading terms remained static where they had not been renegotiated during the period or, in instances where negotiations had occurred, where such negotiations had not resulted in a variation to the rebates already in place. Of the documents examined, 24.5 per cent had rebate levels which remained static from 2002 to 2008.

## Larger suppliers v smaller suppliers

Information was sought about trading terms for similar products sourced by both large-scale and small suppliers.

In general, for fresh fruit and vegetable produce, larger suppliers either provided identical, or a slightly greater, percentage of rebates to retailers than smaller suppliers. A significant amount of evidence obtained during the course of the inquiry from several growers and suppliers indicated that large suppliers often set up their business to supply to the MSCs, who in turn purchase a large percentage of their product. As a result, larger suppliers may substantially depend on the MSCs to move the volume of produce for which they are geared. The MSCs are likely to be aware of this fact and may then use it to their advantage to obtain more profitable trading terms. The ability for MSCs to exercise their buyer power in such a manner depends on the alternative channels available to the supplier to sell their product and the extent to which the product supplied is seen as a 'must have' item by retailers. It also depends on the MSCs' ability to source quality goods, within their specifications and on a reliable basis from some other source(s).

The documents obtained indicate that the trend generally reverses for large suppliers/manufacturers of dry grocery products. Smaller suppliers (who usually supply less well known brands) provide larger percentages of rebates to retailers than larger suppliers (who generally supply the better known grocery brands). Evidence provided to the ACCC during this inquiry indicates that this may be partly as a result of retailers needing to stock certain well known brands due to consumer loyalty towards those brands. This reduces the value of the retailer's outside options and so increases the supplier's negotiating strength. It may also arise because of the greater efficiencies in buying from a large retailer. These factors may enable the supplier to negotiate better terms from retailers than may otherwise have been the case.

In contrast, the balance of bargaining strength is generally tipped in favour of the retailer/wholesaler in negotiations with suppliers of brands that do not enjoy strong consumer loyalty. Thus suppliers of those brands may not be able to negotiate as favourable terms as suppliers of leading brands.

## Metcash

As discussed previously in this report, Metcash operate in a substantially different manner to the MSCs. While the MSCs operate as vertically integrated retailers, Metcash has no retailing arm (although it does maintain equity in a number of large independent retailer companies). As a result, the trading terms negotiated with Metcash are designed to compensate Metcash for different factors to the MSCs and for services provided by Metcash (such as a charge-through service), which are not provided by the MSCs. As a result it is very difficult to compare the trading terms obtained by the MSCs with those obtained by Metcash.

The ACCC received fewer trading term documents evidencing terms from 2002 to 2008 for suppliers dealing with Metcash compared to those provided for the MSCs and therefore less weight should be given to the analysis. Analysis of the documents provided indicates that rebates to Metcash have increased over the period by a slightly higher percentage than those provided to the MSCs. Metcash had a similar percentage of total trading terms that had increased over the period compared to the MSCs, a slightly higher percentage of terms where rebates had fallen and a slightly lower percentage of terms that had remained stable.

Metcash's ability to compete with other retailers on trading terms and issues arising out of Metcash's supply of grocery items to independent retailers have been examined previously in chapter 7 of this report and therefore will not be discussed here.

## ACCC's view

Generally, it appears that retailers in recent times have been able to obtain greater levels of rebates from suppliers. It is, however, difficult in many cases to determine why these rebates were increased and whether there was any external justification for a change in rebates and pricing. A variety of justifications outlined in the documents obtained by the ACCC are discussed in more detail later in this chapter. However, it appears that the results in negotiated outcomes reflect the MSCs' and Metcash's substantial ability to require improved terms, particularly from large suppliers of produce and secondary brands in packaged groceries.

## Non-price factors

### *Settlement terms*

The ACCC has received evidence which indicates that the MSCs in particular have recently attempted to extend the period of time in which they are able to pay the supplier for their goods (essentially purchasing goods on credit). Such requests appear to have been made for both fresh and dry produce.

Payment terms outlined in the documents provided to the ACCC are generally either 14 or 30 days although there are examples of payment terms that are both shorter and longer than these figures (including payment terms of up to 60 days).

Payment terms can either be on a net basis (for example, payment 30 days after invoice) or can be defined in the trading term agreement on the basis of weighted averages. The result of calculating payment terms on a weighted average basis is that the actual time for payment often becomes significantly longer than the specified 14 or 30 days. This may cause difficulties for smaller companies for whom cash flow may be a more important factor.

The topic of settlement terms and Woolworths' ability to negotiate substantial settlement terms were discussed during the course of the public hearings. The following line of questioning was put to Mr Michael Luscombe, Chief Executive Officer of Woolworths:

MR O'DONOVAN: Okay. Now it would be fair to say that all things being equal that a supplier would prefer cash on delivery terms to waiting a month or two months to be paid?

MR LUSCOMBE: Correct.

MR O'DONOVAN: You would agree to that. Yes, all right. So the fact that your suppliers are—give up, I suppose cash on delivery and accept delayed payment is a reflection to some degree of the bargaining power that Woolworths has in respect of those suppliers. Would you agree with that?

MR LUSCOMBE: That would be a fair assumption, yes.

MR O'DONOVAN: All right. So it would be fair to say that because of Woolworths' size and your importance in the market to suppliers that it's able to negotiate terms that are very favourable to Woolworths and suppliers are forced to give up conditions which they would if the bargaining power were more equal would [sic] insist upon?

MR LUSCOMBE: I'm not—are you talking viz a viz [sic] other retailers?

MR O'DONOVAN: No. Only if they had a choice in terms of how they dealt with Woolworths if they felt that they had market power, more market power than they do have would you agree that they would choose to give less generous payment terms to Woolworths?

MR LUSCOMBE: I think that's a natural conclusion that one could reach.<sup>67</sup>

The MSCs clearly use their bargaining power in this sense when they are able to do so. The ACCC received confidential information that indicates that the MSCs have approached suppliers to advise that they intend to extend the periods for payment so as to standardise their terms. The ACCC understands that to reduce the settlement periods, suppliers will be required to provide an additional settlement rebate. The ACCC understands smaller suppliers have been told that if they do not either provide longer payment terms or additional rebates, they may lose their supply contract. Given the volumes of product that flow through the MSCs, and the distinct lack of alternative routes of sale particularly for dry grocery products, de-listing could quite possibly result in the overall failure of the product (and potentially the supplier company).

In general, the examples of trading terms obtained by the ACCC indicate that payment or credit terms have remained fairly static over the period examined. The example above is believed to be relatively recent, which may explain why this has not been noted in the agreements provided to the ACCC. Despite this, there are clear (albeit isolated) examples through the documents where the MSCs in particular have been able to increase their credit terms (e.g. from 10 to 14 days) over a period of time while still claiming the same level of settlement rebates from the supplier. The ACCC is unable to categorically state that these changes are solely as a result of the retailer exercising the power referred to by Mr Luscombe above, although this would seem to be one explanation. There are also isolated examples of settlement terms being extended significantly; however, the settlement rebate previously provided has been completely removed as a result.

### Bundling of trading terms

In recent years, the MSCs in particular have moved from an approach of having a number of individual terms and rebates, to bundling or combining rebates. Instead of negotiating, for example, seven separate rebates with a supplier dealing with various supply issues, the retailer will instead negotiate one comprehensive rebate. The trading term document often does not clearly explain exactly what

<sup>67</sup> ACCC, public hearing transcript, Melbourne, 19 May 2008, pp 32–33.

factors have been taken into account in determining the bundled rebate. Generally, it appears that where terms have been bundled the retailer and supplier have entered into a business plan designed to specify both parties' intentions for the product into the future.

It appears from the documents provided to the ACCC that the vast majority of suppliers who currently operate on a bundled term basis with the retailers are large manufacturers.

Smaller operators appear to largely operate on the earlier trading terms model, possibly as they are not big enough to require the retailer to enter into an agreed business plan.

Larger suppliers, who have advised they operate on a bundled term basis with the MSCs, have largely indicated that they are pleased with the arrangement. Generally suppliers believe that the bundled terms have reduced the complexity of the negotiations for sale price and have reduced the need for negotiations for the rebates provided (which the ACCC understands in the past could occur quite frequently).

The ACCC has not received any submissions from suppliers to indicate that they believed the bundling of terms was a concern. As a result, this issue has not been examined in any further detail.

### Requirement to provide best price to retailers and wholesalers

The vast majority of trading terms provided to the ACCC contain a provision which requires suppliers to acknowledge they are providing the product to the retailer at the best possible price in the marketplace.

Confidentially, some suppliers have raised concerns to the ACCC about the apparent unfairness of such a clause. Woolworths have indicated that they do require suppliers to confirm that they are providing Woolworths with the best price. However, they indicated that this confirmation related only to the 'wholesale list price' and did not take into consideration trading terms. As Mr Ian Dunn, Senior Business Manager, Trade Relations for Woolworths, stated during the public hearing:

It relates to buying at the best rack, the best volume price. It doesn't refer to buying at the best net price, the supplier may well offer deals in the market place, or trading terms that are better to someone else, but generally, as Mr Luscombe says, suppliers have the same list price in the market place anyway, and therefore it tends not to apply.<sup>68</sup>

Mr Luscombe stated he was not aware of any instance where this clause had been used against a supplier of dry packaged groceries.<sup>69</sup>

Further evidence provided during the course of the public hearing indicated that this term has been a standard clause in Woolworths' supply agreements for some time, potentially dating back to the 1970s. Despite its longevity, it is clear that the inclusion of this term in trading term negotiations is of concern to some suppliers.

Suppliers have confidentially indicated that even with the clause being limited to list price, the clause is unfair. Suppliers indicated that the inclusion of such a clause limits the extent that they can negotiate a list price to start negotiations with the retailers which would take into consideration any non-price terms peculiar to their contract with a particular retailer. They argue that even if they were in a position of being able to successfully negotiate a higher list price with one of the MSCs or Metcash, they would not be able to use this price in any event as it would not be the 'best price' offered in the market and would therefore breach their trading terms.

Woolworths has previously been involved in litigation in relation to their requirement to purchase at a

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<sup>68</sup> *ibid.*, p. 99.

<sup>69</sup> *ibid.*, p. 98.

'best price', in *Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores (No. 3)*.<sup>70</sup> In that case, however, Woolworths had taken matters one step further by deleting whole ranges of a supplier's product as a result of independent stores purchasing the products at what was presumed to be a lower price than Woolworths was achieving. There have been no allegations of any such conduct provided by suppliers to the ACCC during this inquiry. This case is examined in further detail in chapter 14 of this report.

### Risk and costs passed back to suppliers

Evidence has also been received from suppliers that costs associated with the supply of the products are being pushed back along the supply chain and ultimately incurred by suppliers.

One example of such conduct, raised on numerous occasions during the course of this inquiry, is the introduction of reusable plastic crates for fresh fruit and vegetable products supplied to the MSCs. Many suppliers have indicated that the introduction of the crates has resulted in increased costs. Growers have noted that each of the MSCs use different reusable crates.

The major issues about the crates arise when product is rejected by the MSCs. As both MSCs use different crates, if a grower wishes to attempt to sell product to the other MSC, the produce must be unpacked and then repacked in the required crate. Similarly, if produce is rejected, but deemed suitable to sell on the central markets, it needs to be unpacked from the crates and repacked into cartons or other modes for storage. Suppliers submitted that this crate requirement has greatly increased their costs, in particular labour costs, in the above circumstances. Further, suppliers also submitted that as these crates are 'shelf ready' the retailer has actually reduced the amount of labour required to display the product for sale. Suppliers have indicated that they have not been compensated for this factor by way of reduced rebates.

### Unilateral contract variations

Concerns regarding unilateral contract variations were raised in a number of submissions to the ACCC. Unilateral variation clauses allow one party to a contract to vary the contract without the agreement of the other party. Various representative bodies have anecdotally claimed that such clauses are a concern for suppliers as they provide retailers with an opportunity to misuse their position of power which exists in many of these relationships. More specifically (but without much in the way of further detail) issues were identified in retailers' changes to agreed specifications for fruit and vegetables without prior negotiation with the supplier.

Evidence provided to the inquiry by growers who supply produce to the retailers indicated that they were generally happy in their relationship with retailers, and in relation to the allegation outlined above, stated that generally retailers only rejected produce when it was outside specifications negotiated in the contract (despite the fact there could be some disagreement over the interpretation of the specifications between the parties).

Evidence has been obtained from growers of fresh produce which indicates that there are occasions, following the setting of a purchase price for the product, when the MSCs may come back to them and ask for additional price assistance, to help them match a lower price available at another retailer. While this appears to be an example of the MSC potentially altering agreed trading terms, the growers have indicated that they generally have a choice as to whether they provide the price assistance requested by the MSCs. It is possible, however, that a grower who holds a particularly weak position in the negotiations may feel obliged to provide such additional assistance, whether they wish to or not.

<sup>70</sup> *Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores (No. 3)* (2001) 119 FCR 1.

However, even in these instances, reduced price is often associated with lower quality produce being supplied to the retailer.

Evidence was also provided to the inquiry that in the case of dry grocery products, the MSCs would demand compensation if they had to lower the shelf price of products which had been de-listed, to help clear the old product. Suppliers indicated that generally they were happy to assist in these cases as they normally had a new product to take the place of the de-listed product, and therefore were keen to get the new product on shelf as quickly as possible. Technically, this is a unilateral variation of contract terms.

Further evidence was provided which indicated that retailers requested suppliers of products which are specifically targeted by shop lifters, to provide additional funding to compensate retailers for the amount of product stolen. If the supplier was not able to provide such assistance, the products involved would be moved off the shelf and placed in a secure area to prevent the products from being stolen. Suppliers appear to have been concerned that such a move off shelf may have affected the product's sales performance and accordingly have agreed to make payments.

Despite the fact that growers and suppliers have provided evidence to the inquiry advising that they are largely content in their dealings with retailers, representative organisations have continued to allege that there are issues relating to unilateral contract variations in the marketplace. Representative organisations have suggested that the reason why evidence of these issues was not provided to the ACCC during this inquiry was due to a fear of retribution from the retailers. Given that it was made clear that evidence to this inquiry could be provided confidentially, the ACCC finds it difficult to understand why suppliers with such concerns have not come forward. When the totality of the evidence obtained by the ACCC is looked at, it appears that few instances of unilateral contract variation take place.

## 15.6.5 Specific factors that have resulted in changes to pricing and rebates

### Woolworths

#### *Changes to distribution and warehousing practices*

As discussed earlier in this report, the MSCs have moved towards a centralised warehouse system to reduce their costs of doing business. Woolworths started implementing such a system in 2005-06 and negotiations with suppliers following this date in relation to trading terms take into account this change in practice.

Suppliers were requested to provide additional rebates to acknowledge the fact that Woolworths would now undertake various steps in the supply chain that the suppliers would previously have performed themselves. As a result, suppliers' costs would be reduced and therefore Woolworths required this be acknowledged in the trading terms through a reduced purchase price.

### Coles

#### *Changes to distribution and warehousing practices*

Similar to Woolworths, Coles also implemented a centralised warehouse system. This occurred in 2007, approximately a year after Woolworths had made similar changes. At this time, Coles sought to vary trading terms with its suppliers to take these changes into consideration.

The correspondence obtained about this issue indicates that Coles advised suppliers that rebates of a

specific percentage to account for the new warehousing practices and savings for suppliers would be added to the rebates previously negotiated. It would appear that in some cases, Coles' suppliers were actually able to negotiate reduced rebates in other areas to partly offset this rise. The general trend for rebates following these negotiations was a small increase in Coles' favour.

### ACCC's view

As discussed above, over the last six years, rebates have generally improved in the retailer's favour. While the general trend indicates that rebates are increasing, this trend is not universal across all products or all suppliers.

The ACCC believes that at least some of the additional rebates provided to retailers arise as a result of the retailer's buyer power. The ACCC cannot however rule out that some increases have occurred as a result of other external factors. The extent to which retailers are able to leverage their buyer power in negotiations regarding trading terms depends largely on the alternative options open to the supplier to sell their product as well as the strength of the supplier's brand (and the subsequent need for the retailer to have the product on shelf).

Confidential information provided to the inquiry indicates that increased payments from suppliers (in conjunction with a number of other factors) are assisting retailers to raise their gross profits.

The ACCC has examined the evidence provided to the inquiry in relation to the concerns listed above, including unilateral contract variations and the requirement to provide a 'best price' guarantee to retailers. The ACCC notes that this conduct occurs as a result of contractual relationships between suppliers and retailers. As a result of the evidence provided to the inquiry, the ACCC has not identified any instances of conduct which would raise concerns under the Act.

## 15.7 Trading terms by size of retailer

As discussed in chapter 14, a buyer with buyer power will usually be able to extract lower prices and better terms and conditions from suppliers than buyers who do not have buyer power.

A relevant issue is what competitive effect, if any, differential trading terms that reflect buyer power have on retailers without buyer power. As explained in chapter 14, the theoretical answer to this question is ambiguous. There is a suggestion, for example, that retailers who lack buyer power will benefit from a larger retailer's buyer power because suppliers may find it strategically optimal to set a lower wholesale price for smaller buyers.

A contrary argument, however, is that larger retailers' buyer power will instead force up the supply prices paid by competing retailers. This so-called 'waterbed effect' arguably arises when an increase in buyer power lowers the large buyer's supply price. As a consequence, suppliers seek to recover lost profits by charging higher prices to other smaller buyers that do not have buyer power.

### 15.7.1 Waterbed effect?

NARGA submitted:

There is no doubt that the independent sector suffers from the waterbed effect on pricing.<sup>71</sup>

According to NARGA, the experience of milk prices in Western Australia since deregulation in that state in July 2000 provides evidence of the existence of a waterbed effect in relation to the supply of milk.

<sup>71</sup> NARGA, submission no. 129, response to Q56.

NARGA defines a waterbed effect as follows:

The 'waterbed effect' is the term used to describe the result when a large player in a market demands lower wholesale prices from suppliers, forcing those suppliers to increase prices to other customers to bring earnings back to a sustainable level. The large body in the middle of the waterbed forces up smaller bodies on the sides.<sup>72</sup>

NARGA considered that the supermarkets are the largest players in the milk market and have demanded low wholesale prices for private label milk. NARGA provided volume and price data for supermarket milk sales that, according to NARGA, shows that private label sales of milk have increased from 41.8 per cent of sales in 2000–01 to 55.1 per cent in 2005–06. During that time, NARGA submitted, the average shelf price of branded regular milk has increased by 19.6 per cent while the price of private label milk has increased by 4.7 per cent. NARGA also submitted that since 2005–06, prices for branded milk in indicative markets have increased by a further 30 cents per litre. NARGA contended that this shows that low prices paid for private label milk are being supported by higher prices in the branded milk range, giving large supermarket chains a competitive advantage at the expense of smaller stores who do not sell generic milk, resulting in higher average milk prices.

As discussed in chapter 12, increases in retail prices charged by the MSCs for milk have largely tracked movements in wholesale prices. Prices for branded milk have increased more than prices for private label milk, both at the wholesale and the retail levels. The divergence in retail prices for branded and private label milk is therefore reflective of a divergence in the respective wholesale price of these products. This divergence is primarily a reflection of three factors:

- vigorous competition amongst retailers for private label contracts
- the buyer power of the MSCs
- the rigidity of private label contracts which means it is more difficult to pass on increases in processor costs of production in a timely manner.

In evidence given confidentially at hearings, and in response to s. 95ZK notices, processors indicated that they did not generally increase wholesale branded milk prices to offset increases in the costs of supplying private label products to the MSCs. One processor did indicate that increased costs for branded products have been able to be recovered in a more timely manner, and another indicated that prices of branded products have sometimes been increased to off-set overall cost increases, both for branded and housebrand products.

However, more generally, processors were generally of the view that:

If Woolworths or Coles is particularly aggressive in negotiating terms it doesn't mean [we] will try to recover more from other customers because the reality is, it couldn't recover any shortfall from other customers because of market shares.

In a more general response to the issue of whether the (on average) more favourable trading terms of Coles and Woolworths create a waterbed effect, Coles submitted:

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. If this effect existed, it would involve C&W 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. Discounts and rebates

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72 NARGA, submission no. 129, p. 12.

offered by suppliers are influenced by sales volume 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, layout and promotions.<sup>73</sup>

GWF also rejected implicitly the existence of a waterbed effect in its submission:

If a MSC puts pressure on GWF to lower prices we are not in a position to 'make this up' elsewhere.<sup>74</sup>

## ACCC's views

Chapter 14 provided a discussion of the economic theory of the waterbed argument. It noted that there are two potential explanations for such an effect, if it exists—a cost-shifting explanation and an explanation that relies on changes to upstream market structure. As further noted in chapter 14, the existence of a waterbed effect in any sector is far from universally accepted.

The ACCC does not consider a waterbed effect to be a significant issue either in relation to groceries generally or milk in particular. Further, the ACCC considers that the cost-shifting explanation violates standard axioms of profit maximisation: If the supplier is able to charge smaller buyers higher prices and the larger buyer negotiates a price reduction, why did it not do so before? These views are borne out by the evidence in submissions stating that suppliers do not have the capacity to recover or make up any margin losses by increasing prices to other customers. The ACCC also notes the evidence that, in consequence of the MSCs' increased sales of generic milk, many independent retailers now also have increased access to such cheaper generic milk.

The ACCC accepts that in many sectors there have been changes in the structure of upstream sectors as a result of consolidation and rationalisation. These changes will often improve a supplier's bargaining strength and thus enable the supplier to negotiate more favourable prices. However, these structural changes have often occurred over long periods of time, reflecting dynamic adjustments to issues that are beyond the control of individual suppliers, such as deregulation and globalisation. The ACCC has found little evidence that these structural changes are the result of a waterbed effect and thus does not consider it to be a significant issue in relation to the pricing of groceries.

## 15.8 Incentives to innovate

Buyer power may reduce suppliers' incentives to innovate if it results in suppliers earning lower returns. Suppliers may respond to these reduced returns by under-investing in innovation because they expect to make an inadequate return on those investments. A reduction in innovation will generally be associated with a reduction in variety, which is usually associated with a reduction in consumer choice.

A contrary view is that large buyers may have an incentive to develop long-term relationships with suppliers and to co-sponsor investments with those suppliers. This may enhance the incentives to innovate.

Furthermore, the presence of large buyers may also increase the incentives for suppliers to innovate as such innovation may increase their ability to sell their products to alternative buyers.

The ACCC does not consider that buyer power is significantly impacting on suppliers' incentives to innovate at this time. This issue is discussed in more detail in the next chapter.

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<sup>73</sup> Coles, confidential submission, May 2008, cited with the permission of Coles.

<sup>74</sup> George Weston Foods, submission no. 138, p. 11.

## 15.9 Consumer behaviour

Consumer behaviour may act as a constraint on buyer power by indirectly reducing the credibility of a buyer's threat to walk away from negotiations or de-list a product. This would occur if the product in question has sufficient brand loyalty so that consumers would switch to alternative retailers if they are no longer able to buy the product from their usual supermarket.

For instance, Coles told the inquiry:

There are products and brand that are fundamental to the success of any Australian grocery retailing business. These include products that have no real substitutes such as Vegemite and Gillette razor blades and those which customers demand despite the existence of substitutes such as Tim Tams, 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.<sup>75</sup>

There are likely to be few brands, however, that have sufficiently strong consumer loyalty to actually cause large numbers of consumers to switch stores in response to non-availability at another store. More likely responses are to either not buy another brand or not buy any competing product. For instance, FoodWorks told the inquiry:

If a desired brand is not available, it is unlikely the consumer will search for the product in another retailer. If the substitute is at a value that outweighs the cost of shopping elsewhere they will readily buy the substitute.<sup>76</sup>

On the other hand, NARGA said:

In some instances, consumers who purchase the bulk of their requirements from Coles or Woolworths will have to go to an independent store to buy a specific brand or product that the majors have discontinued. This is quite common and has resulted in Woolworths announcing a strategy to try to change their ranging to be more store-specific. However if a customer asks a Coles or Woolworths store to stock a particular product easily available elsewhere quite often they are told it cannot be done.<sup>77</sup>

The ACCC's consumer survey found that for 69 per cent of respondents, brand name is at least 'somewhat important', with 28 per cent considering brand name to be 'very important'. The survey also provided some guidance on likely consumer behaviour if their preferred brand is not available in-store. Forty-six per cent of respondents said that they would buy a different brand if their preferred brand was not available while 23 per cent would not buy any product at all. Only 10 per cent would switch to a private label product and 19 per cent would go to another store.

There are a number of characteristics of consumer shopping behaviour and habits that are likely to limit the extent to which consumers will switch stores in response to the unavailability of their preferred brand. In particular, consumers who are time-poor and have a strong preference for one-stop convenience shopping are less likely to shop around if their preferred brand is unavailable.

The supplier will be worse off in all cases of consumer switching in response to the non-availability of its product except where the consumer switches stores to buy the product elsewhere. If the consumer does not buy any product at all then the supermarket will lose the value of the lost sale but retain the remainder of the value of the consumer's shopping basket, so its loss will be relatively small. The impact on the retailers will be ambiguous if the consumer switches to another brand, which may have higher

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<sup>75</sup> Coles, submission no. 225, p. 32.

<sup>76</sup> FoodWorks, submission no. 90, p. 35.

<sup>77</sup> NARGA, submission no. 129, p. 58.

or lower margins than the unavailable product. On the other hand, if the consumer switches stores, the supermarket will potentially lose the consumer's entire shopping basket.

The ACCC considers that consumer behaviour will provide at best a weak constraint on the abuse of any buyer power.

## 15.10 Demand withholding

The concept of demand withholding refers to buyers demanding less than would otherwise be the case (withholding demand) in order to reduce the price paid to sellers. If buyers have retail market power, the reduced volumes could be sold at a higher price and higher margin.

For demand withholding to be of concern, a number of characteristics must be present:

- There must be a large number of sellers who sell into a market and receive the market determined price for their produce. This contrasts with many grocery buyer/seller relationships where supply prices are determined by negotiation between the buyer and seller. Thus, the appropriate analytical framework is the 'monopsony power' model discussed in appendix I.
- Unit product costs must rise with volumes (decreasing returns to scale or upward sloping supply curve).
- There must be a small number of buyers who are able to exercise their buying power to influence volumes traded and hence wholesale market price.
- For demand withholding to be of concern at a retail level it must be the case that buyers have market power at the retail level and thus are able to sell the lower volumes at a higher retail price. If this is the case then consumers are worse off.

The inquiry has been provided with little evidence of demand withholding. The ACCC considers that this practice is unlikely to be an issue in relation to packaged groceries because of the nature of the buyer-seller relationship. Demand withholding is also unlikely to be consistent with the way fresh produce is supplied to the retail level (usually directly or through consolidators rather than through wholesale markets). Although the MSCs do acquire some fresh produce through wholesale markets, their buyer power in those markets would not appear sufficient to influence volumes traded and hence wholesale market price.

The ACCC does note that one allegation has been made of demand withholding by retailers so as to push down the price of a product—namely, avocados—purchased in a wholesale market setting. Avocados Australia told the inquiry that the MSCs had maintained high retail prices and margins despite increased volumes at the wholesale level and falling returns to growers. According to Avocados Australia, the MSCs' actions caused a supply glut that persisted for several months. Avocados Australia told the inquiry that it had discussed this pricing behaviour with both Woolworths and Coles who 'had great difficulty in understanding that [the deliberate maintaining of high retail prices and margins] and accepting it'.<sup>78</sup> The ACCC has closely examined the relevant data regarding retail and wholesale movements of avocado prices during the period in question. The ACCC has concluded on the evidence available to date that the data does not appear to support the existence of the type of pricing behaviour alleged by Avocados Australia and therefore there is no compelling evidence that the MSCs engaged in the type of demand withholding behaviour in relation to avocados as has been alleged. However, the ACCC will carefully examine any further relevant evidence that comes to light.

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<sup>78</sup> ACCC, public hearing transcript, Brisbane, 3 April 2008, pp. 128–30.

## 15.11 Conclusions on buyer power

The inquiry was provided with little evidence to substantiate allegations of buyer power being exercised in an anti-competitive or unconscionable manner. Having said that, however, there were some complaints of buyer power being exercised where the complainant appeared to be genuinely reluctant to provide information to the ACCC out of concern about retribution if details were provided to the ACCC and investigated.

### 15.11.1 Packaged groceries

In relation to packaged groceries, the ACCC considers that the MSCs and Metcash have buyer power, and while suppliers of key brands also possess strong seller power that may offset some of the corresponding buyer power, few suppliers have strong countervailing power across their entire product range.

The ACCC has formed its views for the following reasons:

- Generally buyers' outside options are more valuable than sellers'. For many sellers of packaged groceries, the grocery distribution channel is the major route to consumers. Although there may be alternatives, they are not sufficient to offset volumes lost by walking away from the grocery buyer.
- The MSCs and Metcash are large in absolute and relative terms in relation to most sellers.
- Suppliers are generally more dependent upon the relationship with buyers than the buyer. The amount of product purchased from a supplier by a buyer often represents a large proportion of the supplier's sales and accordingly, income. The loss of this income may cause significant financial stress to the supplier. Buyers on the other hand purchase large numbers of products from a range of suppliers. On this basis, the loss of product provided by one supplier is likely to be comparatively less financially significant to the buyer.
- While there is some efficiency rationale for fees and charges for accessing shelf space, their differential application suggests the use of buyer power. However, there is little evidence that this is having a major impact on competition at the supplier level.
- MSCs generally buy products on better trading terms than other buyers, and those trading terms have generally become more favourable over time.

### 15.11.2 Fresh produce

The MSCs have varying degrees of buyer power in their dealings with suppliers of fresh produce. However, this buyer power is generally weaker than that associated with packaged groceries. The degree of buyer power that an MSC has depends to a large degree on the grower's ability to take advantage of the available outside options.

The ACCC considers that the evidence in relation to fresh produce is inconsistent with arguments that the MSCs are long-term oppressors of growers. Rather, the evidence indicates that, overall, growers have a range of options other than direct supply to the MSCs. The evidence that some buyers have remained in business relations with the MSCs for many years without contractual reasons for doing so suggests that there are benefits from doing so.



# 16 The role of private label products

## Key points

- Sales of private label products are increasing as a share of total grocery sales. However, private label penetration is lower in Australia than in some overseas countries.
- The growth of private labels is not consistent across categories. This suggests that the success of private labels largely reflects consumer preferences.
- The introduction of private label products offers consumers additional choice and is pro-competitive, other things being equal.
- Competition from private labels puts suppliers of many branded products under pressure to offer improved trading terms or more promotions to compete.
- Growth of private label products has the potential to distort competition because retailers may have incentives to:
  - promote their own labels in preference to proprietary brands otherwise preferred by consumers by giving private labels preferential shelf space
  - retain additional promotional benefits obtained from branded suppliers rather than passing those benefits to consumers in the form of lower retail prices.
- There is some limited evidence that in order to preserve the price advantage of private label products, retailers do not always accept promotional price reductions offered by suppliers.
- There is little evidence that:
  - retailers allocate shelf space to private label products in preference to profitable branded labels, though private labels are given prominent positions
  - growth of private label products is reducing incentives for new product innovation
  - the growth of private label products is weakening competition at the supplier level.

## 16.1 Introduction

A supermarket's total product offering consists of a range of proprietary brands (owned by the supplier/manufacturer) and private label brands.<sup>1</sup> Consistent with several overseas countries, the overall sales share of private label brands has been rising in Australia.

Chapter 14 examined the economic theory underlying buyer power, of which private label products are a potential source.

The growth of private label product sales has been a significant trend in Australian grocery retailing and one that has raised concerns from consumers and suppliers. This chapter seeks to analyse the key competition issues relating to private label products. These issues relate to the potential of the introduction and growth of private label products enhancing the buyer power of the major supermarket chains' (MSCs') and harming the competitiveness within vertical supply chains.

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<sup>1</sup> Private label grocery products (also known as home brands, own brands, store brands or generics) are products manufactured or provided by one company (which may also produce its own proprietary branded products in competition with the private label) for sale under a retailer's brand.

## 16.2 Role and impact of brands

An assessment of the impact of private label products on competition and consumers requires an understanding of the benefits and costs of brands in general and of private label brands in particular.

A key role for brands, whether proprietary or private, is to differentiate a product from its competitor products and to position the branded product relative to rivals. By doing so, brands convey a certain degree of pricing power on the brand owner, including some ability to set prices. This can be particularly attractive for producers of otherwise homogeneous products—such as eggs and milk—because product differentiation reduces the intensity of price competition. Price competition is lessened because non-price factors such as quality and packaging also influence consumer choice and reduce the degree of substitutability between competing brands.

Branding can create customer loyalty. This grants producers an advantage over rival producers of new products. In relation to private label products, if a retailer is able to build consumer loyalty for its private label products, it is less likely that consumers will switch to other products. In addition, as private label products are only available at a particular retailer, if a retailer is able to build consumer loyalty for its private label products, it will also build loyalty to its stores.

What could potentially be thought of as negative effects of brands on competition must be considered in light of possible positive effects, such as greater product differentiation and consumer choice. In particular, by giving consumers greater choice of product attributes, brands can satisfy a more diverse range of consumer demands.

In addition, brands can be used to provide information to consumers about the quality of products they are buying and thus reduce the risk of a consumer making an inappropriate choice of product. This is particularly the case for so-called ‘experience goods’ where quality is generally difficult to ascertain before buying the item. Many grocery products are likely to be experience goods.

A positive experience with a particular brand conveys information to the consumer about the likely quality of repeat purchases of both that particular product and other products bearing the same brand name. This information can also reduce the time taken to make an appropriate choice, which reduces consumers’ search costs.

## 16.3 Private label brands in Australian grocery retailing

Private label products have been in Australian supermarkets since at least the 1960s, with the focus on lower prices/lower quality products. Sales of these private label products were historically relatively low, received limited consumer acceptance and offered little competitive threat to suppliers of branded products.

More recently, the MSCs have refocused their efforts on retailing private label products. This has included offering products across a greater number of categories and at different quality and price levels.

The inquiry was told by a number of parties that ALDI’s entry into the Australian market in 2001 fundamentally altered the role of private labels in Australian grocery retailing and the private label strategies that the MSCs had adopted. This was because ALDI predominantly supplied its own private label products that were pitched directly at the branded products offered by the existing retailers. ALDI’s entry prompted the MSCs to reconsider their private label strategies, with Coles and Woolworths increasing their focus on private labels and introducing ‘tiered’ private label ranges to compete with

ALDI's everyday low price (EDLP) strategy.<sup>2</sup> Table 16.1 shows the private labels offered by Australian grocery retailers.

**Table 16.1 Private labels offered by Australian grocery retailers**

<b>Retailer/banner group</b>	<b>Private labels</b>
Woolworths	Homebrand (tier 1) Fresh (tier 2) Select (tier 2) Organics (tier 2) Naytura (tier 2) Freefrom (tier 2)
Coles	Coles Smart Buy (tier 1) You'll Love Coles (tier 2) Coles Finest (tier 3) Various legacy brands
ALDI	Range of private labels
Franklins	No Frills
Metcash/IGA	Black & Gold IGA
FoodWorks	Black & Gold Best Buy
Foodland	Foodland
SPAR/5 Star	Fabulous
Supabarn	Black & Gold Supabarn

### 16.3.1 Private label tiers

As noted above, each MSC has changed its private label strategy from a focus on lower priced/lower quality products to tiered products that are differentiated in terms of price and quality, and which compete directly with proprietary branded products.

Coles told the inquiry that it has adopted a three-tiered strategy. Its Coles Smart Buy label is the budget/tier 1 label positioned to be priced the same as or below competitors' EDLP private label product.<sup>3</sup>

Coles also told the inquiry that its tier 2 You'll Love Coles range of private label products is generally priced at least 10 per cent below the price of a group of target competitor products.<sup>4</sup> You'll Love Coles products are also priced with reference to the comparable Coles Smart Buy product. According to Coles, the You'll Love Coles products are not generally discounted and must not be priced below the comparable Coles Smart Buy product.<sup>5</sup>

Finally, Coles told the inquiry that it also offers the tier 3 Coles Finest premium range of private label products. It currently has 34 products in this range, which are primarily used around peak seasonal periods like Christmas. Coles does not consider that Woolworths' Select products compete with Coles Finest.<sup>6</sup>

2 See, for example, Australian Food and Grocery Council, submission no. 73, p. 2; Metcash, submission no. 74, p. 15; Coles, submission no. 157, freshlogic report, p. 41; ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 56; ALDI, submission no. 81, p. 5.

3 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 9.

4 *ibid.*, p. 46.

5 *ibid.*, p. 52.

6 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 63.

In contrast, Woolworths told the inquiry it has adopted a two-tiered private label strategy. Adopting a similar pricing strategy to Coles, Woolworths said that its Homebrand product (tier1) is priced to match the price of competitors' comparable private label products. The Select label is targeted at the market leader and is generally priced to be cheaper than the market leading brand.<sup>7</sup> Its Organics, Naytura and Freefrom private label brands cater to specific dietary needs.<sup>8</sup>

Woolworths does not consider that its Select range competes with the You'll Love Coles range. Contrary to Coles' view, Woolworths considers that You'll Love Coles products are aimed more at second- and third-tier proprietary brands. According to Woolworths, the Coles Finest range is more closely aligned with Woolworths' Select range in terms of quality. However, as the Coles Finest range is currently quite small there are, according to Woolworths, few Select products that have a direct Coles Finest competitor.<sup>9</sup>

The ACCC considers that the pricing strategies adopted by Coles and Woolworths for their premium private label products generally result in those private label products having lower shelf prices than branded products of comparable quality. This suggests that private label products can be a source of price competition for those proprietary branded products.

### 16.3.2 Private label products' share of grocery sales

Estimates vary as to the share of private labels in total grocery sales. For instance, IBISWorld estimated that private labels accounted for around 12 per cent of the packaged grocery market in 2007.<sup>10</sup> Freshlogic, in comparison, reported that private labels accounted for 18 per cent of grocery sales in full service supermarkets (FSS).<sup>11</sup> Similarly, the Nielsen Company (Nielsen) reported that the share of private label products in packaged grocery sales was 19.9 per cent in the year to July 2007.<sup>12</sup>

Retail World estimated that private labels represented 15 per cent of Coles' total grocery sales and 13 per cent of Woolworths' in 2007.<sup>13</sup> The inquiry has been provided with the MSCs' private label shares on a confidential basis. These estimates are broadly consistent with the publicly available figures.

There is agreement, however, that the share of private labels in Australian grocery sales has been rising over the past few years. For example, Nielsen estimated that private label sales increased by 4.7 per cent in the year to July 2007, slightly ahead of overall growth in total packaged grocery sales. Nevertheless, ACNielsen reported that private label growth has been slower than expected.<sup>14</sup> Metcash submitted that private label sales as a share of defined packaged groceries have grown from 16 per cent in 2002 to 19 per cent in 2006.<sup>15</sup> Coles told the inquiry:

... as we've reported recently in our sales results, you know, our sales are growing double digit on house brand particularly at the Smart Buy and You'll Love Coles end of the world as customers look for better value.<sup>16</sup>

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7 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 40.

8 Woolworths Supermarkets 1997–2008, Woolworths brands, accessed 19 June 2008, [www.woolworths.com.au/Vendors/privatelabel/WOWBrands](http://www.woolworths.com.au/Vendors/privatelabel/WOWBrands).

9 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 40.

10 IBISWorld *Industry Report 2008, Supermarkets and other grocery (except convenience stores) in Australia*, p. 10.

11 Coles, submission no. 157, freshlogic report, p. 41.

12 2007 Nielsen report, p. 20.

13 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2008*, Retail Media, Sydney, 2008, p. 37.

14 Nielsen report, 2007, p. 20.

15 Metcash, submission no. 74, p. 15.

16 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 56.

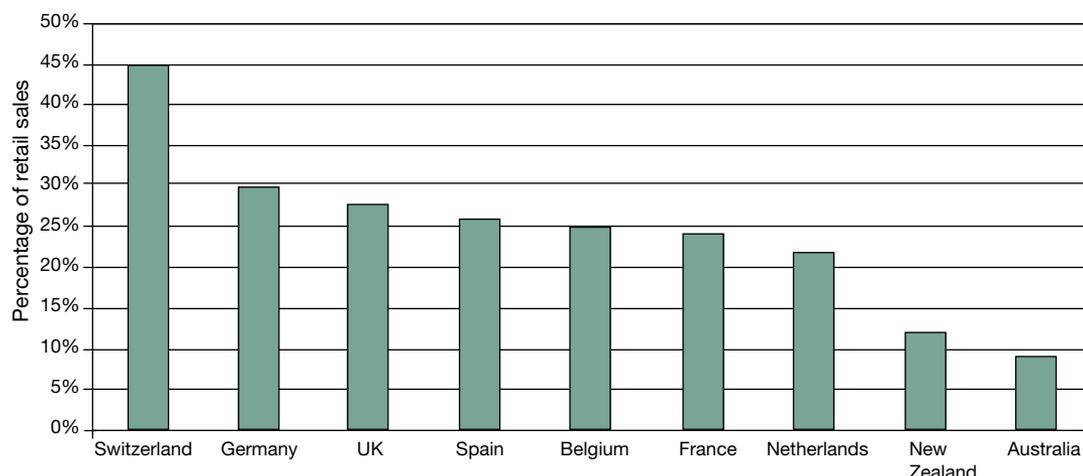
Similarly, Woolworths partly attributed the increase in gross margin in its supermarket division in the first half of 2008 to the success of its private labels.<sup>17</sup>

FoodWorks told the inquiry that Woolworths is targeting a 25 per cent share of sales for private labels.<sup>18</sup>

Other confidential evidence provided by the MSCs relating to private label sales over the past five years also shows that the private labels' share of grocery sales is increasing.

Nevertheless, private label penetration is relatively low in Australia compared with some overseas countries. For example, the United Kingdom's Competition Commission reported that in 2006 around one-third of sales of food and drinks in the UK were of private label products.<sup>19</sup> Coles provided data to the inquiry, shown in chart 16.1, that shows Australia had a small percentage of private labels compared with seven of the other eight countries surveyed by Nielsen in 2005. Although there has been some growth in private label sales in Australia since 2005, these figures suggest that there might be room for further expansion of private labels in Australia.

**Chart 16.1 Value shares of private labels in retail sales, various countries, 2005**



Source: Coles, confidential submission, 23 May 2008, p. 48

Recognising the potential for further growth, the major retailers have adopted strategies that aim to increase sales of private label products. For instance, Coles told the inquiry that it is planning to invest in its Coles Finest range in the future and is generally putting more focus on 'generics'.<sup>20</sup>

17 Woolworths Ltd, Presentation of company results, half year ended 30/12/2007, accessed 19 June 2008, <http://library.corporateir.net/library/14/144/144044/items/281095/2008%20Half%20Year%20Results%20Presentation.pdf>.

18 FoodWorks, submission no. 90, p. 45.

19 Competition Commission, *Supply of Groceries in the UK Market Investigation, Provisional Finding report*, appendix 8(11-1), 31 October 2007.

20 ACCC, public hearing transcript, Melbourne, 26 May 2008, pp. 53, 56.

FoodWorks and Metcash told the inquiry that they are aiming for private labels to represent 10 per cent and 12 to 15 per cent of sales respectively.<sup>21</sup> However, Metcash explained that it has set what it considers to be a modest target for private labels sales share because it considers the presence of proprietary brands on independent retailers' shelves are one of their key competitive advantages.<sup>22</sup>

### 16.3.3 Shares across product categories

Evidence presented to the inquiry shows that the sales share of private label products varies across product categories and retailers. National Foods, for instance, told the inquiry that the share of private labels is generally higher in the staple product categories where there is less product differentiation. According to National Foods, private label penetration tends to be lower in categories such as yoghurt that are highly differentiated, with strong support for branded products.<sup>23</sup>

A supplier said that private label products will generally sell more in categories where there is a low level of consumer brand engagement. For instance, the supplier said that there is still a significant amount of brand loyalty in the cheese category:

'to put it simply, people may not want to have a *No Frills* cheese or a *You'll Love Coles* cheese on their cheese platter if people are coming over. They would rather have a brand offering'.

The supplier also told the inquiry that the MSCs had attempted to introduce private label yoghurt 'a couple of times' but consumers had 'rejected it basically'. However, according to National Foods, overseas trends suggest that private label shares may increase in the more differentiated categories as retailers shift their focus to those categories.<sup>24</sup>

Chart 16.2 shows private label products' share in various grocery categories in 2002 and 2007.<sup>25</sup> Consistent with inquiry participants' views expressed above, it indicates that private labels have achieved greatest share in categories where the product might otherwise be homogeneous to consumers, and consumer choice would be based mainly on price. For instance, private labels have achieved substantial market shares in milk (over 50 per cent in 2007), and eggs and sugar (both over 60 per cent). In contrast, private labels have a relatively low share of sales in the biscuits, fruit juices and drinks categories. As noted above, sales of private label yoghurt products are also relatively low.

The evidence also shows that growth in sales of private label products varies by category, as can be seen in Chart 16.3. From 2002 to 2007, for instance, sales of private label bread increased by nearly 140 per cent. Sales of private label butter, cheese and cooking oils also increased by over 40 per cent during that time. In contrast, private label sales in margarine, dry pasta and frozen vegetables have grown by less than 20 per cent.

The cross-category differences in both absolute shares and sales growth of private labels suggest a range of factors determine the success of such products. Not all of these factors are likely to be under the control of retailers.

The ACCC considers that the tiered private label strategies of the MSCs, which seek to introduce more product differentiation, have contributed to the growth in private label sales. Nevertheless, private label products appear to have less consumer appeal in some categories where loyalty to existing proprietary brands is relatively strong. It remains to be seen whether this loyalty will prevent Australian grocery retailers from increasing sales of private labels to levels comparable with retailers overseas.

21 FoodWorks, submission no. 90, p. 45; Metcash, submission no. 74, p. 52.

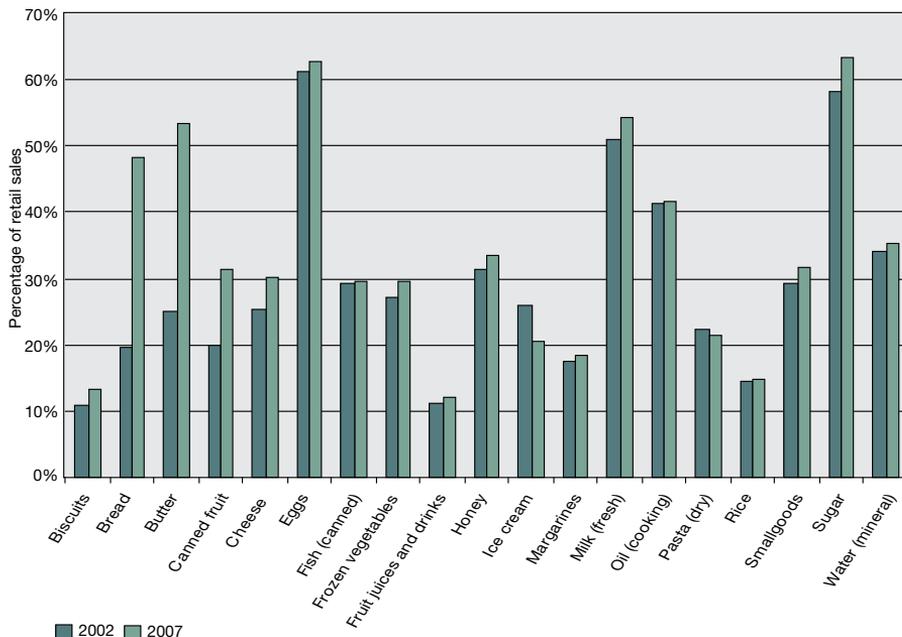
22 Metcash, submission no. 74, p. 52.

23 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 16.

24 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 16.

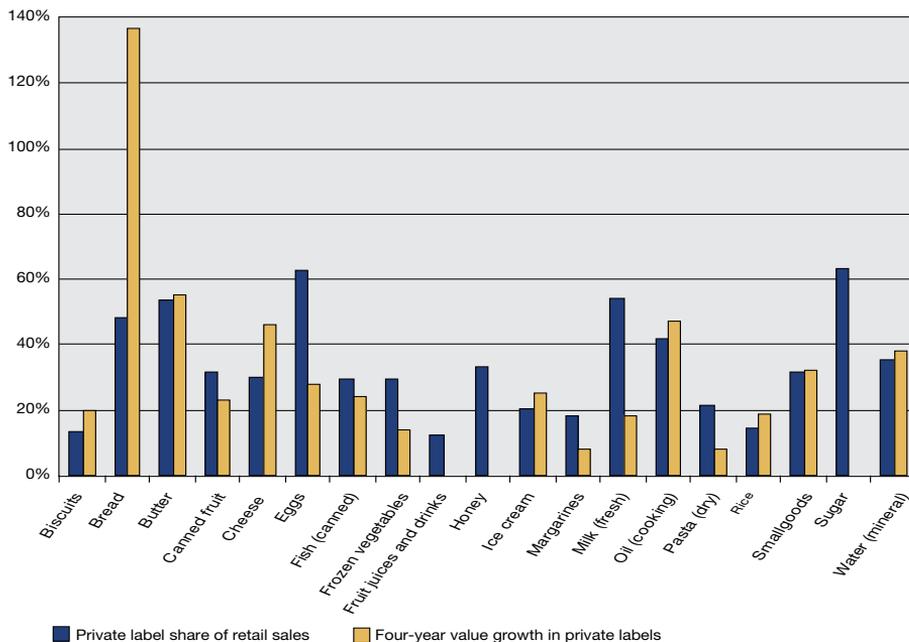
25 Coles, submission no 157, freshlogic report, p. 41.

**Chart 16.2 Private label products share of total category sales, 2002 and 2007**



Source: Coles, submission no. 157, p. 41

**Chart 16.3 Private label products' shares of category sales 2007, and growth in value, 2002-07**



Source: Coles freshlogic report, p. 41

## 16.4 Quality of private label products

The degree of substitutability between private label products and proprietary brands will reflect consumers' perceptions of quality. If consumers consider a private label product to be a close substitute for the targeted proprietary brand, they are more likely to switch to that brand in response to its generally lower price. Even if consumers perceive the quality of private label products to be lower than branded products, they still may decide to change their purchasing patterns if the price difference is large enough. Either way, private labels can provide a source of price competition from proprietary branded products.

According to the ACCC's consumer survey, over 80 per cent of shoppers buy private label products.<sup>26</sup> Although most consumers buy private label products, there appears to be a consumer perception that private label products are of lesser quality than their branded rivals.

This inquiry gathered considerable evidence, some of it in confidence from suppliers, about the physical characteristics of private label products. Some of this evidence indicates that for products such as milk, eggs, cheese and bread, there is little, if any, difference between the private label product and the equivalent proprietary branded product. Similarly, the NSW Farmers Association noted that for milk and eggs, the private label and branded products are identical to one another. In relation to milk, the products often come from the same factory.<sup>27</sup>

Despite limited physical differences, the retail price of the private label milk brand is usually considerably less than the comparable proprietary branded product. For instance, Coles sells both Coles Smart Buy and You'll Love Coles private label milk products. Coles told the inquiry that these products differ in quality only in the 'eyes of the customer', with the key difference being the source of the product. You'll Love Coles milk is generally sourced from the local area (within the state) whereas milk for Coles Smart Buy may also be sourced from interstate.<sup>28</sup> According to Coles, customers attach value to knowing they are supporting local farmers and local producers. Coles charges around 20 per cent more for You'll Love Coles full cream 2-litre milk compared with the equivalent Coles Smart Buy product.<sup>29</sup>

In other cases, the inquiry heard that retailers specify ingredients and packaging that differentiate the private label from its branded rivals, making direct quality comparisons difficult. For instance, ALDI provided the inquiry with product specifications for a number of its private label products on a confidential basis, which showed varying degrees of differentiation compared with the targeted proprietary branded product. Similarly, Woolworths submitted that its Select range often offers products without directly comparable branded competitors. Nevertheless, Woolworths contended that its quality specifications are equal to or better than the market leader in 99 per cent of cases.<sup>30</sup> Finally, Coles submitted that some private labels are aimed at providing a slightly different product to existing proprietary brands, thereby increasing consumer choice.<sup>31</sup>

### ACCC's view

Consumers' perceptions of quality are essentially subjective and can be based on a whole range of factors other than the objective quality of the product. Therefore, in the context of this report, the ACCC

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<sup>26</sup> ACCC consumer survey, 2008.

<sup>27</sup> NSW Farmers Association, submission no. 155, pp. 18, 19.

<sup>28</sup> ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 69.

<sup>29</sup> *ibid.*, p. 70.

<sup>30</sup> ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 49.

<sup>31</sup> ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 55.

does not draw conclusions regarding the quality of private label products in relation to proprietary branded products.

However, as part of the ACCC's preliminary work in developing the GROCERYchoice website (discussed in chapter 1), the ACCC engaged an independent product tester to ensure that the grocery products in the comparison baskets across supermarket retailers were of equivalent quality and therefore would allow meaningful price comparisons to be made. This was necessary because the various baskets include a range of private label products that need to be matched to other brand or private label products available from other retailers. While it has been found that some private label products are equivalent in quality to leading brand proprietary products, this is not always the case.

Moreover, independent of the quality differences, the different price points the MSCs offer private labels adds to the choice available to consumers and creates competitive tensions with branded products.

## 16.5 Impact on choice

The introduction of new private label products may be criticised as an attempt by the MSCs to force lower cost products on consumers and diminish consumer choice by deleting branded products or narrowing the range previously available to consumers.

The inquiry has been provided with evidence that some consumers consider that private labels lead to a reduction in consumer choice. The following comment is indicative of consumer concerns:

Coles and Woolies seem to be 'getting rid' of choice, there are so many of their own brands and other brands are disappearing, no free choice.<sup>32</sup>

A key issue in determining the effect of private labels on consumer choice is assessing whether it is supermarket rather than consumer preferences that are driving the introduction and success of private label products.

On this issue, the National Association of Retail Grocers of Australia submitted that, regardless of customer preference, the major chains have reduced product ranges and deleted brands, replacing them with private label brands:

Desired brands have been delisted now, regardless of customer preferences. Many suppliers complain about being taken off the shelf to make way for a house brand.<sup>33</sup>

However, Coles stated during hearings that:

I actually think that customers are demanding it [private labels] because they're saying I'm going to go to Aldi to buy that pasta or that milk or those eggs unless you have a product of similar quality and better value ...

We don't accept the proposition that the drive to home brands and restricted range is reflective of lack of competition and customer responsiveness on the part of Coles and Woolworths—absolutely not.<sup>34</sup>

Coles further added:

We think they're [private labels] pro choice for customers and pro competitive.<sup>35</sup>

Coles also disagreed that customers would prefer a bigger range of brands and less focus on generics.

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32 Georgina Close, submission no. 105.

33 National Association of Retail Grocers of Australia, submission no. 129, response to question 53.

34 ACCC, public hearing transcript, Melbourne, 26 May 2008, pp. 56, 58.

35 *ibid.*, p. 56.

It cited research that Australians have a 79 per cent propensity to buy private labels, which suggested to Coles that, over time, customers are accepting the brands more and more. Nevertheless, Coles noted:

From a category management perspective we've got a job to be done to ensure we range the most relevant range of branded and home brands for our customers because customers are faced with a choice. They will walk if we don't range according to what they need.<sup>36</sup>

Woolworths agreed that there has been a reduction in range in some categories but said that this represents a different choice for consumers, rather than a reduction in choice.<sup>37</sup> Further, Woolworths submitted that the deleted product may be from another category. A supplier told the inquiry that it does a lot of research work on consumer behaviour—particularly of consumers shifting between brands.

### ACCC's view

The introduction of a private label product at a lower price point to existing comparable proprietary brands offers consumers additional choice and is pro-competitive, all other things being constant.

The ACCC is satisfied that consumers as a whole are not worse off from the growth in private label products. There is little evidence that MSCs are able to override consumer preferences because if they were to do so, they would risk losing customers to other retailers. This implies that although some consumers may be unable to purchase their favourite brands, the success of private label products does not indicate the consumers are worse off overall.

## 16.6 Benefits of private label products to retailers

The inquiry was told that retailers offer private label products for a number of reasons, including to<sup>38</sup>:

- increase margins
- build customer loyalty by offering products that are not available in competitors' stores
- enable the retailer's store brand loyalty to be leveraged into private label offerings, although this must be balanced against the risk that the store's image will be damaged if consumers' quality expectations are not met
- give retailers greater control over supply because supply of private label products is generally subject to fixed-price long-term contracts
- give retailers greater control over quality
- reduce the influence of branded manufacturers and correspondingly improve the retailers' buying power.

Some of these reasons, such as giving the retailer greater control over supply and quality, may enhance the retailer's efficiency. Whether some of these reasons, including attempts to increase margins and buyer power, can have an anti-competitive effect is considered in more detail below.

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<sup>36</sup> *ibid.*, p. 57.

<sup>37</sup> Woolworths, public excerpts from confidential transcript, 19 May 2008, p. 7.

<sup>38</sup> See FoodWorks, submission no. 90, p. 24; George Weston Foods, submission no. 138, pp. 10, 12; Insight Partners, submission no. 122, p. 2; Metcash, submission no. 74, p. 16; Coles, submission no. 157, freshlogic report, p. 41; ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 54.

## 16.7 Profitability of private label products

For the MSCs, private labels can be used to increase gross margins. Indeed, achieving such an outcome is a key component of the MSCs' private label strategies. For instance, Woolworths Ltd reported an increase in gross profit margins for its supermarket division (including petrol and liquor) to 23.69 per cent for the first half of 2008. This contrasts with gross margins of 23.01 per cent (2005–06) and 23.41 per cent (2006–07) for Woolworths' supermarket division (including petrol and liquor). In its presentation of company results, Woolworths attributed this increase, among other things, to the success of its private label offerings.<sup>39</sup> Woolworths told the inquiry that it expects to continue to get a positive contribution to earnings before interest and tax (EBIT) from customers switching from the market leader to the Select product range and that it has been able to maintain its target margins.<sup>40</sup>

Further, Coles told the inquiry that one of the objectives of its private label strategy is to generate higher percentage margins off a lower dollar price, typically five to six percentage points in additional gross margin.<sup>41</sup>

As Coles explained:

If we get a homebrand right we expect to deliver better value to customers and increased EBIT margin too.<sup>42</sup>

Woolworths elaborated, submitting:

It is not a general rule that we make really good margins on all [private label] products. In some categories we actually don't make a great margin.<sup>43</sup>

Coles also expressed the qualification that although private labels earn a higher percentage gross margin for the retailer, the lower prices paid by consumers mean the margin returns in cents are not necessarily higher than for branded products. Further, depending on relative sales volumes between private label and proprietary brands as well as total category sales growth, Coles explained that the overall dollar sales and profits returned could be higher or lower. Coles also argued that its private label strategy requires a substantial investment in product and brand development as well as quality management. According to Coles, these costs will only be recovered in the long term if customers accept the products.<sup>44</sup>

The inquiry was told in confidence that unlike the MSCs, independent retailers do not necessarily earn higher margins on private labels as they do not have the volume to drive supply prices down. For smaller retailers, the role of private label products is often to provide price competition to the MSCs rather than a strategy to increase profit margins. Private labels can also be used to attract a particular customer demographic.<sup>45</sup>

### 16.7.1 Supply prices for private label products

The inquiry was told that, unlike branded products, private label products are generally supplied on terms and conditions specified in contracts of one to two years' duration. These contracts are awarded

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39 Woolworths Ltd, *Presentation of company results, half year ended 30 December 2007*, available at [http://media.corporate-ir.net/media\\_files/irol/14/144044/asx/2008%20Half%20Year%20Results%20Presentation.pdf](http://media.corporate-ir.net/media_files/irol/14/144044/asx/2008%20Half%20Year%20Results%20Presentation.pdf), accessed 14 May 2008.

40 ACCC, public hearing transcript, Melbourne, 19 May 2008, pp. 17–18.

41 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 53.

42 *ibid.*, p. 55.

43 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 17.

44 Coles, submission no. 225, p. 38.

45 ACCC, public hearing transcript, Sydney, 1 April 2008, p. 53.

in several ways, including by tender and online auction. Coles told the inquiry that a tender document will contain product specifications, delivery requirements, estimated volumes and supply terms and conditions.<sup>46</sup>

As the price of private label products is typically less than comparable proprietary brands, the increase in gross margins is mainly achieved by buying the product at a lower price than the comparable branded product. One reason this is possible is that the supplier does not advertise or promote the product and therefore does not need to recover these costs in supply prices. As Woolworths explained:

Private label doesn't carry the cost of marketing that branded product do, we can clearly make a better margin and yet deliver it to the customer at a lower price.<sup>47</sup>

Participants told the inquiry of a number of other benefits that the supply of private label products to supermarkets can provide for suppliers, particularly smaller ones, notwithstanding that such supply is often on a low-margin, fixed-price basis with associated price risk. These benefits include<sup>48</sup>:

- keeping a competitor from increasing volume and reaping benefits from economies of scale
- providing the ability to enter the marketplace and/or gain access to a customer base—though Woolworths stated it would be unusual for it to award all of a tender for a significant product to a start-up company because of a lack of track record in the production or delivery of that product<sup>49</sup>
- providing stability of income and guaranteed volumes for the contract period, which can provide a base for new product development and product innovation
- utilising surplus production capacity
- for small and medium size suppliers, achieving economies of scale that may not otherwise be realised
- improving negotiating position with retailers in relation to branded supply, which may provide an additional incentive to offer a low private label price (see section 16.8.1).

These benefits might be of such value to some suppliers that they are willing to offer prices close to marginal cost. Indeed, this inquiry has heard confidential evidence that some suppliers are making a loss on private label contracts. While this is generally because of unforeseen changes in market conditions, the inquiry has heard confidential evidence that there is also a willingness on the part of some suppliers to earn a lower than normal return on private label sales in order to obtain the benefits of supplying branded products to the large supermarket chains.

On the other hand, a number of suppliers of proprietary branded groceries told the inquiry that they choose not to supply private label products. This is often because the suppliers do not want to compromise their own brand image.

For instance, the inquiry was told during confidential hearings:

We're in the business of building our brand, not someone else's. We know what happens when you go down that road, you effectively put yourself once your brand disappears, in the hands of the retailer ... Their margins are comfortable, your margin may be compressed rather severely. What happens is you end up with a lot of volume business but the earnings are very small and there's uncertainty about continuity of market share.

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46 Coles, submission no. 225, p. 13.

47 ACCC public hearing transcript, Melbourne, 19 May 2008, p. 13.

48 See, for example, ALDI, submission no. 81, p.13; Coles, submission no. 225, p. 12.

49 Woolworths, confidential transcript, 19 May 2008, cited with the consent of Woolworths.

## ACCC's view

The ACCC accepts that not all private label products earn high margins for the MSCs. Further, high margins are not necessarily indicative of weak competition. In a competitive market, however, it would be expected that initially high margins on private label products would fall over time as rivals respond by introducing competing products. Evidence suggests, however, that MSCs expect to maintain or even increase the gross margins earned on sales of private label products.

Although some suppliers choose not to supply private label products, evidence indicates that for many suppliers, particularly smaller ones, a private label contract with an MSC provides many benefits. Therefore, competition to win such a contract is generally strong.

## 16.8 Buyer power

As noted above, one of the reasons that retailers sell private label products is an attempt to reduce the influence of suppliers of proprietary brands. If successful, this would increase the bargaining power of the retailer and thus may increase their buyer power. As noted previously, the competitive effects of buyer power are ambiguous. However, a number of potential competition concerns associated with buyer power arising from private label products have been raised at this inquiry, including:

- retailers may allocate premium shelf space to their own brands in preference to competing suppliers, which could affect competition at the retail level
- branded products may be de-listed to make way for private labels, which could affect competition at the supply level
- private labels may weaken incentives for product innovation
- the impact of 'copycat packaging' of private labels.

### 16.8.1 Shelf space allocation

Retailers with private label products have the ability and incentive to allocate shelf space and positioning in a way that favours the retailer's brand.

If the suppliers excluded from supermarket shelves to make way for private labels have no viable alternative distribution channels, their access to final consumers may be foreclosed. In this way, competition at the supplier level could be distorted if independent suppliers exit the upstream market in response to reduced sales and/or prices.

An additional competition concern considered by this inquiry is whether MSCs tie the allocation of shelf space for proprietary brands to the winning of a private label contract. The ACCC considers that if this were the case, retailers may be able to extract excessive discounts for private label contracts from suppliers, leading to higher barriers to entry at the supply level.

The inquiry did not hear evidence that this is the case. Indeed, Woolworths stated that, when deciding whether to accept a tender offer for a private label, it does not consider how far it can push the supplier's margin down.<sup>50</sup> However, the inquiry heard confidential evidence that the winning of a private label contract can make it easier for a supplier to negotiate access to shelf space for its branded products. On the other hand, another supplier told the inquiry in confidence that it has not had difficulty getting access for branded products where it is not the supplier of private label products.

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<sup>50</sup> Woolworths, confidential transcript, 19 May 2008, cited with the consent of Woolworths.

As discussed in more detail in chapter 15, the layout of a store, including the placement on shelves of individual products within a category, is determined by retailers using a 'plan-o-gram'. Retailers told the inquiry that allocations to a particular position on a shelf are determined by the product's contribution to profit, with those making the greatest contribution displayed in a more favourable location. This is generally the space between eye and hip level.

In relation to shelf space allocation, George Weston Foods (GWF) told the inquiry<sup>51</sup>:

MSCs and independent retailers actively manage shelf placement and promotional offers and tend to support the best performing lines which may adversely affect smaller suppliers. The 'shelf squeeze' has become more acute recently as retailers have reduced the number of products or product variants in particular categories in order to minimise supply chain costs and accommodate new and private label products.

The Australian Honey Bee Industry Council (AHBIC) submitted<sup>52</sup>:

The expansion of own-label products further increases the bargaining position of MSCs in several regards through providing them with the ability to undermine a producer's branded products. This can be achieved through placing producer's products in less well-located shelf positions, raising the retail price of the branded product, or substituting the branded product for their own-label products.

In response, Coles submitted<sup>53</sup>:

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 best performing lines. However, Coles does not agree with George Weston's contention that this necessarily disadvantages small suppliers. Rather, it disadvantages brands which do not perform to requirements.

Confidential evidence presented to this inquiry confirms that MSCs do place their private label products in favourable positions and may give those products priority over branded products.

## 16.8.2 Product de-listing

As well as allocating premium shelf space to their own products, retailers may be able to credibly threaten to de-list rival proprietary branded products in order to make space available for new private labels, thus increasing their buyer power. The category review process that may ultimately lead to product deletion was discussed in chapter 15.

Metcash explained the threat of deletion as follows<sup>54</sup>:

The MSCs can credibly threaten to delist products and/or ranges of suppliers as a ranging strategy or to favour their private label brands. In a highly concentrated market, the delisting of products by the MSCs could result in suppliers exiting the market thus further intensifying the level of market [supplier] concentration.

GWF told the inquiry<sup>55</sup>:

The rise of 'private labels' over the past five years is well established, and retailers are using private labels to keep pressure on branded products and keep the prices that they acquire at down. The growth of private labels in some product categories is over 40%. In some categories this growth is fuelled by the delisting process pursuant to which many enduring national brands are disappearing and suppliers are not being given the opportunity to replace failing brands or SKUs with new products.

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51 GWF, submission no. 138, pp. 8–9.

52 AHBIC, submission no. 59, p. 9.

53 Coles, submission no. 225, p. 19.

54 Metcash, submission no. 74, p. 51.

55 GWF, submission no. 138, pp. 9–10.

The concern that the retailers' push to increase private label sales may lead to deletion of profitable branded products was also raised by Mrs Mac's<sup>56</sup>:

We have experienced a decision by a major retailer to delete our brand in substitution for a range of home brand product after what had been many years of successful business for both parties. It represented a significant quantity of our business and no other brand is now to be permitted in this particular category.

In contrast, another supplier told the inquiry in confidence that the advent of private label products has not made it harder for its branded products to stay on the shelf or caused more deletions of its products.

MSCs noted that any product can be deleted if it does not meet performance criteria. Coles submitted<sup>57</sup>:

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.

In this regard, Coles told the inquiry that from time to time it has launched private labels that have not succeeded because the product has not lived up to consumers' expectations.<sup>58</sup> Indeed, confidential information provided by the MSCs regarding product deletion confirmed that private labels have been deleted in recent times.

Further, Woolworths stated that it is not safe to assume that the introduction of a private label leads to the deletion of an equivalent brand. Even though 'one-in-one-out' is the general rule, it is possible that the deleted product will be from another category. Nevertheless, Woolworths confirmed that products most at risk of deletion are second or third tier brands that are not selling well. However, a private label product not selling well could also be deleted.<sup>59</sup> This evidence is consistent with claims made by Metcash and Fonterra that the number three to five brands in certain product categories have in many cases been replaced with private labels.<sup>60</sup>

However, the ACCC heard confidential evidence from a small supplier of both proprietary branded and private label products that the introduction of private labels does not necessarily harm sales of its competing proprietary brands. That supplier also told the inquiry that private label products can actually increase sales of smaller manufacturers' branded products by increasing public awareness of the category's products in general through the MSCs' advertising.

### The competitive response of suppliers to the introduction of private labels

Suppliers are generally given notice that their product is at risk of deletion and are given an opportunity to improve the at-risk product's performance. Coles told the inquiry that the response of suppliers of proprietary brands to the introduction of private labels varies. According to Coles, some suppliers are more concerned about brand positioning and quality rather than price reductions to improve competitiveness. On the other hand, Coles said that some suppliers are 'very interested in reducing price'.<sup>61</sup>

56 Mrs Mac's, submission no. 152, p. 1.

57 Coles, submission no. 225, p. 38.

58 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 62.

59 Woolworths response to s. 95ZK notice, cited with the consent of Woolworths.

60 Fonterra Brands (Australia) Pty Ltd, submission no. 85, p. 8; Metcash, submission no. 74, p. 51.

61 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 58.

The ACCC has been told that branded suppliers' competitive responses to the threat of deletion and the introduction of private label products may include a combination of:

- a reduction in wholesale list price, although the inquiry was told that suppliers generally do not reduce wholesale prices to all customers in response to a threat from a specific retailer
- an increase in off-invoice discounts, including increased case deals or promotional payments that are intended to reduce the retail price of the product
- an increase in advertising by the supplier.

For example, Coles told the inquiry that private labels create competition for shelf space and can introduce competition into categories where little may have existed before.<sup>62</sup> Coles used Cadbury block chocolate as an example of a supplier's competitive response to the introduction of a competing private label. According to Coles, the regular selling price of a Cadbury block of chocolate was reduced from \$4.69 to \$3.99 for 22 weeks. This was in response to the introduction of You'll Love Coles Belgian Chocolate range. According to Coles, the introduction of the private label product has<sup>63</sup>:

... caused quite a change of heart from that leading supplier both in terms of more promotional support to lower price of their products and in fact just recently to lower the regular price for a six month period.

Further, Coles argued that promotional contributions as a percentage of its business have increased over time as has the number of stock keeping units (SKUs) that are run on promotion. According to Coles, these changes are at least in part driven by the very competitive nature of house brands in that they cause every supplier to respond.<sup>64</sup>

Woolworths agreed with the proposition put to it at the public hearing by the ACCC that, in its role as gatekeeper to consumers, it controls decisions about lowering retail prices and may choose to not accept the benefits of lower wholesale prices or permit increased promotions. However, Woolworths did not agree with the proposition that the existence of private label products provides a positive incentive for it to act that way. Instead, Woolworths told the inquiry that if a leading brand is 'on special' more often as a result of competition from private labels, this has the effect of increasing Woolworths' attractiveness to customers. In this regard Woolworths told the inquiry that it had never chosen not to pass lower wholesale prices on because of its desire to preserve the retail price of the competing Select product.

Further, Coles told the inquiry<sup>65</sup>:

We should be clear we don't accept every promotional proposition that's put to us. I don't believe we've made any different decisions because of house brands.

In addition, a supplier told the inquiry it has not encountered reluctance by retailers to accept and pass on price promotions for branded products because of the presence of private labels.

The inquiry has heard confidential evidence that for some products the branded product can at times sell for less than the private label products. Furthermore, despite a loss of market share to private label products, a supplier told the inquiry that it does not feel that the presence of private label reduces competitive tension as the MSCs largely follow its recommendations regarding shelf space and promotional prices.

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62 *ibid.*, p. 54.

63 *ibid.*, p. 55.

64 *ibid.*, p. 61.

65 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 59.

In contrast to this evidence, the AHBIC told the inquiry<sup>66</sup>:

Discounts have often been offered to the MSCs on branded products to lower the price to consumers in an attempt to increase sales of a particular product line, however, there is no guarantee that the discount is actually passed on to consumers. There have been numerous instances of product discounts being pocketed by the MSCs with no effect on the shelf price.

Confidential evidence presented to this inquiry suggests that a desire to protect sales of private labels does sometimes lead a retailer to maintain branded prices despite the suppliers' wish to price more competitively through the provision of additional promotional payments. However, this evidence is not necessarily inconsistent with the MSCs' position that not every promotional proposition that is put to them is accepted.

### ACCC's view

The ACCC accepts that as retail shelf space is finite, the introduction of a new product, whether a proprietary or private brand, is likely to lead to the deletion of an existing product (the alternative being less shelf space being made available for an existing product). The ACCC has heard considerable evidence about the deletion process and has considered carefully whether the evidence shows that this process differs when the new product is a private label rather than a proprietary brand.

The ACCC understands that suppliers are concerned about the possible deletion of their products given the importance of the retail grocery channel to their sales. The evidence indicates that products most at risk of deletion are second and third tier brands. Further, underperformance is one of the main reasons that products are deleted. This suggests that some products that are deleted to make way for private label products are already under competitive pressure from existing rivals and may well have been deleted regardless of the existence or otherwise of a competing private label. In such cases, the ACCC considers that new private label products may increase competition within a category by offering a stronger rival to remaining brands in a category.

The ACCC considers that in many cases the introduction of a private label product priced below a comparable quality proprietary branded product is a source of price competition. In this regard, the introduction of private label products can be pro-competitive. Nevertheless, the ACCC considers that price competition would be distorted if retailers have reduced incentives to pass through to retail prices the competitive responses of branded product suppliers because of the growth of private labels.

On the evidence available, the positive aspects of private label products appear to be clearly present whereas the evidence of price distortion within a category was not strong.

### 16.8.3 Product innovation

Another concern put to this inquiry is the potential impact of growth in private labels on product innovation. Research and development costs associated with new product innovation are high and fixed. Producers undertake such investments if the expected returns are sufficiently high. The theoretical concern is that if private label sales increase at the expense of branded products, suppliers of branded products may have lesser incentive and ability to undertake new product innovation as expected returns would be lower.

For products that are not protected by proprietary technology or intellectual property laws, the length of time before rivals can copy successful new products (and thus compete away the profits from such products) has a direct impact on producers' incentives to engage in new product research and

<sup>66</sup> AHBIC, submission no. 59, p. 10.

development. If the dissipation of rewards is made faster by the introduction of private label products, incentives for product innovation could be altered. This could ultimately lead to reduced innovation and fewer new products.

The inquiry has been told that suppliers typically share their new product plans with MSCs at annual reviews. This may give MSCs a head start in being able to copy those products compared with other rivals. However, suppliers have not raised concerns about the competitive effect of the requirement to share new product plans in advance with MSCs, nor has the inquiry heard evidence that suppliers have reduced their product innovation as a consequence.

Rather, manufacturers of proprietary brands could choose to respond to the threat of private labels by undertaking more innovation in order to further differentiate their offering from that of the private label. Thus, rather than blunting incentives to innovate, private labels may, in fact, promote product innovation. Indeed the inquiry was told by a supplier that one way to combat the advent of private labels is to be innovative and move into different spaces.

In addition, Coles told the inquiry that it will continue to develop and expand its private label range, reflecting the need to continually provide innovative and price competitive products to meet customer demand and to respond to changing product offerings of Coles' competitors.<sup>67</sup> This suggests that retailers themselves can be sources of product innovation. The Woolworths' Organic and Freefrom private label products may reflect this trend.

On the basis of the evidence presented to this inquiry, the ACCC does not consider that the introduction and growth of private label products raises widespread concerns about product innovation.

#### 16.8.4 Copycat packaging

The inquiry has heard evidence from the AHBIC that MSCs are employing similar or copycat packaging and are engaging in branding practices designed to persuade consumers that their own label product is high quality.<sup>68</sup> As this is the extent of the evidence presented to this inquiry on the topic, the ACCC considers that copycat packaging of private label products is not of widespread concern.

### 16.9 Conclusions

The ACCC considers that the introduction of a private label product at a lower price point to existing comparable proprietary brands offers consumers additional choice and is pro-competitive, all other things being equal. Indeed, much of the evidence presented to the inquiry on this point shows that suppliers of rival branded products typically react competitively to the introduction of private label products. This reaction has led to lower retail prices in some categories.

However, the ACCC recognises that retailers have incentives to:

- promote their own labels in preference to proprietary brands by giving them preferential shelf space, including deleting branded products that are less profitable than the private label product
- retain additional promotional benefits obtained from branded suppliers in response to competition from private labels rather than passing those benefits to consumers in the form of lower retail prices.

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<sup>67</sup> ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 5.

<sup>68</sup> AHBIC, submission no. 59, p. 9.

However, the ACCC considers that to remain competitive, retailers must continue to deliver products that consumers value, or risk seeing their customers shop at other stores. The deletion of proprietary brands that consumers prefer in favour of private labels is unlikely to be in the long-term interests of the MSCs.

The inquiry has heard evidence indicating that MSCs generally accept increased promotional funding and pass through the funding to retail prices, although in limited circumstances this funding had been declined. The ACCC notes that there are risks of breaching s. 46 of the Act if promotional funding from a rival supplier of a proprietary brand is rejected in order to protect a private label product. Section 46 of the Act is directed at preventing firms with substantial market power from taking advantage of that market power for the purpose of eliminating or substantially damaging a competitor, preventing market entry or deterring or preventing competitive conduct in a market.

On balance, the evidence suggests that for many products, brands are important to the majority of Australian consumers. This loyalty provides some protection for proprietary brands from the competitive threat of private label products. Nevertheless, the evidence indicates that in most instances the introduction of a private label product leads to a competitive response from rival proprietary product(s), often in the form of increased promotional activity aimed at reducing the retail price of the proprietary branded product. ACCC does not consider that the growth of private label brands by the MSCs or other retailers raises significant competition concerns at this time or, importantly, that this growth is inconsistent with consumer preferences.



# 17 Conclusions on supply chains, buyer power and vertical relationships

## Key points

The ACCC conclusions are:

- The ACCC is largely satisfied most categories of products are subject to adequate competitive pressure at each level of the supply chain.
- Movements in retail prices broadly reflect increases in costs and prices in other parts of the chain and for the most part the prices paid to producers as a proportion of the final retail price have not reduced significantly over time.
- Market concentration does deliver to the major supermarket chains (MSCs) and Metcash a substantial amount of buyer power in packaged groceries, which they use to improve price and non-price terms of supply. This buyer power does not appear to result in inefficient outcomes and uncompetitive pricing, and can in some circumstances benefit consumers.

## 17.1 Introduction

The preceding six chapters addressed three questions concerning the vertical supply chain for standard groceries:

- Is there sufficient competition at each stage of the supply chain to deliver grocery products at competitive prices to consumers?
- Do retail prices reflect prices paid for goods at other levels in the vertical chain, or is there an expanding gap between the prices paid to producers and the prices charged by retailers?
- Does the buyer power afforded to the MSCs and Metcash because of market concentration at the retail and wholesaling level result in inefficient outcomes or uncompetitive pricing of grocery products through the supply chain?

This chapter contains the ACCC's conclusions on the efficiency of supply chains, market power and vertical relationships. In broad terms the ACCC is satisfied that:

- There is competition at each stage of the supply chain, with competition strongest at the primary producer level.
- There is no general trend of an increasing gap between prices paid to producers and prices charged by retailers.
- Market concentration does deliver to the MSCs and Metcash a substantial amount of buyer power. This buyer power does not appear to result in inefficient outcomes and uncompetitive pricing, and can in some circumstances benefit consumers.

## 17.2 Horizontal competition through the supply chain

In considering whether there is adequate horizontal competition through the grocery supply chain, the ACCC has examined supply chains for various food and non-food items. While each supply chain had different characteristics, a number of elements were common.

## 17.2.1 Producer level

Primary producers, including farmers, graziers and growers, sit at the start of many supply chains. Markets for the supply of primary products are highly competitive. They are characterised by large numbers of sellers and low barriers to entry. The prices in these markets fluctuate with domestic, and in many cases international, supply and demand.

When the market is oversupplied, prices will decline. When supply is short, prices can move up sharply. These markets can be subject to supply shortages for a variety of reasons. In the last eighteen months the best example of shortage of supply is wheat, which rose from \$192 per tonne in 2005–06 to a forecast of \$440 per tonne in 2007–08.<sup>1</sup> This was driven by a worldwide shortage of grain and strong increases in demand.

Other products exhibiting sudden surges in recent years include raw milk, for which the farm gate price has moved from 33c per litre to 48c per litre in the past 12 months, and Cavendish bananas, for which the wholesale price, following cyclone Larry, increased from \$2.18 per kilo to a peak of \$12.23 per kilo in the space of five months.<sup>2</sup>

These price increases reflect the operation of workably competitive markets. The ACCC has no concerns that these price changes represent a competition problem at this level of the market, but rather reflect international prices and supply-and-demand factors.

## 17.2.2 Wholesale level

Prices at the wholesale level need to be considered from two perspectives:

- the price paid to primary producers
- the price obtained when product is on-sold to retailers.

### Prices to primary producers

The wholesale level of the supply chain in all products involves considerably fewer participants than the producer level.

For products traded internationally, such as wheat, this narrowing did not raise any concerns.

However, for products such as red meat, milk and fruit and vegetables, producers have expressed concerns that their options for sale were narrow and that the prices they receive for their produce may not be a true product of market forces. Accordingly, the ACCC examined several of these supply chains to determine whether they operated competitively.

For red meat, because of the relatively small number of wholesale buyers (including the MSCs, abattoirs and meat processors) and given the narrow specifications set for livestock sold onto the domestic market (making the MSCs a larger purchaser of that type of product than generally might be the case), a competition problem at this level could be possible. However, there are many features of the market that give the ACCC confidence that any competition problems are isolated.

First, Woolworths, the largest buyer, only buys 6 per cent of domestic production. Second, pricing evidence suggests that margins in processing are already low and that processors have offset recent increases in their costs of production with efficiency gains rather than passing through higher prices up the supply chain. Third, the MSCs are involved in the supply chain back to the farm gate. The

1 Australian Bureau of Agricultural and Resource Economics (ABARE), *Australian commodities*, March 2008, p. 33.

2 Wholesale price data purchased from Ausmarket.

retail gross margins the MSCs report on meat are relatively low and there is no evidence of a trend of such margins increasing. This suggests that involvement down the supply chain does not provide the MSCs with access to higher margins that would otherwise be earned at the processor level. Fourth, in percentage terms over the last decade, farm gate beef prices rose by more than the retail price, and for most of the last decade price increases at the retail level have fluctuated in line with wholesale prices. This suggests that processor and retailer margins are not expanding. As such, the ACCC does not consider it likely either processors or retailers are exercising substantial market power.

In relation to milk, the ACCC is satisfied that the number of dairy processors available in Australia result in a workably competitive market. While not every dairy farmer has access to every processor, the ability to transport fresh or processed milk domestically and internationally has the result that farm gate prices in south-east Australia<sup>3</sup> broadly reflect the prevailing international price of milk. In other parts of the country, where raw milk is not processed for export, farm gate prices are primarily set on the basis of local supply and demand.

For fruit and vegetables, a reasonable range of options appear to be available to a grower to sell their produce so that any price received will broadly reflect the conditions in the marketplace. Growers may sell their produce through a wholesaler operating in one of the wholesale markets, a growers' shed in the wholesale markets, directly to an MSC or to one of their consolidators, or directly to an independent retailer. The ACCC notes, however, that not all alternatives will be available to all growers.

In light of these findings, the ACCC is satisfied that as a general rule there is adequate competition for produce at the wholesale level and the prices paid to producers broadly reflect the operation of a competitive market.

### Prices obtained when products are on-sold to retailers or Metcash

Retailers obtain products through a number of different channels.

Sales of packaged groceries and non-food items primarily occur through direct dealings between manufacturers and the MSCs or Metcash. As there are no wholesale markets for manufactured products, these negotiations are strongly influenced by retailer expectations and consumer reactions to the products themselves. Regular product reviews and intense trading term negotiations between the MSCs and suppliers appear to result in supply of product to the MSCs and Metcash on terms that reflect the scarcity of retail shelf space and the level of competition from other brands in the category. The ACCC is satisfied that this aspect of the market is generally competitive.

For products like fruit and vegetables, dealings can be directly between retailer and grower or between grower and a third party buying on behalf of a retailer. In the case of independent retailers, it is more common for the retailer to approach a wholesaler or to attend the wholesale markets to obtain their fresh produce. Consequently, the price of produce in the wholesale markets influences the pricing of products to all retailers. Prices achieved in the central markets are published regularly and are available to any interested party. Some operators in the market have their own sources of market intelligence which they use to determine the prevailing price in the market. The prevailing price strongly influences any direct negotiation between a grower and the MSCs and supply prices broadly reflect market conditions.

Products like milk and eggs are often obtained by a retailer through direct dealings with the producer or processor. Independent retailers usually obtain such products from Metcash. Prices for these products, including those sold under house-brands, are set following competitive tender processes in which

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<sup>3</sup> South-east Australia produces around 80 per cent of domestic milk production.

various suppliers compete. These processes produce extremely competitive supply prices to the MSCs in particular.

Prices for branded products are set following negotiation between retailer and producer or processor. Generally, the supplier will have a list price that is available to all purchasers. However, most retailers will negotiate discounts or rebates off the list price, with larger buyers usually receiving the most favourable terms. This reflects the volumes purchased by these buyers and the importance to the supplier of securing shelf space with large retailers.

The ACCC is satisfied that the market at this level is competitive.

### 17.2.3 Retail level

The competitiveness of retail pricing is the subject of analysis in the first part of this report and its analysis will not be repeated here.

It is sufficient to say that, generally speaking, it is at the retail level where price competition appears to be the least vigorous when compared to competition at other levels of the supply chain.

### 17.2.4 ACCC view on whether farm gate prices reflect retail prices

An analysis of pricing through the supply chain and, in particular, pricing at the farm gate and retail levels was completed in chapter 13 of this report.

The evidence presented in chapter 13 suggests that, contrary to popular belief, retail prices are not rising faster than farm gate prices in many grocery categories. A significant number of submissions received by the ACCC were concerned about such a phenomenon in fresh fruit and vegetables. As demonstrated in chapter 13, movements in the retail prices of eight key fruit and vegetables are largely in line with movements occurring in the wholesale markets as a result of supply-and-demand dynamics. Given that the MSCs' internal documentation shows that gross margins in the produce category have declined overall since 2002–03, it appears that the public's concern that retailers are stretching their margins is unfounded.

For milk, eggs, beef, chicken and apples, there were some periods where margins between farm gate/wholesale and retail prices stretched, but on other occasions those margins shrank.

The ACCC further notes that comparing farm gate prices with retail prices of some products is difficult and not necessarily instructive, given the level of processing that occurs after the product leaves the primary producer. For these products, given the high proportion that the cost of processing is to the end retail price, changes in farm gate prices may show very little correlation with the prices paid at the retail level. For example, the cost of wheat is only around 10 per cent of the cost of producing a loaf of bread. It would not be expected that changes in wheat prices would significantly affect retail bread prices.

The ACCC is satisfied that as a general rule, where the farm gate price is a significant proportion of the cost of producing the product, farm gate price movements over time are reflected in retail price movements.

### 17.2.5 ACCC's view on buyer power

There are many circumstances and many product categories in which the MSCs enjoy significant buyer power. However, the extent to which they have such power is not purely a function of their size or

market dominance, but is most often a reflection of the outside options available to the party with which they are negotiating.

## Packaged groceries

It is in the area of packaged groceries where the MSCs have the most buyer power. The power is a result of the size of their retail market share (which on a reasonable estimate is around 70 per cent of national sales in this category), the weakness of price competition from competitors, who generally source their packaged groceries through Metcash, and the lack of alternative sales channels available to suppliers.

Consequently, if a supplier wishes to distribute packaged groceries to a mass market in Australia, it is extremely important that it secures shelf space in at least one of the MSCs. As discussed in chapter 11 of this report, shelf space is a highly valued commodity in the grocery retail industry. The retailers' limited shelf space means that retailers are continually looking to range products that provide the greatest return to them (i.e. providing higher margins and higher sales) in order to maximise their profits. Accordingly, manufacturers have to deliver products that can be marketed at a retail price which is attractive to customers while providing retailers with the kind of returns it expects from the category. To be introduced to and sustained within a supermarket's range, a product must deliver superior price and non-price attributes to the products it competes with for scarce shelf space.

Unless a supplier of a product has a powerful brand (or is able to build such a brand) which the MSCs perceive as important to a category, the terms that can be negotiated with the MSC will tend to favour the MSC and from the supplier's perspective may erode over time. This broad, but not universal, trend is reflected in the ACCC's analysis of supply terms over time.<sup>4</sup> Further, in some cases, the MSCs were able to shift costs to suppliers and effectively unilaterally alter the terms on which goods are supplied, even after delivery.

The ACCC considers that this is a consequence of lack of real alternatives for the supplier in these instances.

### *Is this a significant problem?*

Obviously, this bargaining weakness is a problem for the particular companies concerned, but not necessarily for consumers or the Australian community more generally. The risk associated with buyer power is that the companies which possess it will drive down prices in a way that discourages innovation or reduces competition at the supplier level. Neither of these effects is apparent in the Australian market at present. In addition, many of the companies that dominate this sector of the market are large multi-nationals with strong brands that often have significant consumer loyalty. Buyer power, particularly when increased by the use of private label products, may drive down margins and retail prices on branded products to the benefit of consumers.

## Fresh produce

The buyer power of the MSCs in their fruit and vegetable transactions appears to be less than in packaged groceries. The ACCC considers that this is to be expected given the current market structure.

Growers and producers have significant outside options in the form of the central markets, direct supply to customers and export channels. It is the extent to which a grower has developed these outside options that appears to influence the outcomes they achieve.

<sup>4</sup> See chapter 15 of this report for further analysis about supply terms.

Interestingly, as discussed in chapter 15 of this report, it is growers who generally have less of their business committed to supplying MSCs, who, on the face of it, receive better terms from the MSCs. A possible explanation for this is that growers who have geared their business model to the requirements of the MSCs may be more vulnerable in negotiations. The ACCC has received evidence that suggests that growers who have failed to develop alternative options to the MSCs are extremely vulnerable to the price pressure that appears to be routinely applied by the MSCs. As a result, growers with more developed outside options, no matter what their size, are more likely to negotiate more advantageous terms with the MSCs.

### *Is this a significant problem?*

The MSCs' ability to pressure growers on terms of supply is a problem for growers who have failed to develop alternatives to dealing with the MSCs. However, well-structured growing businesses appear to deliver returns that make the business viable and profitable in the long term. There does not appear to be a case for any kind of regulatory intervention to alter the way in which the market operates. Indeed, there was very little complaint from MSC suppliers summonsed to give evidence. In many cases suppliers expressed satisfaction with the conduct of the MSCs.<sup>5</sup> In particular, the MSCs were reported to have been supportive of new, capital intensive products, such as packaged salads, and were able to assist the development of new or struggling businesses by underwriting volumes.<sup>6</sup> Growers who were updating their processes in an attempt to obtain greater efficiency seemed to get real benefits from dealing with the MSCs.

The issue of manipulation of wholesale markets was raised with the ACCC in the context of avocado supply, but on the evidence available it was impossible to draw any meaningful conclusions about whether this was occurring.

## Dairy

There is no doubt that the MSCs are able to exercise considerable buyer power in the context of the contracts for the provision of house brand milk. The contracts are fiercely contested and the supply terms in some cases appear to be below cost. The remainder of the dairy range is also strongly competitive, but competition is not as vigorous as it is in the provision of private label milk.

### *Is this a significant problem?*

This does not appear to be a problem for consumers and has probably resulted in cheaper milk than would be available in a less concentrated retail market. The price of private label milk appears to shift margin away from processors, and the benefit of that lower margin is shared between consumers and the MSCs. Accordingly, the change in the pricing structure brought about by the MSCs' buyer power appears to have benefited consumers, but has not resulted in any reduction to the farm-gate price. It is the dairy processors who appear to have suffered a decline in margin as a consequence of the MSCs' buyer power. A more competitive retail market, while likely to mean that the MSCs would have less buyer power, may, however, result in more of the benefit of any buyer power being passed on to consumers.

## Beef, chicken and other meat

As a substantial buyer of meat, and in particular yearling heifers and steers primarily grown for domestic consumption, the MSCs' buying behaviour can influence price.

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5 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 75.

6 ACCC, public hearing transcript, Hobart, 10 April 2008, p. 26.

However, given the medium-term option for graziers to switch cattle production to export, and the size of the export market as percentage of Australian beef production (approximately 65 per cent of domestically produced beef is exported), it is difficult to accept that the MSCs are manipulating the market to push prices below the cost of production.

The current low prices for beef relative to their costs of production appear to be the result of oversupply, which may be caused in part by the high Australian dollar. Accordingly, buyer power is not the root cause of low farm gate prices and, while there were many submissions that urged such a finding, there was no coherent explanation of how this was possible given the current market structure.

For chicken—the size of chicken producers and outside options available to them make it unlikely that they are the victims of buyer power; certainly there were no complaints to the inquiry to that effect.

The low price of bacon and ham was also raised with the inquiry, but it appears to have been influenced primarily by international factors rather any power on the part of the MSCs.

### *Is there a market power problem?*

Looking at red meat, where the MSCs have the most influence in the supply chain, the ACCC does not consider that there is evidence of any benefit from competitive weakness in the supply chain accruing to the MSCs.

Retail margins in meat are low. In the case of the two MSCs, on the basis of information the ACCC obtained about the margins achieved in the category and information concerning the MSCs' overall cost of doing business, retailing meat contributes little to the bottom-line profitability of supermarkets. If there are beneficiaries from some distortion in the supply chain, there is no evidence that it is the MSCs.

In relation to participants at the processor level, it seems unlikely that they are able to manipulate the market to any significant degree. The evidence suggests that the gap between farm gate and wholesale pricing is low. There are players within the market who switch supply between the export and domestic market depending on market opportunities.<sup>7</sup> This suggests that international factors influence returns and that there are no above average returns to be made from supplying the Australian domestic market.

## 17.2.6 Buyer power and the consumer

The ACCC is not persuaded that there is a significant buyer power problem in the retail chain that requires broad regulatory action to resolve.

The sheer size of the MSCs and their share of sales in some categories obviously deliver to them a significant amount of bargaining power in many transactions and there are suppliers who are disappointed with the returns they receive when dealing with the MSCs.

However, there are also suppliers who are content with the terms they are able to obtain from the MSCs. Many are appreciative of the business opportunities that a deal with the MSCs provides to their business.

Accordingly, from the point of view of suppliers, no single picture emerges regarding the buyer power of the MSCs.

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<sup>7</sup> The ACCC understands that in particular meat processors and abattoirs may be able to take advantage of market opportunities in this way.

From a consumer's point of view, buyer power is generally only of concern if it is coupled with competitive weakness at the retail level. Such competitive weakness means that retailers do not have an incentive to pass on savings in the cost of goods to consumers.

As explained in chapter 10, the ACCC has concerns that while grocery retailing is workably competitive, there are currently factors that limit strong price competition and it is this aspect of the market where improvements can be made.

However, it should be highlighted that some aspects of the retail market do appear to be vigorously competitive. For example, in milk, private label prices have been lower as a consequence of the MSCs' buyer power and the benefits of those lower prices have been shared with consumers. Similar beneficial outcomes have been achieved for consumers in areas like generic eggs and bread. It is ultimately the individual consumer's choice as to whether they buy these lower priced private label products.

The ACCC's major concern rests with packaged groceries, particularly in brands that are not used by the MSCs to drive traffic. However, the most effective approach to these concerns is to lower barriers to entry, which would increase the likelihood of competitive entry or expansion of competitive retailers and a new wholesaler to compete with Metcash.

Accordingly, with the exception of changes to the Horticulture Code, which are addressed in chapter 18 of this report, the ACCC makes no specific recommendations to address the issue of buyer power. If steps to enhance competitiveness at the retail level are successful, it is likely that the retailers' buyer power will decrease and more likely that any benefits derived from remaining buyer power would be shared with consumers.

## 18 The Horticulture Code

### Key points

That the following recommendations be considered by the Horticulture Code Committee:

- Amend the *Trade Practices Act 1974* (the Act) to introduce civil pecuniary penalties and infringement notices for a breach of a mandatory code made under Part IVB, such as the Horticulture Code, and to give the ACCC powers to facilitate the conduct of random record audits as an enforcement mechanism available under the code.
- Amend the Horticulture Code to regulate first point of sale transactions of horticulture produce between a grower and a retailer, exporter or processor.
- Amend the Horticulture Code to regulate first point of sale transactions between a grower and a trader in horticulture produce, including transactions entered into under agreements made prior to 15 December 2006.
- Amend the Horticulture Code to require a merchant to provide a grower, before delivery, with either a firm price or a formula for calculating price. Any agreed method used to calculate price must be by reference to the amount received by the merchant from the sale of the produce to a third-party purchaser.
- Amend the Horticulture Code to require that if a merchant does not reject the produce within 24 hours of physical delivery, the produce is deemed to be accepted.
- Amend the Horticulture Code to enable a merchant to deduct the cost of any services that are supplied to prepare the produce for resale as part of the price amount or as part of the method for calculating the price amount.
- Amend the Horticulture Code to only permit an agent to recover their commission for services performed under an agency agreement as a deduction from amounts paid by a third-party purchaser.
- Amend the Horticulture Code to exclude persons who may be an agent's competitor from inspecting that agent's records on a grower's behalf.
- Amend the Horticulture Code to ensure that transactions between a grower and a cooperative/packing house, in which that grower has a significant interest, are exempt from regulation under the Horticulture Code.
- Amend the Horticulture Code to permit agents and growers to engage in pooling and price averaging.
- Amend the Horticulture Code to exempt transactions entered into in a grower shed at the central markets from regulation under the code, while permitting parties to these transactions to access the code's dispute resolution procedure.
- That the costs incurred by the parties to a dispute under the Horticulture Code dispute resolution procedure be subsidised by the Australian Government to the same extent as they are under the voluntary Produce and Grocery Industry Code of Conduct (PGICC). That the ACCC undertake further education in relation to the Horticulture Code and its dispute resolution procedures, including the role of assessors in resolving disputes.

## 18.1 Introduction

One of the terms of reference of this inquiry includes an assessment of the effectiveness of the Horticulture Code of Conduct (the Horticulture Code) and whether the inclusion of other major buyers such as retailers, would improve the effectiveness of the code. The effectiveness of a prescribed industry code is typically assessed on the basis of how well the code has achieved its objectives.

The Horticulture Code's objectives are to:

- regulate trade in horticulture produce between growers and traders to ensure transparency and clarity of transactions (the code does not seek to regulate prices)
- provide a fair and equitable dispute resolution procedure for disputes arising under the code or a horticulture produce agreement.

## 18.2 Review of the Horticulture Code by the Horticulture Code Committee

The ACCC notes that when the Horticulture Code was first introduced it was intended that the code would be reviewed following a two-year implementation period, during which industry participants would need to adapt their business practices in order to bring about compliance with the code. In September 2007, approximately four-months after the commencement of the Horticulture Code, the then Minister for Agriculture, Fisheries and Forestry, the Hon. Peter McGauran, appointed the Horticulture Code Committee to commence deliberations on industry issues associated with the operation and performance of the code and to provide advice to the minister on the operation of the code.

As part of the review process the Horticulture Code Committee's role has been to develop and recommend practical options and actions that support the effective operation of the Horticulture Code and to consider whether such amendments will further the code's objectives, and also to consider the impact the amended code may have on individual sectors of the industry, including in relation to ongoing compliance costs.<sup>1</sup>

The Horticulture Code Committee has informed the industry of its outcomes through the distribution of media releases and meeting minutes following each meeting. The Horticulture Code Committee has also informed the minister of the outcomes of each meeting and will provide the minister with an annual report on its activities in terms of how it is addressing the terms of reference. The ACCC was also invited to attend and participate as an observer (with no voting or decision making rights) in the Horticulture Code Committee meetings. The ACCC's role on the Horticulture Code Committee has therefore been to provide general advice on Horticulture Code related issues and to answer questions on its role in bringing about compliance with the code.

## 18.3 The ACCC grocery inquiry

When the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs requested in January 2008 that the ACCC review the effectiveness of the Horticulture Code as part of the inquiry, a number of parties noted that the code had only been in place for 14 months. The Horticulture Code Committee, for example, commented that while the committee had already met twice to discuss these

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<sup>1</sup> Horticulture Code Committee, *Statement of outcomes*, 20 February 2008

very issues, this period of time had, 'not adequately allowed the committee to reach its own position or make recommendations to the minister'.<sup>2</sup>

It also commented that it would, following a third meeting, await the outcome of the inquiry before undertaking any further consideration of the Horticulture Code. The Produce and Grocery Industry Code Administration Committee<sup>3</sup> and the National Farmers Federation<sup>4</sup> also noted that it may be difficult to assess the effectiveness of the Horticulture Code at this early stage as the industry may not have had adequate opportunity to make the necessary adjustments to its business practices.

Avocados Australia mirrored these concerns in commenting that:

the code probably needs five years and some tweaking. It does need some improvement, just ensuring that it meets what it was intended to meet going forward in that period. But when you are talking about a set of business practices that have existed for 50 or 100 years, you are not going to change it in 12 months. It's just not physically possible.<sup>5</sup>

While the ACCC has sought to address the industry's initial resistance to the Horticulture Code through a comprehensive education and liaison strategy (discussed further below), the ACCC is also aware that the introduction of the code imposed a significant cultural change within the horticulture industry. The introduction of any code of conduct can only be measured when the industry has had sufficient time to assess the changes, take measures to change operational procedures to address the code, bed down and refine the changes and, to gain industry wide acceptance. The introduction of the Franchising Code of Conduct, for example, was opposed by the key industry body for almost four years following its introduction. However, nearly a decade later a cultural change has taken place within the franchise sector whereby the peak body encourages compliance with the Franchising Code and supports continual improvement and training within its membership. The ACCC is therefore aware that the horticulture industry may also require a further period of adjustment in order to bring about the significant cultural and structural changes required by the Horticulture Code.

In order to adequately address the complex Horticulture Code issues that have been raised throughout the inquiry and to ensure that industry participants have had an opportunity to provide detailed comments on these issues, the ACCC published a second Horticulture Code issues paper. As a result, the ACCC has received and considered submissions in response to the more general issues paper and 28 submissions in response to the more specific Horticulture Code issues paper.

While a wide range of issues have been raised throughout the inquiry, the ACCC has identified and addressed the following key Horticulture Code issues in this chapter:

- industry compliance and the ACCC's enforcement of the code
- whether the code should be extended to include retailers, processors and exporters
- whether pre-existing contracts should continue to be exempt from regulation under the code
- the definition of 'delivery' and the shifting of ownership between parties
- the rights and obligations of agents under the code
- whether packing houses and cooperatives should be regulated by the code
- whether pooling and price averaging should be permitted by the code
- whether grower sheds should be regulated by the code
- the effectiveness of the code's dispute resolution procedure.

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2 Horticulture Code Committee, submission no. 32, p. 2.

3 Produce and Grocery Industry Code Administration Committee submission no. 50, p. 4.

4 National Farmers Federation, submission no. 137, p. 15.

5 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 137.

Following consideration of these issues, it is the ACCC's view that the diversity and complexity of the horticulture industry cause it to be a difficult industry to regulate effectively without causing unintended side effects and incurring compliance costs. Nevertheless, the ACCC believes the Horticulture Code has merit and, if amended in accordance with the recommendations outlined below, the code has the potential to provide a framework which ensures transparency in transactions and fairness in dispute resolution procedures. The ACCC considers, however, that the inquiry is not the appropriate forum to redraft the Horticulture Code and proposes that the existing Horticulture Code Committee is better placed to further consider the recommendations outlined below with a view to providing the government with a more detailed analysis on how these recommendations may be implemented. The ACCC would also propose that a subsequent review of the Horticulture Code be undertaken in two or three years time to assess whether the code has brought about greater clarity and transparency throughout the industry and an accessible dispute resolution procedure.

The ACCC notes that many of the issues and concerns that ultimately led to the development of the Horticulture Code were initially raised by industry participants as part of the development of the Produce and Grocery Industry Code of Conduct. A brief discussion regarding the development and the proposed benefits of this voluntary code is therefore set out below.

## 18.4 The Produce and Grocery Industry Code of Conduct

On 10 December 1998 the federal parliament established the Joint Select Committee on the Retailing Sector to inquire into and report on the impact of market concentration in the retail sector and to recommend possible revenue-neutral courses of action for the Australian Government. On 30 August 1999 the Joint Select Committee on the Retailing Sector (later known as the Baird Inquiry) produced a report, *Fair market or market failure?* One of the committee's recommendations was the establishment of a mandatory code of conduct to regulate the retail grocery sector.<sup>6</sup>

On 17 December 1999 the Australian Government released its response to the report. It announced the development of a voluntary Retail Grocery Industry Code of Conduct (RGICC), full Government funding for a Retail Grocery Industry Ombudsman to assist in the resolution of industry disputes, and amendments to the Act to improve access by small businesses to remedies and damages.<sup>7</sup> However, the announcement was not without reservations. The minister also indicated that a mandatory code of conduct may still be adopted, 'if a review of developments indicate an unsatisfactory participation level'.<sup>8</sup>

Therefore, in accordance with the government's decision, an industry-funded committee comprising a cross-section of industry representatives was established on 13 February 2000 to develop the voluntary code of conduct for the produce and grocery industry. The committee developed and launched the RGICC on 13 September 2000.

A review of the RGICC was subsequently conducted in 2003 by an independent reviewer, Mr Neill Buck. The review, which concluded on 12 December 2003, found that while the RGICC had made some progress in addressing issues in the sector, the Code had 'not worked well enough to resolve some major issues in the retail grocery industry supply chain', and that this was, 'affecting the economic health and efficiency of the sector'.<sup>9</sup> The review therefore recommended that, 'a principles-

6 Joint Select Committee on the Retailing Sector, *Fair market or market failure—a review of Australia's retailing sector*, 1999, pp. xxii–xxiii, recommendation 5.

7 N Buck, *Report of the review of the Retail Grocery Industry Code of Conduct*, December 2003, p. 19.

8 The Hon. Peter Reith MP, Minister for Employment, Workplace Relations and Small Business, media release, 17 December 1999.

9 N Buck, *Report of the review of the Retail Grocery Industry Code of Conduct*, December 2003, pp. 12–13.

based code underpinned by regulation be implemented', in order to deal with a number of significant challenges in the sector.<sup>10</sup> Following the review, on 11 February 2005, the RGICC was renamed the PGICC and the administering body became the Produce and Grocery Industry Code Administration Committee (PGICAC). The federal Department of Agriculture, Fisheries and Forestry (DAFF) provides secretariat support for the PGICAC, manages the contract for the Produce and Grocery Industry Ombudsman (the PGIO) mediation service and runs the communications campaign for the PGICC.<sup>11</sup>

The PGICC provides a voluntary set of guidelines that aims to promote fair, open and equitable trading practices, and seeks to guide the conduct of businesses throughout their vertical transactions within the produce and grocery industry supply chain (which includes processors, wholesalers, distributors and retailers but not consumers). The PGICC also provides an accessible government-subsidised dispute resolution mechanism for industry participants through the PGIO mediation service.<sup>12</sup> While a number of key organisations and businesses have committed to promoting the PGICC and their own internal dispute resolution procedures, other organisations may also endorse the voluntary code.<sup>13</sup>

## 18.5 Introduction of the Horticulture Code

Supporters of the PGICC have argued against a mandatory code, stating that the voluntary code already provides industry participants with a government subsidised, voluntary system of mediation along with some guidance as to how businesses may conduct themselves with greater clarity and certainty.<sup>14</sup> However, some growers of horticulture produce and their representative associations continued to voice the concerns raised in the Buck report<sup>15</sup> and called for the implementation of a 'principles based code underpinned by regulation with simple disclosure and business practice provisions'<sup>16</sup>. In particular, those calling for a mandatory horticulture code of conduct argued that the existing voluntary PGICC code did not require signatories to enter into written contracts to evidence terms and conditions of supply, and did not enable one party to require another to participate in the mediation of a dispute.

To address these concerns, the government determined that the PGICC had failed to provide the industry with the transparency and certainty it required, and publicly committed itself to prescribe a mandatory industry code of conduct for the wholesale horticulture industry under s. 51AE of the Act.<sup>17</sup> On 1 October 2004 the then Deputy Prime Minister, the Hon. John Anderson, announced that a re-elected coalition government would introduce a mandatory Horticulture Code of Conduct that would 'aim at improving the transparency of trading transactions in the wholesale fresh fruit and vegetable sector'.<sup>18</sup>

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10 N Buck, *Report of the Review of the Retail Grocery Industry Code of Conduct*, December 2003, p. 14.

11 On 20 November 2006 the government transferred responsibility for administering the PGICC from the Office of Small Business in the federal Department of Industry, Tourism and Resources to DAFF.

12 The Produce and Grocery Industry Code Administration Committee, submission no. 50, p. 1.

13 The Produce and Grocery Industry Code Administration Committee, submission no. 50, p. 3; ALDI Stores; Australian Chamber of Fruit and Vegetable Industries Ltd; Australian Dairy Farmers; Australian Chicken Growers Council; Australian Egg Corporation Limited; Australian Food and Grocery Council; Australian Retailers Association; Coles Group Limited; Murray Valley Winegrape Growers; National Association of Retail Grocers of Australia; National Farmers Federation; National Retail Association; Horticulture Australia Council; Queensland Retail Traders and Shopkeepers Association; and Woolworths Limited.

14 Annexure to the Produce and Grocery Industry Code of Conduct.

15 N Buck, *Report of the review of the Retail Grocery Industry Code of Conduct*, presented to the Office of Small Business, Department of Industry, Tourism and Resources, Canberra, 2003.

16 Explanatory statement for the Horticulture Code of Conduct, Select Legislative Instrument 2006, no. 376 p. 1.

17 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 2.

18 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. 1.

More specifically, the draft<sup>19</sup> and the final<sup>20</sup> regulation impact statement recommended that the Horticulture Code should seek to:

- regulate trade in horticulture produce between growers and traders to ensure clarity and transparency of transactions
- provide a fair and cost-effective dispute resolution procedure.

While a significant amount of data regarding the wholesale price of horticulture produce is generally available to industry participants, it is often argued by growers and grower associations that this data is subject to manipulation by market intermediaries.<sup>21</sup> In particular, wholesalers have generally sought to protect their interests by retaining confidentiality regarding their supplier and on-sale networks as well as market price information. Similarly, wholesalers have noted that they are often uncertain about the quality and quantity of produce that a grower will supply until the produce arrives at the marketplace.<sup>22</sup> This systemic lack of clarity and transparency in the wholesale market has led to information asymmetries between growers and traders.<sup>23</sup>

These problems have been exacerbated by the failure of industry participants to invest in written trade documentation, including written transaction information and written trading agreements.<sup>24</sup> Prior to the introduction of the Horticulture Code, much of the wholesale trade in horticulture produce was conducted on the strength of a verbal agreement between growers and wholesale traders.<sup>25</sup>

In the absence of clear and transparent written terms of trade or written contracts, many wholesale traders have sought to maximise their profits and minimise their risk in the marketplace by trading in accordance with the 'hybrid model'. The hybrid model does not require the trader to clarify with the grower whether the trader is operating as an agent or as a merchant in any particular transaction.

Accordingly, the hybrid system of trade creates uncertainty as to:

- When the transfer of ownership in the produce occurs. The hybrid model ensures that ownership and commercial risk in the produce resides with the grower until the produce is sold on to a third-party purchaser (in some cases the risk may remain with the grower until the third-party buyer accepts and on-sells the produce). In turn, the trader may pass any loss incurred as a result of produce being returned or rejected by the third-party purchaser, back onto the grower.<sup>26</sup>
- When and how the price for the produce is determined. Under the hybrid model, the trader will undertake to achieve 'the best price they can' for the grower in the market. While this appears to fit an agency model, the trader will trade as a 'merchant' and make a profit by on-selling the produce to a third-party purchaser, rather than charging a commission. The trader is therefore in a strong position to determine the price that the grower will receive for their produce after the trader has sold the produce onto a third-party buyer and subtracted the trader's profit or commission on that sale.

Some growers and grower associations also expressed concerns regarding the common industry practice of cost and price averaging. Some growers have argued that this practice 'simplifies transactions but also mutes price and cost signals, reducing incentives to maximise quality and creating

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19 *ibid.*, p. 3.

20 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 2.

21 S Spencer, *Price determination in the Australian food industry: a report*, DAFF, Canberra, 2004, p. 60.

22 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. 26.

23 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 8.

24 *ibid.*

25 *ibid.*, p. 3.

26 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. 14.

incentives which tolerate excess supply of low quality fruit [and vegetables]<sup>27</sup>, and further exposes growers to price-return risks, regardless of product quality.<sup>28</sup> In turn, wholesalers and central market chambers have argued that growers contribute to the uncertainty in wholesale markets by delivering unsolicited produce to traders and labelling produce of various grades and quality as 'A1'.<sup>29</sup>

In order for growers and traders to effectively resolve disputes that arise under their agreements and the Horticulture Code, the final regulation impact statement identified the need for an effective dispute resolution process, including an independent assessment of transactions and a mediation process.<sup>30</sup>

### 18.5.1 The Horticulture Code development and consultation process

The Department of Agriculture, Forestry and Fisheries, the policy agency responsible for the development of the Horticulture Code, retained the Centre for International Economics and Allens Arthur Robinson to assist in the development of a draft regulation impact statement and a draft Horticulture Code. These documents were released for public consultation in August 2005 and public forums were held in five capital cities<sup>31</sup> and three regional centres<sup>32</sup> to discuss the issues raised. The public consultation process also included an extensive number of meetings with individual growers, grower representatives, wholesalers at central wholesale markets, independent and major retailers, processors, packing sheds, state government representatives in every state and the Northern Territory, and Australian Government agencies such as the ACCC.<sup>33</sup>

In response to a call for written submissions on 24 August 2005, over 213 submissions were received on the draft code options. The draft code options were further developed in consultation with key representative groups, including the National Farmers Federation, Horticulture Australia Council, the Australian Chamber of Fruit and Vegetable Industries and the Central Markets Association of Australia. Six options were then considered in the final regulation impact statement cleared by the Office of Regulation Review.<sup>34</sup>

The preferred option was selected on the basis that it could facilitate—with lower compliance costs—improved clarity and transparency in transactions between growers and wholesale traders that would in turn raise trading standards in the horticulture industry and improve market efficiency.<sup>35</sup> A draft copy of the regulations was informally distributed to the industry in early December 2006.

His Excellency the Honourable Major General Michael Jeffery AC, CVO, MC (Retd), Governor-General of the Commonwealth of Australia signed the Trade Practices (Horticulture Code of Conduct) Regulations 2006 (Cwth) on 13 December 2006, and registered the regulations on the Federal Register of Legislative Instruments on 15 December 2006. The regulations were tabled in federal parliament on 6 February 2007. The Horticulture Code therefore commenced as a prescribed mandatory industry code of conduct under s. 51AE of the Act on 14 May 2007. A primary role of the ACCC under s. 51AE of the Act is to administer mandatory industry codes of conduct that have been prescribed (i.e. made law) by the Australian Government. A prescribed mandatory industry code of conduct is binding on all

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27 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. 29.

28 S Spencer, *Price determination in the Australian food industry: a report*, DAFF, Canberra, 2004, p. 54.

29 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. 29.

30 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 8.

31 Sydney, Hobart, Melbourne, Brisbane and Adelaide.

32 Atherton, Humpty Doo and Mildura.

33 Explanatory statement for the Horticulture Code of Conduct, Select Legislative Instrument 2006, no. 376, pp. 1–2.

34 Explanatory statement for the Horticulture Code of Conduct, Select Legislative Instrument 2006, no. 376, p. 2.

35 *ibid.*

industry participants. Section 51AD of the Act provides for the ACCC to take action against breaches of prescribed codes such as the Horticulture Code.

## 18.5.2 Current coverage of the Horticulture Code

The Horticulture Code regulates wholesale trade in horticulture produce.<sup>36</sup> Subject to certain exceptions, it applies to traders and growers who trade with each other in horticulture produce on and after 14 May 2007.<sup>37</sup>

Horticulture produce is defined in the Horticulture Code to mean unprocessed fruit, vegetables (including mushrooms and other edible fungi), nuts, herbs and other edible plants.<sup>38</sup> A grower is defined in the Horticulture Code as a person who grows their own horticulture produce for sale. A trader is defined as either an agent or a merchant. More specifically, a merchant is defined as a person who purchases horticulture produce from a grower for the purpose of reselling that produce, and an agent is defined as a person who sells horticulture produce on behalf of a grower to another person for a commission or fee. The Horticulture Code does not currently regulate those who purchase produce for the purpose of retail, processing or export.<sup>39</sup> As recommended in the draft and the final regulation impact statement, the Horticulture Code's objectives are to:

- regulate trade in horticulture produce between growers and traders to ensure transparency and clarity of transactions
- provide a fair and equitable dispute resolution procedure for disputes arising under the code or a horticulture produce agreement.

## 18.5.3 Current exemptions from regulation by the Horticulture Code

### Retailers, processors and exporters

Both the draft<sup>40</sup> and the final<sup>41</sup> regulation impact statement, prepared before the commencement of the Horticulture Code, reported that supermarket retailers, exporters and processors provide growers with comparatively clear and transparent supply agreements. In particular, the draft regulation impact statement also noted that:

supermarkets are likely to gain nothing from implementation of the code due to the fact that they are largely achieving the desired objectives of the code now but under voluntary codes of conduct<sup>42</sup>.

In recognition of what was understood to be relatively clear and transparent retailer horticulture produce supply arrangements, the government exempted retailers from the Horticulture Code.<sup>43</sup>

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36 Clause 2 of the Horticulture Code.

37 Regulation 3 of the Trade Practices (Horticulture Code of Conduct) Regulations 2006.

38 The term 'unprocessed' is not defined in the code. The meaning of unprocessed will be determined by the circumstances of each case. However, the ordinary meaning of unprocessed is produce that has not been converted, altered or modified in some way for the purpose of making it into a new form. Nursery products are not considered to be horticulture produce and trade in them is not regulated by the Horticulture Code. 'Nursery products' include trees, shrubs, plants, seeds, bulbs, corns and tubers (excluding edible tubers), propagating material and plants tissue cultures (grown for ornamental purpose or form producing fruits, vegetables, nuts or cut flowers and foliage), and cut flowers and foliage.

39 Clause 3 of the Horticulture Code.

40 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. xix.

41 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 9.

42 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. xviii.

43 *ibid.*, pp. 17–19.

## Existing written agreements

The Horticulture Code came into effect on 14 May 2007 and automatically applied to horticulture trade that occurred on or after that date. However, if a grower or trader has a written agreement that was entered into prior to 15 December 2006 (the date the code was registered on the Federal Registrar of Legislative Instruments), the Horticulture Code does not apply to those transactions. If a grower or trader varies the agreement on or after 14 May 2007, the Horticulture Code will automatically apply to trade that takes place under that agreement from the date of variation. Any written agreement that was entered into after 15 December 2006, but before the Horticulture Code commenced on 14 May 2007, is subject to the code from 14 May 2007.

## Limitations on coverage under the Act

It is important to note that the Act, and therefore the Horticulture Code, regulates corporations, trade across state borders and trade within a territory (i.e. the Australian Capital Territory and Northern Territory). While the Horticulture Code does apply to unincorporated bodies where the wholesaler and respective grower are in different states and/or territories or within the same territory, the Horticulture Code does not apply to unincorporated bodies where the wholesaler and the respective grower are within the same state and both grower and trader are unincorporated. However, if one of the parties to the transaction is incorporated, it is the ACCC's view that the Horticulture Code applies. It is estimated that a high proportion of wholesale horticulture trade occurs across state borders and around 50 per cent of wholesaling businesses are incorporated.<sup>44</sup>

## Potato marketing schemes

The Horticulture Code does not apply to growers and traders already trading under a statutory potato marketing scheme. A statutory potato marketing scheme is a state or territory scheme that regulates the marketing, sale or disposal of unprocessed potatoes.

### 18.5.4 Key obligations under the Horticulture Code

The Horticulture Code requires that traders and growers comply with certain obligations. These obligations are summarised below.

#### Trader's terms of trade

The Horticulture Code requires that a trader must prepare, publish and make publicly available a document setting out the terms and conditions under which they are prepared to trade in horticulture produce with growers. This document is called a trader's terms of trade. A trader must give a copy of their terms of trade to any grower who asks for them.<sup>45</sup> The Horticulture Code specifies that a trader's terms of trade must comply with the code and contain certain specific information.<sup>46</sup>

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<sup>44</sup> DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 2.

<sup>45</sup> Clause 4 of the Horticulture Code.

<sup>46</sup> Clause 5 of the Horticulture Code.

## Horticulture produce agreements

The Horticulture Code requires that a trader and a grower can only trade in horticulture produce with each other if they have entered into a horticulture produce agreement that complies with the Horticulture Code.<sup>47</sup> A horticulture produce agreement must be in writing, signed by the parties to it, and cover specific matters required by the Horticulture Code.<sup>48</sup>

## Trader's responsibilities

In addition to requiring a terms of trade document and horticulture produce agreements, the Horticulture Code places further obligations on all traders, both agents and merchants, as well as specific obligations for agents and specific obligations for merchants.

## Dispute resolution procedure under the Horticulture Code

Part 5 of the Horticulture Code provides that growers and traders may use any dispute resolution procedure they choose to resolve horticulture disputes that arise between them. However, if a grower or trader (the complainant) initiates a dispute under the dispute resolution process set out in the Horticulture Code, the other party (the respondent) must participate in that process as required by the code.<sup>49</sup>

The Horticulture Code mediation adviser (the mediation adviser) has been established to assist industry participants to resolve disputes and, on request, appoint mediators from a specialist panel of experienced mediators across Australia. Part 6 of the Horticulture Code also provides growers and traders with access to horticulture produce assessors. Horticulture produce assessors are individuals that have been selected by the mediation adviser as having the necessary technical skills and independence to investigate and provide a report on any matter arising under a horticulture produce agreement.

## 18.5.5 Compliance and enforcement of the Horticulture Code

The ACCC plays an important role in promoting compliance with the Horticulture Code and the Act. It achieves this through education, providing access to information, and, where necessary, enforcement action.

In particular, the ACCC:

- administers s. 51AD of the Act, which prohibits contraventions by corporations and by individuals of applicable industry codes (e.g. the Horticulture Code)
- administers s. 51AC of the Act, which allows courts to determine unconscionable conduct in a particular case with regard to the requirements of any applicable industry code (e.g. the Horticulture Code)
- promotes compliance with the law by educating industry participants about their rights and obligations under the Horticulture Code
- enforces the provisions of the Horticulture Code where necessary by seeking remedies available under the Act
- enforces all other relevant provisions of the Act.

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<sup>47</sup> Clause 6 of the Horticulture Code.

<sup>48</sup> Clause 9 of the Horticulture Code.

<sup>49</sup> Clause 30 of the Horticulture Code.

- To promote compliance with the Horticulture Code, the ACCC has developed and distributed the following compliance materials:
- *An overview of the Horticulture Code*—an A4 double-sided information sheet that summarises the Horticulture Code in plain language.
- *The guide to the Horticulture Code for growers and wholesale traders in the horticulture industry*—an A5 booklet summarising the Horticulture Code in plain language.
- *The Horticulture Code—how does it affect you?* (DVD)—an educational DVD outlining the key parts of the Horticulture Code.
- *The Horticulture Code compliance manual*—a plain language manual aimed at providing stakeholders with guidance on how to comply with the Horticulture Code and establish an effective compliance program. The manual contains information flow charts and checklists, and a CD containing template documents.
- *Horticulture Code—questions and answers*—answers to the most common questions regarding the Horticulture Code.
- *Horticulture Code fact sheets*—A4 double-sided information sheets on the following specific topics:
  - *Does the Horticulture Code apply to packing houses?*
  - *What to do if you receive horticulture produce without a horticulture produce agreement*
  - *Why say NO to backdated horticulture produce agreements*
  - *Can growers collectively bargain?*
  - *What are a merchant's rights and responsibilities under the Horticulture Code?*
  - *What are an agent's rights and responsibilities under the Horticulture Code?*
  - *What is unprocessed horticulture produce?*
  - *Service agreements and complying with the Horticulture Code.*

The ACCC also created an information network for stakeholders in the horticulture industry, to provide them with timely information about compliance with the Horticulture Code. The ACCC currently has 611 subscribers, including representatives from grower and wholesaler associations, and the federal government and state governments.

While the Horticulture Code committee acknowledged, 'the work that the ACCC has carried out in educating and communicating to industry about the code and judges that there is sufficient information available about the code'<sup>50</sup>, grower associations have argued that more needs to be done to bring about compliance with the Horticulture Code.

The NSW Farmers Association noted, for example, that, according to a survey conducted in February 2008, of 24 of its horticulture producers:

- 79 per cent had a trading relationship that required an agreement
- 32 per cent had not discussed the matter with the agent/merchant
- 21 per cent were trading without an agreement
- 58 per cent did not know if their agreement was compliant with the code.<sup>51</sup>

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<sup>50</sup> Horticulture Code Committee, submission no. 32, p. 3.

<sup>51</sup> NSW Farmers Association, submission no. 155, p. 21.

The ACCC also heard evidence from a wide range of parties, including Horticulture Australia Ltd, AUSVEG Ltd and Grow South Australia (Grow SA), that the ACCC has not undertaken sufficient enforcement of the Horticulture Code to bring about compliance throughout the industry. Horticulture Australia Ltd, for example, commented that:

In relation to the [Horticulture Code], industry organisations and grower advocates acknowledge that there are many examples where the introduction and compliance with the code has resulted in successful business relationships between growers and traders as defined by the code. However there is a substantial groundswell of dissatisfaction being expressed by these bodies about the level of non-compliance from traders, the tactics utilised by many traders to avoid complying with the code, and the will and ability of the ACCC to enforce the code and understand the commercial dynamics between these two traditionally disparate thinking groups.<sup>52</sup>

While the central market chambers have not sought further enforcement of the Horticulture Code, the New South Wales Chamber of Fruit and Vegetable Industries Inc. commented that, 'The other reason that the code is not impacting on business is because many within the industry are simply ignoring it.'<sup>53</sup>

*In fact, the NSW chamber argued that it is growers rather than traders that are refusing to enter into compliant agreements and explained that:*

The traders involved are attempting to comply with the code yet the growers are not signing the documents and returning them to the trader. Their reluctance to do so is placing the traders in a less than ideal situation as they cannot trade with the grower without an agreement in place. Yet the growers in many instances continue to send their produce in to the trader knowing that they are in breach of the code.<sup>54</sup>

Since the commencement of the Horticulture Code, the ACCC has only received a small number of substantive complaints alleging non-compliance with the Horticulture Code. While the central market chambers argued that this is largely due to growers' disinterest in the code, grower groups have argued that growers are reluctant to provide the ACCC with adequate complaint details regarding alleged breaches of the Horticulture Code because of concerns that growers will in turn be singled out by disgruntled traders and subjected to harassment and/or commercial ruin.

The Horticulture Australia Council noted, for example, that its recent survey indicates that 85 per cent of its members agreed that growers were often unwilling to raise issues with major retailers and wholesalers for fear of retribution.<sup>55</sup> Similarly, Ms Sue Brigendi, a packer of horticulture produce, explained that even if the marketer, for example, does not comply with their agreement with the grower, there is little the grower can do about it:

... there's not many growers that will take on a marketer, especially a large marketer. They can't afford to. It's a small industry and you can't afford to get people offside because you'd be branded a troublemaker.<sup>56</sup>

Grow SA also acknowledged that growers fear potential:

...punitive behaviour designed to enforce desired behaviours by suppliers (e.g. issues associated with 'being made to take a holiday' and return of product). There is a fear of retaliation/victimisation amongst growers.<sup>57</sup>

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52 Horticulture Australia Council, submission no. 92, p. 106.

53 New South Wales Chamber of Fruit and Vegetable Industries Inc., submission no. 99, p. 5.

54 The Chamber of Fruit and Vegetables Industries in Western Australia Inc., Horticulture Code issues paper submission no. 5, p. 3.

55 Horticulture Australia Council, submission no. 63, p. 5. The ACCC notes that the council did not provide the sample size for this survey.

56 ACCC, public hearing transcript, Griffith, 8 April 2008, p. 20.

57 Grow SA, submission no. 112, p. 8.

Grow SA also commented that:

There are also examples of growers being “black listed” by all wholesalers in one or more of the central markets if they attempted to negotiate a compliant agreement, or raise issues or complaints with the ACCC.<sup>58</sup>

While similar concerns exist in other industries, the ACCC is aware that growers of horticulture produce may rely on an expectation that they will remain in the industry for the long term and any damage to their ability to continue to participate in the industry would cause significant harm. The ACCC is also aware that growers who have non-compliant trading arrangements may not wish to bring these matters to the attention of the ACCC out of fear that they may also be prosecuted. Unfortunately, growers’ reluctance to provide substantiated complaints to the ACCC has only further inhibited the ACCC’s ability to take effective enforcement action and bring about compliance with the Horticulture Code.

It is also apparent that a significant proportion of the horticulture industry currently trades under agreements entered into prior to 15 December 2006 that are not required to comply with the Horticulture Code. The lack of clarity regarding how these agreements were entered into, and which parties have entered into such exempt agreements, poses additional challenges to the effective enforcement of the Horticulture Code. This issue is addressed in more detail below.

Grower associations have also suggested that the ACCC may lack the necessary enforcement tools to address the mischief that the Horticulture Code seeks to remedy. Grow SA for example submitted that:

Feedback commonly received is that the code has no strength or impact as there has been no enforcement or any penalties associated with doing the wrong thing.<sup>59</sup>

Grow SA also commented that:

The only way recalcitrant players will be brought into compliance is through a real threat of punishment. Thus the code must be not only enforced appropriately by the ACCC - but it must be seen to be enforced.<sup>60</sup>

The South Australian Farmers Federation also supported the call for mandatory industry codes of conduct to be enforced with stronger penalties.<sup>61</sup> In light of these concerns, the ACCC notes that in the event of a breach of the Horticulture Code<sup>62</sup>, the ACCC is currently limited to seeking the following remedies:

- declarations that particular conduct breaches the Act
- injunctions to stop the prohibited conduct continuing, or to require some action to be taken
- damages
- rescission of relevant contracts
- community service orders
- corrective advertising.

However, the ACCC notes that in spite of the availability of these penalties, growers have indicated their reluctance to provide the ACCC with complaints against traders who have failed to comply with the Horticulture Code for fear of retribution.

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58 *ibid.*, p. 9.

59 Grow SA, submission no. 112, p. 9.

60 *ibid.*, p. 10.

61 SA Farmers Federation, submission no. 156, p. 3.

62 These remedies may be available if the Horticulture Code or consumer protection (e.g. misleading conduct) or unconscionable conduct provisions of the Act have been breached.

It is therefore the ACCC's view that the Horticulture Code may be more effectively enforced if the ACCC had the ability to conduct random audits of trader's and grower's records. This would enable the ACCC to investigate matters raised confidentially or anonymously by growers and in turn empower the ACCC to bring about compliance with the Horticulture Code.

Another aid to ensuring compliance would be the introduction of civil pecuniary penalties and infringement notices. Such enhancements would be consistent with those recently recommended by the Productivity Commission in its review of Australia's consumer policy framework inquiry report.<sup>63</sup> The ACCC considers that the ability to obtain civil pecuniary penalties, declarations and injunctive relief, and other measures such as corrective advertising within a single action would significantly enhance the ability of the ACCC to obtain effective outcomes. Infringement notice powers may also be appropriate in dealing with minor issues in a swift and less costly manner than taking court proceedings and may also have a deterrent effect.

**Recommendation:** that the Act be amended to introduce civil pecuniary penalties and infringement notices for a breach of a mandatory code made under Part IVB such as the Horticulture Code and that the ACCC be given powers to facilitate the conduct of random record audits as an enforcement mechanism under the code.

### 18.5.6 Extension of the Horticulture Code to cover retailers, exporters and processors

The current Horticulture Code does not regulate the sale of horticulture produce to retailers, processors or exporters as the final regulation impact statement prepared prior to the introduction of the Horticulture Code did not, on balance, indicate that these transactions required regulation under the code.

While the ACCC is aware that myriad arrangements exist within the horticulture industry whereby unprocessed horticulture produce is passed through the supply chain from grower to retailer, three key models have emerged.

Firstly, retailers may obtain supply of horticulture produce from wholesale traders that operate within the central markets. In these circumstances, retailers are unlikely to use written contracts as produce is generally purchased in this manner on an ad hoc basis in order to fill supply gaps. However, the ACCC notes that, unless the grower entered into an agreement with a trader prior to 15 December 2006, the first transaction in the supply chain between the grower and the wholesaler will already have been subject to the Horticulture Code. Therefore, there is little argument as to why the Horticulture Code should be extended to regulate transactions between the wholesaler and the retailer in these circumstances.

Secondly, retailers may seek direct supply of produce from growers who have been approved by the retailer as preferred suppliers. Retailers have increasingly sought to source horticulture produce directly from growers, rather than source the produce through the wholesale markets.<sup>64</sup>

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<sup>63</sup> Productivity Commission 2008, *Review of Australia's consumer policy framework*, final report, Canberra.

<sup>64</sup> Coles, submission no. 157, p. 16.

Coles, for example, submitted that:

Securing the volume of fruit product required for the [full-service supermarket] has led the major retailers to negotiate direct supply arrangements with producers. This buying strategy, which mirrors changes in other developed markets, has provided security supply but has led to the balance of the crop being distributed by the capital city central markets.<sup>65</sup>

Coles further explained that:

Direct supply improves competition and lowers costs by removing intermediaries and improving the scale opportunities, i.e. larger, more capital intensive efficient horticultural growers and stock producers delivering consistent quality and lower unit prices.<sup>66</sup>

In these circumstances, retailers provide approved suppliers with their standard terms and conditions of supply (usually in electronic form on the retailer's website<sup>67</sup>) and then place orders with those suppliers closer to harvest time. This gives the supplier the right to supply rather than guaranteeing that the supplier will receive an order.<sup>68</sup> These arrangements are generally not formalised into written contracts. In most cases retailers obtain supply directly from growers on an ongoing or ad hoc basis without the use of written supply agreements. Coles, for example, noted that its 'arrangements for the supply of fresh fruit from wholesale markets and growers are negotiated and agreed on a weekly basis.'<sup>69</sup>

While growers recognise that major retailers use their purchasing power to achieve the lowest purchase price<sup>70</sup>, and to require strict adherence to detailed produce specifications and quality assurance procedures<sup>71</sup>, retailers have been able to achieve a competitive advantage over wholesale traders by offering growers streamlined supply arrangements, prompt payment, stable revenue streams and access to a dispute resolution process through the voluntary PGICC.<sup>72</sup>

Growers and grower associations have raised concerns regarding the absence of written contracts when growers directly supply the major supermarket chains (MSCs), regarding the ambiguity inherent in applying the MSCs' produce specifications and regarding their ability to reject produce long after the produce has been delivered. For these reasons some growers and grower associations have supported the view that in order to ensure greater equity, transparency and certainty throughout the horticulture industry, the Horticulture Code should be extended to also cover first point of sale transactions between a grower and a retailer, processor or exporter.

The NSW Farmers Federation submitted, for example, that some growers in the apple industry found that they had little certainty when supplying directly to the MSCs. The federation explained that:

In the apple industry supermarkets use verbal agreements and can gouge prices by placing an order at one price, two weeks ahead of delivery and offer a spot price upon delivery if the market has dropped.<sup>73</sup>

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65 Coles, submission no. 157, freshlogic report, p. 63.

66 *ibid.*, p. 35.

67 Coles, submission no. 157, p. 16.

68 The Australian Chamber of Fruit and Vegetable Industries, Horticulture Code issues paper submission no. 14, p. 2.

69 Coles, submission no. 225, p. 13.

70 Coles, submission no. 157, freshlogic report p. 35.

71 Coles, submission no. 157, p. 16.

72 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 6. The PGICC is a voluntary set of guidelines promoting fair trading practices in the produce and grocery industry and provides a simple dispute resolution mechanism. The PGICC provides mediation service to all industry participants through the Produce and Grocery Industry Ombudsman mediation service. Unlike the Horticulture Code, the PGICC seeks to guide the conduct of all participants (except consumers) in the Australian produce and grocery industry, including: growers, processors, exporters, wholesalers, distributors and retailers.

73 NSW Farmers Association, submission no. 155, p. 19.

It further explained that:

While growers' relationship with agents/merchants is the most problematic area, supermarkets are not guilt free. They offer no written contracts, only 'growing agreements', and produce specifications are not available for all produce lines leaving ambiguity and scope for dispute. Importantly, over 50 per cent of their produce is sourced direct from growers and is increasing. For these reasons, association supports retailer's inclusion within the code. The code must bring the whole horticulture supply chain under the one system [to include wholesalers, retailers, processors and exporters].<sup>74</sup>

The National Farmers Federation (NFF) also argued that:

To reduce complexities with the administration of the code, the NFF believes that the code should apply to all parties involved in the first transaction from the grower to wholesalers, produce merchants, brokers, retailers, exporters and processors. In our view, the major retail chains and processors already offer contractual clarity and transparency in their dealings with horticulture growers. Therefore, including these parties within the code will not add any compliance costs or regulatory burden to these businesses.<sup>75</sup>

The National Association of Retail Grocers of Australia support the view that the 'inclusion of other retailers and major buyers into the code must strengthen the code'.<sup>76</sup> Similarly, Mr Bob Katter MP argued that the Horticulture Code should be extended to cover the retail supermarket chains to ensure there is transparency along the supply chain 'from paddock to plate'.<sup>77</sup>

The issue of rejection has also been raised as a major concern for growers who provide their horticulture produce directly to retailers. The ACCC notes, for example, that Coles' standard 'terms and conditions of supply' provide that Coles may reject produce back to the grower at the grower's expense at any time prior to 'acceptance' of the goods if the produce does not meet the specified standards. However, Coles is only deemed to have accepted goods under these standard terms 'once it has had a reasonable time after any latent defect has become apparent'.<sup>78</sup> Temperature-controlled produce can be rejected by Coles 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).<sup>79</sup>

The ACCC also notes that Woolworths' 'standard national vendor trading terms' provide for an even longer opportunity to reject produce by stating that:

If at any time, whether after delivery of or payment for the goods and notwithstanding our acceptance of the goods, we find that the goods do not meet the standards and requirements set out in these terms we may notify you that we have rejected the goods, return the rejected goods to you at your own cost and require you to replace or repair the rejected goods immediately at your own cost.<sup>80</sup>

In spite of these apparent differences, evidence provided to the ACCC indicates that the practices of both MSCs in receiving, inspecting, accepting or rejecting produce is likely to be very similar. As a general rule, both MSCs seek to inspect produce on receipt and will at that time provide formal notice to the grower that the produce is to be rejected because of a failure to meet the required specifications.

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74 NSW Farmers Association, submission no. 155, p. 21.

75 National Farmers Federation, submission no. 137, p. 16.

76 The National Association of Retail Grocers of Australia, submission no. 129, p. 69.

77 Bob Katter, *Independent bid to rewrite Horticulture Code*, media release, 21 May 2007.

78 Coles, submission no. 225, p. 15.

79 *ibid.*, p. 16.

80 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 95.

However, the ACCC is aware that in some instances the MSCs may reject some or all of a grower's produce at a subsequent time if a latent defect becomes apparent.

Some growers and grower associations have raised concerns regarding these practices by noting that a MSC may reject produce at the store level or the distribution centre or may seek to enter into a renegotiation with the grower regarding the price of the produce, depending on whether another party wants to supply that product to the retailer at a cheaper price. In contrast, it has also been noted that when retailers buy produce directly from the central market, they accept whatever price and quality is available at that time and there is little opportunity for subsequent rejection of produce.<sup>81</sup> Riverina Citrus noted that 'the rejection issue can come in at significantly different levels throughout the supply chain'<sup>82</sup>, and explained that:

The fruit then delivered from the packer through to the wholesaler has a rejection point in it. If it doesn't meet that wholesaler's requirements...it can either go direct to the wholesaler or to the retail chain distribution centre which also has the rejection process there, but even right through to store level it can get to the store and then be rejected at the store, either on delivery or post-delivery to come back.<sup>83</sup>

The ACCC has also heard evidence that growers can incur significant costs when produce is rejected by retailers, in terms of repackaging the produce and transporting that produce to another buyer where possible. The NSW Farmers Association noted that:

... supermarkets have been known to reject specifically packaged produce. The farmer then has had to repackage the product at his expense, to be able to place his product on the open market, in [an] attempt to recover his losses.<sup>84</sup>

Some growers have also argued that while retailers provide growers with clear produce specifications, the interpretation of these specifications is often the source of some dispute.

Representative for Vernview Pty Ltd, Mr David Finger, acknowledged that:

The specifications that [grocery] chains give us are very, very clear, and highly technical right down to temperatures and bricks and pressures, and you name it, it's in there, even to the length of the apple verses the width of the apple, versus all of these things. Most of my difficulties occur with rejections at [the] DC [distribution centre] about the interpretation of those specifications by my staff, by the QC [quality control] at the DC.<sup>85</sup>

The Chamber of Fruit and Vegetable Industries Western Australia also noted that if there is a dispute regarding the application of the produce specifications, the retailer is not required to attend mediation under the existing PGICC:

The chamber understands that retailers that buy direct from growers already have clear terms of trade and usually purchase produce on a farm gate price basis. However there does not appear to be a mandatory dispute resolution process in place if these retailers trade contrary to the specifications detailed in their supply agreements. This leaves open the potential to manipulate produce orders, as specifications can be relaxed when produce supply is short, or alternatively specifications can be tightened during periods of oversupply.<sup>86</sup>

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81 ACCC, public hearing transcript, Griffith, 8 April 2008, pp. 12–13.

82 *ibid.*, p. 9.

83 *ibid.*, p. 11.

84 NSW Farmers Association, submission no. 155, p. 19.

85 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 18.

86 The Chamber of Fruit and Vegetable Industries WA, Horticulture Code issues paper, submission no. 5, pp. 3–4.

Mr Finger further explained that when produce is rejected by the MSCs:

They're very [formal]... they're forms that come by email. They even have photographs, all of that very detailed, almost as detailed as the specifications that you send it in under x amount of fruit. Major defect, minor defect, very detailed. The dispute arises over the interpretation of what's actually being seen and not being seen.<sup>87</sup>

It therefore appears that while retailers may provide their direct suppliers with clear specifications as well as prompt and formal notice regarding when and why produce has been rejected, growers may not be sufficiently clear about their rights and obligations as to when produce can be rejected and returned to them at their own cost under their agreement with the retailer.

The third model by which growers may provide produce to a retailer is through consolidators (also known throughout the industry as aggregators, intermediaries, service providers or retailer's agents).

Food and Agribusiness Consultant for Horticulture Australia Limited, Mr Shane Corniskey, explained that there is a huge diversity of relationships between growers and grower consolidators that vary from crop to crop.<sup>88</sup> This group includes growers who consolidate other growers' produce in order to supply a large retailer, and wholesalers who routinely sell growers' produce onto a retailer, while also selling produce at the central markets. While retailers may have ongoing arrangements with these consolidators<sup>89</sup>, growers may have little indication as to whom their produce will be sold on or the role the consolidator will play in that transaction.

Despite the fact that these consolidators will often have obligations under the Horticulture Code to enter into a written horticulture produce agreement with a grower (as an agent or a merchant), evidence provided to the inquiry indicates that many fail to provide growers with a written supply agreement. The consolidator may provide the grower only with a retailer's publicly available produce specifications (although specifications are not always available for all lines) as a vague indication that the consolidator will on-sell the produce to that retailer.

The absence of written agreements in these transactions means that the capacity in which the consolidator acts in a transaction is often not made clear to the grower. The Victorian Farmers Federation explained that:

On the whole, those of our members who deal directly with the two major chains don't have a lot of concerns, but those who deal with the major chains via the intermediary have a lot of concerns.<sup>90</sup>

...

One of the problems we have... is that there's not a clear differentiation between agents and brokers. And that when you go down the chain, the change of use, it gets very muddled on who is doing what. And that's one of the concerns.<sup>91</sup>

The Horticulture Australia Council also explained that:

Growers frequently complain of tactics where wholesalers claim (either explicitly, or by requesting product to a certain retailers' quality and packaging specifications) to be acting on behalf of a particular retailer (i.e. as a buyer's agent). In some cases, of course, this is accurate. In many cases (to the detriment of the retailer's reputation), it is not.<sup>92</sup>

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87 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 19.

88 ACCC, public hearing transcript, Cairns, 4 April 2008, p. 15.

89 Coles, submission no. 225, pp. 13–14.

90 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 38.

91 *ibid.*, p. 44.

92 Horticulture Australia Council, Horticulture Code issues paper, submission no. 26, p. 1.

It may, for example, appear to a grower from discussions with their consolidator that the consolidator is acting on behalf of the retailer in a particular transaction (i.e. as the retailer's agent), while the consolidator is actually purchasing the produce from the grower as a merchant, then selling the produce onto a retailer or to another wholesaler in the central markets. It may therefore be unclear to the grower whether any particular transaction entered into with a consolidator is regulated by the Horticulture Code. If the consolidator purchased the product as a true agent of a retailer, the transaction would not currently be regulated by the Horticulture Code. If, however, a trader is acting as a merchant by purchasing the produce outright from the grower in order to fill a retailer's order or to on-sell the produce onto the central markets, the transaction is currently regulated under the Horticulture Code and requires a written horticulture produce agreement.

While the arrangements between the parties will differ in each case, it is unlikely that consolidators do in fact operate as agents for retailers. Coles explained that 'The aggregators deal with the growers to source the fresh produce and on-sell it to Coles'.<sup>93</sup> Coles does not appear to engage these aggregators as their agents, in the strict legal sense, but rather seeks to purchase produce from these aggregators in their role as merchants who have already purchased the necessary produce from a range of growers.

It is therefore the ACCC's view that the MSCs do not currently engage consolidators as their legal agents. The Horticulture Code already regulates transactions between a grower and a consolidator in their capacity as either an agent or a merchant, but the transaction between a consolidator and a retailer is not currently regulated by the Horticulture Code.

The lack of transparency in these transactions is further highlighted when produce is rejected by a retailer or the consolidator. The Victorian Farmers Federation explained that when a retailer sources produce through a consolidator and the retailer rejects a grower's produce, the merchant may advise the farmer that their product does not reach the specifications required by the supermarket and the loss is then pushed back on the grower.<sup>94</sup> The Victorian Farmers Federation explained that the grower is often unclear as to where the rejected produce has been sent or how it has been dealt with following rejection. The Victorian Farmers Federation explained that '...when it's rejected by a supermarket, these agents then sell it off wherever they can'.<sup>95</sup>

Vernview Pty Ltd representative, Mr Finger, also commented that:

The problem that arises is when you are actually supplying a supermarket chain through a potential black hole, because what happens in those situations is you pack to that very high specification and for whatever reason it's rejected from that third agent's system, not the more direct route. It's usually not shipped back to you to deal with, it's dealt with at that point, and so the traceability, the transparency of tracking that product, it's not there, and often, it's discounted far more than you would expect for the sort of problem that it would be rejected for at a DC [distribution centre] or at point of sale, retail.<sup>96</sup>

The Horticulture Australia Council noted that:

... this tactic [of a merchant holding himself out to the grower as a retailer's agent] allows the supposed buyers' agent to reject product, based on the spurious assumption/assertion that it had been rejected by the retailer. This is frequently allied with an offer to "assist" the grower out of a difficult situation by placing/selling the product on their behalf; though ["naturally"] this will incur the penalty of a reduced return [that is, a price discount has been extracted from the grower]. In some

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93 Coles, submission no. 225, p. 17.

94 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 46.

95 *ibid.*, p. 38.

96 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 24.

cases, if the market is over-supplied, the produce will simply be returned at the growers' expense, of course, and in many cases, several days after [it] was received (and frequently with the quality impaired).<sup>97</sup>

The Horticulture Australia Council has therefore submitted that:

... we are willing to consider (for reasons of equity, clarity and administrative simplicity) the possibility of one code (Horticulture Code of Conduct) which governs all transactions in the fresh produce sector.<sup>98</sup>

It has also been argued that exporters and processors should be regulated by the Horticulture Code as produce may originally be provided by a grower to a trader for export or processing, thereby avoiding regulation by the Horticulture Code and then subsequently be diverted back onto the domestic market for resale. The Western Australian Fruit Growers' Association Inc. argued that:

Two issues for consideration are the structure of the supply chain, where export businesses deal through intermediaries who consolidate supply for another business, and the reassignment of export fruit for domestic purposes. In the latter, often for perfectly reasonable commercial factors, fruit initially consigned for export is sold on the domestic market, and these transactions by-pass the code.<sup>99</sup>

While the inquiry heard evidence that many growers are often satisfied with their direct supply arrangements with retailers, the ACCC's view is that growers may nonetheless be unclear regarding their rights and obligations. In particular, evidence provided to the inquiry indicates that growers are often unclear as to the manner in which retailers apply their product specifications and a retailer's ability to reject produce at the grower's expense. The ACCC is also of the view that the inclusion of exporters and processors as 'traders' under the Horticulture Code can remove ambiguities that may arise when growers seek to determine whether the code applies in any particular instance.

**Recommendation:** that the Horticulture Code be extended to regulate first point of sale transactions of horticulture produce between a grower and a retailer, exporter or processor.

### 18.5.7 The Horticulture Code transitional arrangements

The exemption of pre-existing contracts (i.e. contracts entered prior to 15 December 2006) from regulation by the Horticulture Code raises a significant compliance and enforcement challenge for the ACCC because it is difficult to identify industry participants that currently fall within the scope of the Horticulture Code regulations.

Evidence provided to the ACCC indicates that a significant number of growers and traders opted not to move from written agreements existing before 15 December 2006 to agreements subject to the Horticulture Code, to avoid regulation by the Horticulture Code. The ACCC is aware that a significant number of growers entered into written agreements with traders just before 15 December 2006 to avoid coverage by the regulation.

The New South Wales Chamber of Fruit and Vegetable Industries explained that while the Horticulture Code was intended to cover the majority of the wholesale market:

the code has not impacted significantly on the day-to-day business within the central market system. This is because most of the business is done between growers and wholesalers under pre-existing written agreements or between parties who are not subject to the code.<sup>100</sup>

97 Horticulture Australia Council, Horticulture Code issues paper, submission no. 26, p. 1.

98 Horticulture Australia Council, submission no. 63, p. 7.

99 Western Australian Fruit Growers' Association Incorporated, Horticulture Code issues paper submission no. 6, p. 3.

100 New South Wales Chamber of Fruit and Vegetable Industries, submission no. 99, p. 5.

The Australian Chamber of Fruit and Vegetables Industries (Australian Chamber) also commented that:

The reality is that a lot of the business continues to be conducted on agreements entered into prior to the implementation of the code. Any growers and traders that have had a long term relationship have pre-existing agreements in place and those agreements are not subject to the code.<sup>101</sup>

The Australian Chamber explained that some traders are now reluctant to trade with growers who are not exempt from the Horticulture Code:

One distinct result on behaviour in the marketplace is the reluctance of wholesalers to accept produce from new growers that wish to supply them. As most of the established growers and wholesalers are operating on pre-existing agreements a new supplier usually means increased paperwork, cost and a possibility of prosecution if a mistake is made in any of the requirements under the code. This means that the opportunity for grower to change to another wholesaler has been diminished. Unless the grower is substantial or able to provide a unique or vastly superior product, most wholesalers will not take the risk of operating with new growers under the code. Where existing growers have opted to trade under the code after its introduction, wholesalers are now assessing whether these growers are worth the extra time, cost and risk of prosecution in continuing to deal in their produce.<sup>102</sup>

The Australian Mango Industry Association explained that traders' reluctance to deal with growers who must comply with the Horticulture Code places growers in an untenable situation. Chairman of the Association, Mr Delis, recalled that:

I had on two occasions last year ... people make contact with me personally asking for advice because they had been approached by their merchant asking them to sign a backdated agreement, and ... they asked me what to do.<sup>103</sup>

Mr Delis further noted that:

Unfortunately, growers are their own worst enemy despite the fact that they knew what was being asked of them and what the implications were and that they could actually make an issue of it, the comment was, "I still want to do business with these people".<sup>104</sup>

It is apparent from the evidence provided to the ACCC that as long as agreements entered into before 15 December 2006 are exempt from complying with the Horticulture Code, there will be reluctance by traders to enter into new code-compliant supply arrangements and there will be further confusion throughout the industry regarding when compliance is required.

The ACCC would therefore support the view put forward by the Mareeba District Fruit and Vegetable Growers Association that the Horticulture Code be amended to provide a sunset clause that would end the exemption currently provided to these pre-existing agreements.<sup>105</sup>

**Recommendation:** that the Horticulture Code be amended to regulate first point of sale transactions between a grower and a trader in horticulture produce, including transactions entered into under agreements made prior to 15 December 2006.

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101 Australian Chamber of Fruit and Vegetables Industries, submission no. 135, p. 8.

102 Australian Chamber of Fruit and Vegetables Industries, submission no. 135, p. 8.

103 ACCC, public hearing transcript, Darwin, 21 April 2008, p. 13.

104 *ibid.*

105 ACCC, public hearing transcript, Cairns, 4 April 2008, p. 81.

## 18.5.8 Delivery, ownership and the provision of services

### The definition of 'delivery' and establishing price

It is the ACCC's view that the Horticulture Code requires a merchant to provide a grower with a set price (rather than a method or formula by which price may be calculated) before on-selling the produce to a third party.<sup>106</sup> Merchants are therefore prohibited from providing the grower with a formula or price range and then subsequently providing the grower with a share of the returns once the trader has secured their margin. In this way, the Horticulture Code aims to eliminate 'hybrid' transactions in which traders may minimise their risk in the produce while maximising their return by employing elements of both the merchant and the agent model.

Before the commencement of the Horticulture Code, a wholesaler would commonly establish the price the grower would receive for their produce, by first advising the grower of an indicative price before the produce was sent to market. After the produce was inspected, and in some cases on-sold, the wholesaler would remit to the grower the proceeds of the sale, less any commissions, fees or charges. While this hybrid system may provide flexibility for wholesalers to sell the produce onto another party at the 'market price', this pricing method leaves the grower uncertain as to the amount they can expect to receive for their produce.

This system also means that produce rejected by the third-party purchaser may be returned by the trader to the grower for any reason whatsoever (e.g. oversupply of the produce), in spite of the fact that the trader holds themselves out as a 'merchant' throughout the transaction. Again, the trader is able to avoid taking any risk in the produce they 'purchased' by passing the loss back onto the grower. For these reasons, the government decided that, on balance, the Horticulture Code would achieve greater clarity and transparency by requiring traders to act as either agents (who must provide reports to growers and allow the grower to inspect the agent's relevant records) or merchants (where price is agreed in writing before produce is despatched or immediately upon delivery of the produce to the merchant).

However, it has been argued by wholesalers and the central market chambers that the definition of 'delivery' in the Horticulture Code in conjunction with the requirement to agree on an actual price, as opposed to a formula or indicative price, before or immediately upon delivery, creates considerable additional paperwork and imposes the impractical requirement of inspecting large volumes of produce and then contacting growers in the very early hours of the morning to negotiate price. Brisbane Markets Limited explained that:

It must also be understood that wholesalers cannot physically negotiate prices in the time between the receipt of produce and the opening of trade. Receipt of product generally begins at 2 am and trade commences at 6 am. The sheer volume of transactions makes making agreements in writing impossible. If wholesalers attempted to agree prices on delivery for all produce entering the markets, the system would collapse. That is why the state-based farm produce marketing legislation allowed for price setting on merchant transactions after the produce received had been made available for sale. It is also why many wholesalers and growers entered into pre-code contracts.<sup>107</sup>

Furthermore, some wholesalers and the central market chambers argue that the requirement to establish a price before knowing the true value of that produce in the market on that day will result

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<sup>106</sup> Clause 25 of the Horticulture Code.

<sup>107</sup> Brismark, submission no. 68, appendix 1: Brismark submission to the Horticulture Code Committee, p. 4.

in substantially lower prices being paid to growers as merchants seek to manage their risk. The Horticulture Code Committee explained that:

... traders argue that this requirement is unworkable, as they [the merchants] do not have enough resources to price all the produce early in the morning when produce is delivered and sold and at the same time to obtain a grower's written agreement to the proposed price.<sup>108</sup>

The Horticulture Code Committee suggested that 'much of the resistance to the code could be overcome if a more flexible method of agreeing price in merchant transactions was introduced into the code'.<sup>109</sup> The Horticulture Code Committee also suggested that:

... it may be appropriate to allow a method, based on the merchant sale price, to be used to calculate price in a merchant transaction with appropriate and additional reporting requirements. This may provide growers with appropriate levels of transparency and provide wholesalers, inside and out of the central markets, with the flexibility to obtain returns for growers.<sup>110</sup>

The ACCC agrees that these practical difficulties may be alleviated by requiring the merchant to provide the grower, before delivery, with either a price or a method for calculating a price. The ACCC also recommends that if the merchant does not reject the produce within 24 hours of physical delivery, the produce is deemed to be accepted. Ownership of the produce transfers when the produce is accepted by the merchant. The ACCC notes that, as set out in clause 14 of the current Horticulture Code, the merchant must exercise all reasonable due care and skill in handling and storage of the grower's produce to ensure that the produce remains of the highest quality possible while the grower's produce is under the control of the merchant (i.e. following delivery but prior to acceptance of the produce). The ACCC also recommends that a range of other mechanisms set out below be put in place to ensure that both parties are provided with adequate clarity and transparency when they enter into these transactions.

### The definition of 'delivery' and the provision of services

As the Horticulture Code is currently drafted, the term 'delivery' can have two meanings when produce requires ripening or other services. Delivery can refer to the time when produce arrives for conditioning or storage, or it can refer to the time when produce is ready for sale. As the Horticulture Code does not permit a merchant to charge a grower a fee for services performed under a horticulture produce agreement, merchants have sought to enter into service agreements in order to provide growers with other services such as warehousing; ripening and conditioning; sorting; packing; grading; cold storage; and food safety services. The Horticulture Code does not apply to these service agreements.

Where a grower and a merchant enter into a separate service agreement:

- the grower retains ownership of the produce for the duration of the service agreement
- the produce may subsequently be either physically delivered or deemed to be delivered to the merchant under the parties' horticulture produce agreement when the service agreement for that consignment ends.

If the merchant already has custody of the consigned produce, delivery will be deemed to have taken place when the horticulture produce agreement begins.

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108 Horticulture Code Committee, submission no. 32, pp. 5–6.

109 *ibid.*, p. 6.

110 Horticulture Code Committee, Horticulture Code issues paper submission no. 24, p. 2.

However, it is the ACCC's view that these arrangements are both unnecessarily complex and artificial. The recommendation outlined above therefore seeks to enable the merchant to purchase produce from the grower and deduct the cost of any services that are required to prepare the produce for resale, as part of the price or as part of the method for calculating a price.

**Recommendation:** that the Horticulture Code be amended as follows:

- The price paid by a merchant for the purchase of a grower's produce may be an amount or a method for calculating an amount.
- The price or a method for calculating the price must be agreed in writing between the merchant and the grower before delivery of the produce to the merchant.
- Any agreed method used to calculate a price must be by reference to the amount received by the merchant from the sale of the produce to a third-party purchaser.
- If the merchant does not reject the produce within 24 hours of physical delivery, the produce is deemed to be accepted. Ownership of the produce transfers when the produce is accepted by the merchant. (As set out in clause 14 of the current Horticulture Code, the merchant must exercise all reasonable due care and skill in handling and storage of the grower's produce to ensure that the produce remains of the highest quality possible while the grower's produce is under the control of the merchant).
- The merchant must seek consent from the grower regarding any non-arms-length transactions.
- If the parties use an agreed method to calculate a price, the merchant must report to the grower regarding how the price was calculated according to the agreed method.
- If the parties use an agreed method to calculate a price, the merchant must permit the grower, or an appropriate representative, to inspect records that relate to the grower's produce.
- The merchant is liable for any bad debts arising from the sale of the produce to a third-party and any produce returned by a third-party purchaser.
- The merchant may provide the grower with services as part of a horticulture produce agreement and deduct the cost of any services that are required to prepare the produce for resale, as part of the price or as part of the method for calculating the price.

### 18.5.9 Rights and obligations of agents under the Horticulture Code

The Horticulture Code requires that a grower and an agent must enter into a horticulture produce agreement that sets out how transactions between them are to take place.<sup>111</sup> The Horticulture Code defines an 'agent' as a person who sells horticulture produce on behalf of a grower to a third-party purchaser for a commission or fee<sup>112</sup>, and provides that an agent must act in the best interests of the grower and sell the grower's produce on an arm's-length basis.<sup>113</sup>

An agent is also required to report to the grower regarding the details of the transaction<sup>114</sup> and to enable the grower, or their representative to inspect the relevant agent's records.<sup>115</sup> However, agents are not required to give the grower the name and contact details of the buyer unless it is explicitly stated in the horticulture produce agreement that it is the responsibility of the grower to recover bad

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111 Clauses 6 and 9(3) of the Horticulture Code.

112 Clause 3 of the Horticulture Code.

113 Clause 18 of the Horticulture Code.

114 Clause 20 of the Horticulture Code.

115 Clause 22 of the Horticulture Code.

debts and that information is required in order to do so.<sup>116</sup> Since the Horticulture Code requires a clear distinction between those traders who act as agents and those who act as merchants, it has become apparent that, with the exception of the Perth and Adelaide central markets, very few traders at the central markets act as agents for the following reasons.

### Goods and services tax

An agent transaction attracts goods and services tax (GST) on the service the agent provides to the grower in marketing their produce. While agents may already be registered with the Australian Tax Office for the purpose of GST collection, the obligation to declare the full extent of the services that they provide to growers may deter some traders from acting as agents. Some traders therefore seek to continue to trade as 'merchants' while utilising the benefits of the hybrid system of trade.

### Bad debt

The Horticulture Code provides that a bad debt that arises from the sale of the grower's produce by their agent to a third party is the grower's bad debt (rather than the agent's bad debt).<sup>117</sup> If the grower's agent is to pursue the bad debt, the parties must set out in their horticulture produce agreement the scope of the agent's authority in this regard. For example, the agent may be authorised to utilise a credit marketing service or a subagent such as a debt collection agency, to pursue the debt on behalf of the grower.

Where the parties' horticulture produce agreement provides that the grower will pursue their own bad debts, the Horticulture Code specifies that the agent must provide the grower with the name and contact details of the third-party purchaser, in order that the grower can pursue that debt.<sup>118</sup> However, agents are often very reluctant to provide growers with these details for fear that growers may take the opportunity to circumvent the agent and deal with the third-party directly in the future. Growers are often not well placed to effectively collect debts from third-party purchasers. For example, most market credit services, which operate within the central markets to assist their trader members to collect their debts, do not collect debts on behalf of growers. On the other hand, the use of horticulture produce agreements that assign the recovery of a grower's bad debts to an agent, may act as a disincentive for a trader to act as an agent as they may perceive that there will be more work to complete before they receive their commission or fee.

In order to resolve these concerns, it may be more appropriate for the Horticulture Code to only permit an agent to recover their fee or commission for services performed under the agency agreement as a deduction from amounts paid by the third-party purchaser. This creates an incentive for the agent to recover the outstanding debts while compensating the grower if they must pursue the debt directly. Accordingly, if it is agreed that a grower shall pursue the debt themselves, the agent will not recover their commission relating to that sale.

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<sup>116</sup> Clause 23 of the Horticulture Code.

<sup>117</sup> Clauses 19 and 23 of the Horticulture Code.

<sup>118</sup> Clause 23 of the Horticulture Code.

## Reporting to growers

It has also been argued by the central market chambers that the reporting obligations set out in the Horticulture Code<sup>119</sup> act as a significant deterrent to traders that may otherwise act as agents. In particular, Brisbane Markets Limited argued that:

Wholesalers who source multiple grades and sizes of products from many different growers and combine those lots to fill complex orders cannot meet agency reporting requirements in a cost effective manner. This is a major reason why some wholesalers are not prepared to consider trading with growers on an agency basis.<sup>120</sup>

However, the ACCC is aware that the industry increasingly requires all parties to maintain comprehensive quality assurance records to enable any produce to be effectively traced through the supply chain back to the farm gate. It therefore appears that the obligations placed on agents under the Horticulture Code complement this broader shift towards greater transparency throughout the supply chain.

## Inspection of an agent's records

While the Horticulture Code permits a grower's representative to inspect an agent's records regarding the sale of their produce<sup>121</sup>, the code does not stipulate who the grower's representative can or cannot be. While it may be unlikely, this could enable a grower to appoint an agent's competitor to inspect the agent's records on the grower's behalf. It would therefore be appropriate to amend the Horticulture Code to enable an agent to prevent a person who may be the agent's competitor, from being appointed to inspect the agent's records on the grower's behalf.

**Recommendation:** that the Horticulture Code be amended to:

- only permit an agent to recover their fee or commission for services performed under the agency agreement as a deduction from amounts paid by the third party purchaser. Accordingly, if it is agreed that a grower shall pursue the debt themselves, the agent will not recover their commission relating to that sale.
- enable an agent to prevent a person who may be the agent's competitor, from being appointed to inspect the agent's records on the grower's behalf.

## 18.5.10 Packing houses and cooperatives

Growers from several large sectors of the horticulture industry, including the citrus, apple, pear and avocado sectors, provide their produce to cooperatives/packing houses before it is on-sold. However, the Horticulture Code does not contain any specific reference to packing houses or cooperatives. The application of the Horticulture Code to transactions involving these entities is therefore determined on a case by case basis. A transaction between a cooperative/packing house and a grower is currently regulated by the Horticulture Code if the cooperative/packing house acts as either a merchant (purchasing and then on-selling the grower's horticulture produce) or an agent (selling the grower's horticulture produce on behalf of the grower).

If the owner of a cooperative/packing house grows their own horticulture produce for sale, they will be defined as a grower for the purposes of the Horticulture Code. However, when several growers

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119 Clause 20 of the Horticulture Code.

120 Brismark, submission no. 68, appendix 1: Brismark submission to the Horticulture Code Committee, p. 4.

121 Clause 22 of the Horticulture Code.

deal with a cooperative/packing house, the Horticulture Code may apply to a transaction between the growers and the cooperative/packing house if the cooperative/packing house:

- is a separate legal entity from the growers (this legal entity may be owned collectively by the growers or by an individual grower) and acts as an agent, selling horticulture produce on behalf of the grower for a commission or a fee, or
- acts as a merchant, buying the grower's horticulture produce to on sell it.

However, it is the ACCC's view that the Horticulture Code does not apply to subsequent transactions in which the cooperative/packing house on-sells the produce to another trader because these will not be transactions between a grower and a trader. Instead, they are transactions between two traders.

This interpretation of the Horticulture Code ensures that all cooperatives/packing houses that act as agents or merchants, whether they are grower-owned or not<sup>122</sup>, are transparent in their dealings with growers. However, it should be noted that where the first transaction is between a grower and a cooperative/packing house, traders in the central markets are not required to enter into a horticulture produce agreement.

Some growers and grower associations have raised concerns that where the first transaction is between a grower and a cooperative/packing house, traders in the central markets will not be required to enter into transparent horticulture produce agreements as they will not be regulated by the Horticulture Code. For instance, the Horticulture Code Committee noted that:

Growers & grower-owned cooperatives believe that the first point of transaction that should be covered by the code is the one between the grower-owned cooperative and the trader, as this is where the actual sale of produce takes place.<sup>123</sup>

The NSW Farmers Association explained that in its view:

The Horticulture Code currently sweeps pack houses, cooperatives and other marketing organisations up within the definition of a 'trader' which then excludes the relationship between the cooperative and the trader from regulation.<sup>124</sup>

The association suggested that:

Amending the Code regulation to include all cooperative like or produce pooling structures, which are registered with the Australian Taxation Office, under the definition of a "grower" will focus the transparency back on the relationships which exercise market power against the growers' interests.<sup>125</sup>

In support of this argument, Mr Plunkett, Deputy Chair of the Fruit Growers of Victoria, commented that he sees little value in the Horticulture Code regulating the arrangements between growers and their co-operatives or packing houses. He explained that:<sup>4</sup>

... in my case...we pack our own fruit, and we also pack fruit for about twenty other growers. Under the current definition of the code, the code applies from the first transaction from the farmer, so the code is applying between myself and the grower next-door'.<sup>126</sup>

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122 However, if a grower owns a cooperative/packing house and the cooperative/packing house is the same legal entity as the grower, the Horticulture Code will not apply where the grower passes their own produce onto the cooperative/packing house. The code then applies to subsequent transactions of the grower's produce between the cooperative/packing house (which is the same legal entity as the grower) and a trader (as defined in the code).

123 Horticulture Code Committee, submission no. 32, p. 4.

124 The NSW Farmers Association, submission no. 155, p. 22.

125 *ibid.*

126 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 57.

The North Queensland Banana Growers Cooperative also argued that although the government has spent significant amounts of money encouraging growers to form cooperatives in order to market more effectively, the application of the Horticulture Code to transactions between growers and grower-owned packing houses and cooperatives was a disincentive for growers to form such cooperatives.<sup>127</sup>

In response to these arguments, Brismark (the Queensland Chamber of Fruit and Vegetable Industries Co-operative) submitted that such:

exemptions are unfair, placing burdens on only one part of the industry, giving other parts a competitive advantage and distorting the market. As the Central Market wholesalers have borne the greatest cost in relation to the Code we oppose any further exemptions or charges that will shift even more of the impacts of the Code onto our members.<sup>128</sup>

Brismark argued that:

Many grower packhouses are not cooperatively owned, and many have a very strong position in terms of their negotiating power with their grower suppliers. Clearly, a portion of the complaints and misunderstandings that occur within the industry relate to the grey area which can exist when one grower is marketing both their own and other grower's produce.<sup>129</sup>

It added that:

It should also be noted that packing houses, whether grower owned co-operatives or not, are separate legal entities and have not always acted in the best interests of their suppliers.<sup>130</sup>

The Chamber of Fruit and Vegetable Industries in Western Australia (Inc.) also supported the view that:

Trading entities involving grower ownership are no different to businesses without grower ownership they are both in the business of buying and selling fresh produce from growers to another party. On a national scale there are some very large scale businesses with grower shareholdings ... many of these operations have trading floors in central markets and it would be discriminatory to apply the code to some trading floors in central markets and not others.<sup>131</sup>

The ACCC recognises that the 'cooperative/packing house' category is a broad one that incorporates a range of entities, some of which are wholly and equitably owned by a small number of growers while others are large, remote entities dominated by a small number of growers with little interest in operating in a way that is clear and transparent to its smaller members. The ACCC is also aware that exempting these parties from the Horticulture Code may enable some traders to seek to avoid their obligations under the code by assuming the identity of a cooperative/packing house<sup>132</sup>, which may in turn disadvantage growers and bring about further compliance and enforcement challenges.

In light of these arguments, it is the ACCC's view that transactions between a grower and a cooperative/packing house in which the grower has a significant interest should be exempt from regulation under the Horticulture Code. However, the manner in which such a cooperative/packing house is dealt with under the Horticulture Code should vary depending on whether the cooperative/packing house purchases the produce outright from the grower or merely markets the grower's produce onto a third party.

**Recommendation:** that the Horticulture Code be amended to ensure that transactions between a grower and a cooperative/packing house, in which that grower has a significant interest, are exempt

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127 ACCC, public hearing transcript, Cairns, 4 April 2008, p. 89.

128 Brismark, Horticulture Code issues paper, submission no. 9, p. 10.

129 Brismark, Horticulture Code issues paper, submission no. 10, p. 13.

130 Brismark, Horticulture Code issues paper, submission no. 28, p. 4.

131 The Chamber of Fruit and Vegetable Industries in Western Australia (Inc.), Horticulture Code issues paper, submission no. 5, p. 5.

132 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. xix.

from regulation under the Horticulture Code where the cooperative/packing house 'markets' the grower's produce.

The ACCC also recommends that transactions in which a grower sells their produce to a cooperative/packing house should be exempt from regulation under the Horticulture Code where the grower has a significant interest in that cooperative/packing house.

The precise mechanism by which this result is achieved should be considered by the Horticulture Code Committee in consultation with the industry.

### 18.5.11 Pooling of produce and price averaging

The Horticulture Code requires that an agent must pay the grower the money received for that grower's produce after subtracting any commission or agent fees permitted under the horticulture produce agreement and any extra amounts that may be deducted under the agreement. The ACCC's view is that the practice of paying growers a price based on the average price received by the agent for a pool of produce (i.e. where various grades of produce from various growers are mixed together and then sent by the agent to be sold in markets throughout Australia) is not permitted under the Horticulture Code.

However, the ACCC's view is that the Horticulture Code permits agents to pool produce received from a different grower, if the agent also complies with the following obligations:

- The agent must act in the grower's best interests when selling their produce under a horticulture produce agreement.
- The agent must be able to trace and record where, to whom and for how much each grower's produce was sold.
- The agent must meet all their reporting obligations set out in the code.
- The agent must let the grower or their representative inspect those parts of the agent's records pertaining to the grower's produce.
- The grower has a role under the horticulture produce agreement in the collection of bad debts; the agent must provide the grower with the names of the purchasers.

The ACCC has heard evidence that the broader practice of pooling different growers' produce and averaging the price received in different markets across produce grades arguably distorts the market by obscuring the true market indicators<sup>133</sup>, removing the ability to trace crop disease and providing growers with little incentive to improve productivity or the quality of their produce, as growers that produce high-quality produce can only expect an average price under this system.<sup>134</sup>

However, the ACCC has also heard evidence from a sector of the horticulture industry that supports these practices as a mechanism that enables growers to continue to manage their risk in circumstances where there are significant fluctuations in produce prices over time and across various markets throughout Australia.

Horticulture Australia Limited explained that:

an anomaly exists, however, in the [Horticulture Code] whereby network growers through the provision of service providers such as an agent, merchant or non-grower consolidator, have their returns "averaged" through a pooling mechanism. Under the current definitions of the [code], an

<sup>133</sup> Chairman of the Australian Mango Industry Association, Mr Peter Delis, ACCC, public hearing transcript, Darwin, 21 April 2008, p. 11.

<sup>134</sup> President of Mareeba District Fruit and Vegetable Growers Association, Mr Joe Moro, ACCC, public hearing transcript, Cairns, 4 April 2008, pp. 79–80.

agent, merchant or non-grower consolidator would be committing an offence under the [code], despite the fact that the network growers are in agreement that it should occur.

...For example, a group of growers may decide to have their returns averaged by the agent, merchant or non-grower consolidator on the basis of a period of time (week, month or year), regional location, across a grade/s, end user/customer, etc. The group of growers may willingly enter into such an arrangement so that inequities or perception of same do not occur. By pooling, a marketer does not have to be concerned which growers product goes to which market. For instance, if an export market is being developed which provides lower returns initially, the marketer does not need to be concerned that all of grower A's product continues to go to export, because with pooling they will receive some of the benefit of going to the higher priced markets through averaging.

...Pooling does not imply that packout is not a major factor in net return calculations or that the transaction is not transparent.

...

Network growers or other similar grower groups have expressed concerned that the [code] does not cover this eventuality which is quite common across a broad range of fruit and vegetables.<sup>135</sup>

The Fruit Growers of Victoria Limited explained that the price of some produce has a long selling season and varies significantly over that season. It may even drop below the cost of production for a period. Smaller growers have benefited from the ability to pool and average the price—enabling produce to be held in cool storage and slowly released onto the market over time. This system enables growers to share freight costs and work together to meet large orders.<sup>136</sup>

Vernview Pty Ltd representative, Mr Finger, also commented that these practices may limit price fluctuations that would otherwise be passed onto the consumer.<sup>137</sup> The Geoffrey Thompson Fruit Packing Company Pty Ltd noted that as these practices are not permitted under the Horticulture Code:

there could be a substantial variation in the price paid to any particular grower, due to the timing of packing their fruit, which is largely out of the control of the grower. This can result in a price on the day that is significantly below the growers cost of production if the growers fruit is packed when the selling price is distressed...the smaller the grower, the larger the likely price fluctuations due to their entire crop being packed on one particular day.<sup>138</sup>

On balance, it is the ACCC's view that the Horticulture Code should be amended to enable the horticulture industry to continue to manage its risks through the practice of pooling and price averaging. However, the ACCC would encourage the industry to adopt practices that encourage pooling and price averaging of similar quality produce, to ensure growers receive accurate price information regarding the market value of their produce.

**Recommendation:** that the Horticulture Code be amended to permit agents and growers to engage in pooling and price averaging of produce.

## 18.5.12 Grower sheds

Three of Australia's central fruit and vegetable markets (the Sydney, Adelaide and Melbourne central markets) incorporate an area which is commonly called a 'grower shed'. A grower shed is that part of a central fruit and vegetable market reserved for growers to sell their produce directly to a diverse group of purchasers, including wholesalers, processors, exporters, provedores, retailers, consumers and

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<sup>135</sup> Horticulture Australia Limited, submission no. 167, p. 51.

<sup>136</sup> ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 60.

<sup>137</sup> *ibid.*, p. 26.

<sup>138</sup> Geoffrey Thompson Fruit Packing Company Pty Ltd, Horticulture Code issues paper, submission no. 2, p. 1.

other growers. Growers may use a grower shed to sell their own produce directly to purchasers and/or to sell other grower's' produce on an agent or merchant basis. Transactions undertaken by growers who trade in a grower shed typically involve a high frequency of small quantity (and therefore low value), face-to-face, short-term 'spot' sales. For example, approximately 480 growers are currently registered as permanent or casual users of the grower shed within the Sydney central market and approximately 300 growers trade in this grower shed on any one day.

The following types of transactions that take place within a grower shed are currently regulated by the Horticulture Code:

- a grower who sells their own produce to a merchant
- a grower who sells their own produce through an agent
- a grower who sells their own produce to another grower, who acts as a merchant
- a grower who sells their own produce through another grower, who acts as an agent.

The Horticulture Code provides that the first purpose of the code is 'to regulate trade in horticulture produce between growers and traders to ensure transparency and clarity of transactions'.<sup>139</sup> In order to establish transparency and clarity throughout these transactions, the Horticulture Code requires that the agreement states whether the trader is trading as an agent or merchant under the agreement.<sup>140</sup>

However, a grower operating out of a grower shed may not have the opportunity to establish whether a purchaser is purchasing the produce in the capacity of a merchant, agent, retailer, exporter, processor, consumer or as another grower. Similarly, the purchaser may be unclear whether the grower is selling their own produce or selling produce on behalf of another grower. If the capacity of the parties entering into the transaction is unclear, it will also be unclear whether the transaction is regulated by the Horticulture Code and therefore whether the parties involved need to enter into a written agreement that complies with the code. For these reasons it may be difficult for parties trading in a grower shed to comply with the Horticulture Code and for the ACCC to effectively bring about compliance with the code.

In spite of the lack of clarity regarding the capacity of the parties to these transactions, it is arguable that transactions entered into in a grower shed are, on the whole, more transparent and clear than long-term, long-distance agreements. This is because a purchaser of produce from a grower shed is typically able to inspect the produce, negotiate a price for the produce and collect the produce in person within a very short period of time. It is also foreseeable that growers that operate out of a grower shed are less likely to be able to absorb the regulatory compliance costs involved in complying with the Horticulture Code than those growers that are engaging in high-volume, high-value transactions.

For these reasons, it may be more appropriate for parties that enter into agreements in a grower shed to be exempt from the Horticulture Code while retaining the ability to access the Horticulture Code's dispute resolution procedure established under parts 5 and 6 of the code. The code will also need to clearly define the nature of the trade that may take place within a grower shed to ensure that other traders are not able to shift their operations into a grower shed to avoid compliance with the code.

**Recommendation:** that the Horticulture Code be amended to exempt transactions that are entered into in a grower shed from regulation under the code. However, it is recommended that parties

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<sup>139</sup> Clause 2 of the Horticulture Code.

<sup>140</sup> Clause 9(2)(a) of the Horticulture Code.

that enter into these transactions be permitted to access the Horticulture Code's dispute resolution procedure established under parts 5 and 6 of the code.

### 18.5.13 Dispute resolution procedures

Disputes regarding transactions between growers and wholesale traders of unprocessed horticulture produce<sup>141</sup> may currently be resolved according to two distinct dispute resolution mechanisms: the dispute resolution procedure established under the Horticulture Code or the dispute resolution procedure established under the voluntary PGICC. However, disputes regarding transactions that involve other groups within the broader produce and grocery horticulture supply chain (such as retailers, processors and exporters) are limited to the dispute resolution scheme established under the PGICC.

The main objective of the Horticulture Code's dispute resolution procedure is to provide growers and wholesale traders, who have agreements under the code, with a fair and equitable dispute resolution mechanism. The Horticulture Code provides that growers and traders may use any dispute resolution procedures they choose to resolve horticulture disputes that arise between them. However, if either a grower or trader wishes to use the Horticulture Code's dispute resolution procedure, the other trading party must comply.<sup>142</sup>

In contrast, the PGICC is a voluntary code that applies to a broad range of industry participants including:

those businesses involved in the production, preparation and sale of food, beverages and non-food grocery items, including (but not limited to) primary producers, manufacturers and/or processors, wholesalers, importers and/or distributors, brokers and/or agents and grocery retailers.<sup>143</sup>

Moreover, the PGICC does not exempt agreements entered into before 14 May 2007 as is the case with the Horticulture Code. However, the ACCC notes that while the PGICC enables retailers to access the dispute resolution scheme, the PGICC has acknowledged that under the voluntary code dispute resolution process 'there has been minimal dispute activity in relation to the retailers'.<sup>144</sup>

An additional difference between the Horticulture Code and the voluntary code is that the former provides for the appointment of the horticulture mediation adviser who can assist parties to resolve their disputes and, on request, appoint mediators from a specialist panel of experienced mediators across Australia. The horticulture mediation adviser has established a list of horticulture produce assessors who can investigate and report on any matter arising under a horticulture produce agreement. The Horticulture Code also enables parties to a horticulture produce agreement to use the services of an assessor to investigate a matter and report the findings in relation to the issues in question.

The ACCC notes that the availability of assessors under the Horticulture Code may assist parties to resolve a dispute without the need for a formal mediation, and that in a case where a dispute proceeds to mediation, the use of assessors is likely to result in a more efficient and fair outcome. However, it appears that these assessors have rarely been called upon since the commencement of the Horticulture Code. The reason for this may be the lack of awareness regarding their role under the

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141 Clause 3 of the Horticulture Code.

142 Clause 30 of the Horticulture Code.

143 Clause 4 of the Produce and Industry Code of Conduct. However, it is important to note that while the PGICC dispute resolution procedure is voluntary and no party is bound to participate, if a party were to hold itself out as endorsing the PGICC, but refused to participate in the dispute resolution process established under that code, this might raise some concerns for the ACCC because it might potentially constitute misleading or deceptive conduct under s. 52 of the Act.

144 ACCC, public hearing transcript, Melbourne, 30 May 2008, p. 4.

Horticulture Code. According to the Horticulture Code committee, 'there is lack of knowledge of the code, the horticulture mediation advisor and horticulture produce assessors.'<sup>145</sup>

The ACCC also notes that the use of horticulture produce assessors can only be effective if such a service is available to industry participants in a timely manner (because the dispute is in relation to the quality of fresh produce). The need for urgency when assessing fresh horticulture produce may also explain why industry participants have not more widely utilised the services of these assessors to date.

The Australian Government subsidises the full cost of the mediator's fees under both schemes, with the exception of an application fee of \$50, which is payable by the parties to enable them to undertake mediation.<sup>146</sup>

However, unlike the PGIO mediation service, the Horticulture Code provides that the parties will generally be required to share the costs for any video conference, telephone conference, venue or travel costs incurred by the mediator.

Both dispute resolution procedures encourage the parties to resolve their disputes prior to mediation.<sup>147</sup> Under the Horticulture Code, the two parties are at first encouraged to attempt to resolve the dispute themselves and, if that fails, may participate in mediation as described above. However, statistical data from the PGICC indicates that the number of the dispute resolution inquiries and mediations undertaken by the PGIO has been decreasing since July 2001. The PGICC noted, for example, that of the 587 registered dispute inquiries received by the PGIO since 2001, 240 proceeded to apply for mediation, of which 170 proceeded to mediation and 151 ended in a contractual resolution of the dispute.<sup>148</sup>

According to the new PGIO mediation service established in 2006, in which the PGIO administers a panel of mediators and no longer has a promotional role<sup>149</sup>, the PGIO now focuses on seeking to resolve disputes before escalating disputes to mediation. These changes to the PGIO mediation service appear to have resulted in a further reduction in the number of dispute inquiries and the number of disputes escalated to mediation. The PGICC noted, for example, that during 2006–07 and 2007–08, the number of dispute inquiries fell to a total of only 70, of which only 12 became mediation applications, seven proceeded to mediation and six entered signed agreements. However, it is unclear whether these trends are due to early resolution of disputes by the PGIO prior to mediation, reduced awareness of the service, increased use of internal dispute resolution procedures or otherwise.<sup>150</sup>

Regardless of which dispute resolution mechanism a party may use, it is apparent that most parties prefer to settle their disputes within an internal dispute resolution process rather than utilising a mediation service. This may suggest that both parties seek to resolve their disputes as quickly as possible. Alternatively, it may also suggest that larger industry participants are reluctant to use external dispute resolution procedures due to the affect it may have on their reputation and that smaller party's fear retaliation or victimisation if they insist on pursuing matters through a formal mediation process.

On balance, the ACCC considers that the dispute resolution procedure established under the Horticulture Code may offer complainants greater certainty that the matter will be resolved, as the other

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145 Horticulture Code Committee, submission no. 32, p. 3.

146 See [www.hortcodema.com.au](http://www.hortcodema.com.au) and [www.produceandgrocerycode.com.au](http://www.produceandgrocerycode.com.au).

147 The Produce and Grocery Industry Code Administration committee, submission no. 50, p. 3.

148 *ibid.*, pp. 5–6.

149 The same provider undertakes mediation services for the PGICC and the Horticulture Code. However, mediation under the Horticulture Code is compulsory should either party request it, whereas mediation remains voluntary under the PGICC.

150 The Produce and Grocery Industry Code Administration committee, submission no. 50, p. 3.

party is bound to participate in the dispute resolution procedure<sup>151</sup>, whereas, under the PGICC, both parties need to agree to participate in such a process. The voluntary nature of the PGICC enhances the ability of a party with more market power to pressure a party with less market power to settle a dispute outside of these formal dispute resolution mechanisms, as both parties must agree to participate before the process can proceed. In contrast, the Horticulture Code enables a party with less market power to require a party with more market power to participate in the code's formal dispute resolution procedure.

The dispute resolution procedure established under the Horticulture Code therefore appears to offer a party with less market power an opportunity that may not otherwise be available to participate in an independent dispute resolution process rather than a less formal, voluntary process that may effectively be managed by the other party.

**Recommendations:** that the costs incurred by the parties to a dispute under the Horticulture Code dispute resolution procedure be subsidised by the Australian Government to the same extent as the voluntary PGICC, and that the ACCC undertakes to provide further education relating to the Horticulture Code and its dispute resolution procedures, including about the role of assessors in resolving disputes.

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<sup>151</sup> Clause 30 (2) of the Horticulture Code.

# 19 The role of the Trade Practices Act in addressing impediments to competition

## Key points

- Recent growth by the major supermarket chains (MSCs) has largely occurred through organic growth rather than growth through acquisitions. While creeping acquisitions are not currently an issue in the grocery industry, they are a broad issue that can affect many industries. The ACCC accordingly maintains its support for the introduction of legislation that would better allow it to address creeping acquisitions more generally.
- A number of parties raised allegations of predatory pricing by the MSCs. While specific examples were provided of vigorous price discounting by the MSCs which competitors struggled to match, such conduct does not of itself constitute predatory pricing. Price competition of this nature is often pro-competitive and can deliver benefits to consumers. The ACCC was not presented during the inquiry with examples of conduct that would appear to constitute predatory pricing. It does not consider that specific predatory pricing rules need to be introduced for grocery retailing. However, it recognises that predatory pricing is a potential concern in the grocery industry.
- A number of parties raised concerns about price discrimination. Price discrimination often has sound efficiency justifications and can deliver benefits to consumers. The ACCC considers that the existing provisions of the Act are sufficient to address instances where price discrimination is used in an anti-competitive manner.

## 19.1 Introduction

This chapter focuses on Part IV of the *Trade Practices Act 1974* (the Act) and possible measures that have been raised during the inquiry to deal with concerns about the retail grocery industry. Chapter 1 examined much of the work that has been done by the ACCC or its predecessors. This chapter instead focuses on three further issues:

- s. 50 and mergers and acquisitions
- s. 46 and predatory pricing
- the former s. 49 and price discrimination.

In relation to each of these issues, this chapter will examine:

- the provision of the Act
- submissions made by interested parties
- arguments for and against amending the Act.

## 19.2 Mergers and acquisitions

During the inquiry, some market participants expressed concern about mergers and acquisitions, and in particular creeping acquisitions, by the major MSCs, Coles and Woolworths. For example, the National Association of Retail Grocers of Australia (NARGA) submitted that:

Market share growth by Woolworths and Coles has been the result of (factors including)...  
"creeping"—store by store—acquisition of successful independent stores by Woolworths and Coles.<sup>1</sup>

The term 'creeping acquisition' generally refers to the practice of making a series of acquisitions over time that individually do not raise competitive concerns, usually because the changes in competitive rivalry from any individual acquisition are too small to be considered a substantial lessening of competition. However, when taken together, the acquisitions may have a significant competitive impact. The term creeping acquisition might also refer to a player with existing market power making a small acquisition, even though the small acquisition does not substantially lessen competition in itself.

Creeping acquisitions may be a concern when they occur in a market where the structure of that market facilitates the exercise of market power, and in particular, where that market is characterised by high barriers to entry or expansion.

The following discussion focuses on acquisitions by the MSCs. There have also been a large number of mergers and acquisitions, involving companies that provide wholesaling services to independents, which ultimately led to the formation of Metcash. They were previously discussed in detail in chapter 7, which examined the competitive position of independents supplied by Metcash.

### 19.2.1 Submissions on mergers and acquisitions in the grocery industry

Some interested parties submitted that creeping acquisitions are occurring in the retail grocery industry and are having a detrimental effect on competition.

Concerns have been raised that creeping acquisitions have the potential to directly affect competition in grocery retailing by eliminating or preventing competition from other grocery retailers:

... creeping acquisition tactics of the majors has further extinguished the scope for the development of independent groups.<sup>2</sup>

Further concerns have been raised that, collectively, retail acquisitions may also affect the grocery wholesaling sector and have a flow-on effect on grocery retailing. Industry participants submitted that grocery wholesalers can potentially suffer two sources of competitive disadvantage from acquisitions in grocery retailing:

- loss of economies of scale in wholesaling relative to the MSCs (see chapter 8 for further discussion of economies of scale in wholesaling)
- loss of bargaining power in negotiations with suppliers relative to MSCs.

Metcash submitted that:

... creeping acquisitions are extremely detrimental to the maintenance of competitive forces in the retail market—when an MSC acquires an independent retailer in an area, not only is there a

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<sup>1</sup> NARGA, submission no. 129, p. 3.

<sup>2</sup> Koundouris Group, submission no. 35, p. 4.

reduction in the level of choice available to consumers in the area, but the entire cost base of the independent sector is also undermined due to the corresponding loss in economies of scale, scope and density.<sup>3</sup>

Some participants also expressed concerns that the growth of MSCs through acquisitions may increase the MSCs' buying power and have a detrimental impact on suppliers (see chapters 15 and 16 for further discussion of buyer power).

Concerns about creeping acquisitions stemmed from a view that s. 50 of the Act, the regulatory tool for reviewing mergers and acquisitions, does not enable the ACCC to assess the accumulated competitive impact of a series of acquisitions over time:

Small businesses argue that the nature of the TPA and its application means that minor or so called "creeping acquisitions" by MGRs (major grocery retailers), (ie. purchases of existing independently-owned stores or the opening of new stores) are not precluded or actively prevented.<sup>4</sup>

We are concerned about the potential competition problems that result from 'creeping acquisitions'. We continue to be concerned that section 50 may not be sufficient to deal with this issue.<sup>5</sup>

Organisations such as CHOICE called for amendments to s. 50 to ensure that consideration is given to any accumulated competitive impact:

Choice supports a review of the ACCC's competition powers in relation to dealing with creeping acquisitions ... Small acquisitions of additional stores which in themselves don't raise a competition problem should be looked at on an aggregate basis and that accordingly there needs to be some change to the law in relation to how those issues are dealt with.<sup>6</sup>

NARGA submitted that it may be appropriate that there be further amendments to the Act to provide greater scrutiny of mergers and acquisitions in the grocery retail sector.<sup>7</sup>

NARGA suggested the introduction of a 'competition test' to assess local market concentration before the approval of any acquisition or development application.<sup>8</sup> A test of this nature was recommended by the Competition Commission as part of the recent investigation into the supply of groceries in the UK.<sup>9</sup> Such a test would prohibit the acquisition of existing stores or development of new stores by a market operator where the overall presence of that operator in a defined local market exceeded a certain threshold.

The Koundouris Group<sup>10</sup> and the Master Grocers Association (MGA)<sup>11</sup> also suggested limitations on MSCs opening new stores in markets where they already have a presence. The MGA, however, acknowledged that restrictions of this nature can adversely affect smaller market participants:

It should be noted that increased regulation of creeping acquisitions may sometimes have a negative effect, albeit limited, on independent supermarkets. Restricting the ways in which the major chains can appropriate individual independent stores could decrease the potential exit pathways for independent supermarket owners wishing to sell their businesses. Indeed, increased regulation of creeping acquisitions acts to limit the growth of the chains market share rather than stimulate the introduction of new independent stores to the market place.<sup>12</sup>

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3 Metcash, submission no. 181, p. 39.

4 NARGA, submission no. 14, attachment by PricewaterhouseCoopers, p. 22.

5 Consumer Action Law Centre, submission no. 124, p. 11.

6 ACCC, public hearing transcript, Sydney, 1 April 2008, p. 7.

7 NARGA, submission no. 129, p. 6, 35-6; NARGA, submission no. 159, p. 11.

8 NARGA, submission no. 129, p. 36.

9 Competition Commission, The supply of groceries in the UK market investigation, volume 1: summary and report, April 2008, p. 17.

10 Koundouris Group, submission no. 35, p. 4.

11 Master Grocers Australia, submission no. 96, p. 10.

12 *ibid.*

Coles submitted that s. 50 allows the ACCC to fully investigate the competitive impact of a supermarket acquisition:

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.<sup>13</sup>

Coles ... 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.

Coles also submitted that there would be potential adverse impacts on market participants and consumers as a result of additional regulation:

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.

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.<sup>14</sup>

Woolworths submitted that any additional regulatory burden would add to development times and cost of new supermarkets:

... in terms of do we need to have a whole host of other tests that would need to be tested in court and subject to appeal, it would just add to the length of development and would actually add to the cost of that development which naturally is going to be recouped over time.<sup>15</sup>

Woolworths submitted that there was no creeping acquisitions strategy being followed by the MSCs and that most of its growth had been through 'organic' growth such as conversion of non-supermarket retail sites, development of greenfield sites or moving store locations.<sup>16</sup>

Woolworths also submitted that regulatory reform may detrimentally affect the competitive process:

Regulatory reform that leads to a limitation on the range of potential buyers of independent supermarkets through reducing the ability of Woolworths and other major supermarket chains to bid for such businesses would detrimentally affect the competitive process that currently exists under the Charter for the Acquisition of Independent Supermarkets. In particular, two outcomes are likely to result:

- Metcash may become a monopsonist in the market for the acquisition of existing and future IGAs, an outcome which will not likely increase the welfare of independent grocery retailers or their customers; and
- the value that independent grocery retailers could obtain upon exiting the business would diminish (because of the smaller number of potential bidders), which would ultimately discourage entry into independent grocery retailing because of a perceived inability to adequately execute a financially viable "exit strategy" should the retailer choose to cease trading.<sup>17</sup>

Woolworths also noted the existence of the Charter for the Acquisition of Independent Supermarkets

<sup>13</sup> Coles, submission no. 225, pp. 25–26.

<sup>14</sup> Coles, submission no. 226, p. 26.

<sup>15</sup> ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 7.

<sup>16</sup> Woolworths, submission no. 232, p. 1.

<sup>17</sup> Woolworths, submission no. 232, p. 4.

and Produce and Grocery Industry Code of Conduct.<sup>18</sup>

## 19.2.2 ACCC view on mergers and acquisitions in the grocery industry

Section 50 of the Act prohibits a corporation from acquiring shares or assets if the acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a market.

Under s. 50 the ACCC has reviewed a number of supermarket acquisitions notified to it voluntarily over the last 10 years. The ACCC can, under s. 50, oppose an acquisition (or accept a remedy to resolve its competition concerns) where it has been able to establish that an acquisition, on its own, has the likely effect of substantially lessening competition in a market.

### Application of s. 50 to single acquisitions

Aside from the issue of creeping acquisitions, there has also been interest during the inquiry concerning how the ACCC generally approaches the application of s. 50 to single acquisitions of supermarkets. A single acquisition can be an acquisition of only one supermarket or an acquisition of a number of supermarkets at one time.

#### *Recent ACCC assessment of single acquisitions*

The ACCC's view is that where a single acquisition has significant competitive implications in a local retail area, it can be assessed under s. 50. Where there are a relatively small number of supermarkets in a retail area, an acquisition of one supermarket may have a substantial impact on competition within that area, and can be assessed accordingly. For example, on 25 June 2008 the ACCC opposed Woolworths' proposed acquisition of the Karabar supermarket in Queanbeyan, New South Wales.<sup>19</sup> This acquisition was opposed on its own merits, based on an analysis of local retail and wider wholesale markets, and not on a 'creeping acquisitions' approach. It does not reflect any significant change in the ACCC's approach to acquisitions. The ACCC will oppose acquisitions where it forms the view that there will be a substantial lessening of competition.

Several factors were important in the ACCC considering that a substantial lessening of competition was likely if the Karabar transaction went ahead:

- the concentration of Woolworths stores in the local market
- barriers to entry, including access to suitable sites in the local market that would allow for expansion by competitors to Woolworths
- the likelihood of a strong competitive outcome if the acquisition by Woolworths did not go ahead (the 'counterfactual scenario' or the 'future without the transaction'). In this case, the ACCC had strong evidence to support a likely counterfactual scenario of an acquisition by an independent that would compete strongly with Woolworths and other players in the local market.

The ACCC analysed the Karabar transaction, as it has with other supermarket transactions in the past, based on an assessment of local retail and wider wholesale markets. It is in these markets that any anti-competitive effects are likely to be felt. For instance, in a local retail market, an anti-competitive acquisition by an MSC can lead to less competition on prices and service, and may lead to less innovation or dynamism in offerings to consumers who shop in that local market.

Wholesale market analysis was conducted for the Karabar transaction, but was not a deciding factor

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<sup>18</sup> Woolworths, submission no. 232, p. 1.

<sup>19</sup> ACCC, *ACCC opposes the proposed acquisition of Karabar supermarket by Woolworths Limited*, media release, 25 June 2008.

in the ACCC's decision to oppose the acquisition. When assessing wholesale markets, the ACCC is interested in the effect that acquisitions may have on the ability of competitors at the wholesale level to compete in their supply to the independent supermarkets. As the number of supermarkets the wholesale competitors supply in a given wholesale market (and the consequent scale of purchases made by them) diminishes, the costs per item supplied for the wholesalers may increase and their ability to be competitive decline. As an acquisition of an individual supermarket by an MSC is unlikely to have a substantial impact on competition at the wholesale level, the focus of the ACCC's competition assessments when examining supermarket acquisitions tends to be on local market impacts.

While there is no specific reference to 'local market' in the Act, the ACCC has always considered such markets are capable of being 'substantial' markets, as required by s. 50.<sup>20</sup> The ACCC has considered whether a new local competition test for supermarkets needs to be inserted into the Act to remove any doubt over this issue but, given its view that 'local' markets are capable of being 'substantial' markets, the ACCC does not consider that such a change is needed at this stage. The ACCC has never had its view challenged, nor has the issue been tested in the courts. If it were ever found by a court that local markets were not capable of being 'substantial', then the ACCC would recommend that the government amend the legislation to make it clear that local markets can be considered in the context of the s. 50 substantial lessening of competition standard.

The ACCC also considers that acquisitions of larger supermarket chains can be assessed under s. 50. In 2005 the ACCC conducted a major investigation of the sale of Foodland Associated Limited's (FAL) supermarket and wholesaling business. This investigation examined Woolworths' proposed acquisition of 22 Action supermarkets and development sites in Western Australia, Queensland and New South Wales; and Metcash's proposed acquisition of the remaining 60 Action supermarkets and FAL's wholesale distribution business. In 2001 the ACCC conducted a major investigation into the sale by Dairy Farm of the 287 supermarkets in its Franklins chain to companies including Pick 'n Pay, Woolworths and Metcash.

It is relevant to note that s. 50 prohibits an acquisition that results in a substantial lessening of competition relative to a counterfactual situation without the merger or acquisition. For example, regarding the Franklins sale, the counterfactual was that Franklins had not been a successful business and competitive force in the period leading up to its sale and this was likely to continue into the foreseeable future if the acquisition did not proceed.

In addition to the Foodland investigation, the ACCC has publicly reviewed nine transactions involving nine supermarkets over the last three years.<sup>21</sup>

### *Notification of acquisitions*

Review of the above proposed transactions occurred after they were brought to the ACCC's attention. However, it should be noted that notification of proposed acquisitions is not compulsory. Mandatory notification of proposed acquisitions was recommended in the Baird report by the Joint Select Committee on the Retailing Sector in 1999.<sup>22</sup> The Produce and Grocery Industry Code of Conduct—a voluntary code introduced by the Australian Government in 2000 to which both Coles and Woolworths

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20 Section 50(6) states that the word 'market' is defined to mean 'a substantial market for goods or services in: Australia, a state; a territory; or a region of Australia'.

21 A full list of public merger reviews conducted by the ACCC about supermarket acquisitions over the last three years is included in appendix F.

22 Joint Select Committee on the Retailing Sector, *Fair market or market failure: a review of Australia's retailing sector*, Parliament of the Commonwealth of Australia, Canberra, 1999.

are signatories—states that the ACCC is to be notified of acquisitions of a controlling interest in a grocery retailer.<sup>23</sup> Despite the requirements of the code, the ACCC is aware of a small number of acquisitions over this period where it has not been notified.

### Application of s. 50 to creeping acquisitions

While s. 50 of the Act applies to individual acquisitions, the application to potential ‘creeping acquisition’ issues is more problematic. The ACCC takes the view that, while it can assess under s. 50 the competitive issues associated with an individual acquisition, s. 50 is unlikely to allow it to examine the cumulative impact of a series of acquisitions of smaller competitors over time that individually do not raise competition issues. Section 50 is unlikely to be able to deal with such acquisitions because, among other things:

- s. 50 expressly refers to a single acquisition only
- ss. 45 and 47 contain provisions expressly allowing the examination of multiple transactions, while s. 50 does not.

The ACCC has previously examined the issue of creeping acquisitions in the supermarket industry, most recently in its 2004 inquiry into the effects of shopper docket discounts and acquisitions in the petrol and grocery sectors.<sup>24</sup> The ACCC recognised the challenges that creeping acquisitions presented and, although it did not find any evidence that such acquisitions raised competition concerns in the grocery industry at that time, it recognised the potential for issues to arise.

Following the 2004 inquiry, the ACCC also introduced the voluntary Charter for the Competitive Sale of Independent Supermarkets in July 2005.<sup>25</sup> This charter was designed to address concerns over exclusive negotiation clauses being placed in contracts for the acquisition of independent supermarkets by MSCs. Metcash, Coles, Woolworths and Franklins are all parties to the charter.

Under the charter, acquiring parties cannot prevent independent supermarket retailers from seeking alternative purchasers for their stores after receiving a purchase offer, and must make sure that the target store owners are aware of their rights under the charter.<sup>26</sup> Available information suggests that the charter has generally been complied with to date.

The ACCC notes concerns raised by some industry participants that the cumulative effects of individual acquisitions have been significantly detrimental to competition in grocery retailing. However, none of the submissions making that claim identified specific markets where there had been a substantial lessening of competition as a result of a series of acquisitions. The ACCC has not been able to identify any supermarket acquisitions in the last five years where the result would have been different had the ACCC been able to take into account other acquisitions in the same market. This suggests that the cumulative effect of a series of acquisitions of independent supermarkets by the MSCs has not been a significant contributor to any competition problems in the supermarket sector in recent years.

Submissions and information obtained during the inquiry show that acquisitions of existing retail grocery businesses over the past 15 years have to some extent contributed to the growth of MSCs. However, the main source of growth has occurred through the development of new retail sites. It is also notable that a significant proportion of growth through acquisition of existing retail businesses is attributable to

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23 Produce and Grocery Industry Code of Conduct, December 2007, clause 8, available at [www.produceandgrocerycode.com.au/](http://www.produceandgrocerycode.com.au/).

Acquisition in the code is defined as acquiring a controlling interest in a retailing entity trading in the retail grocery trade within Australia.

24 ACCC, *Assessing shopper docket petrol discounts and acquisitions in the petrol and grocery sectors*, February 2004, pp. 26–29, 41–42.

25 ACCC, *ACCC announces charter to promote competitive sales of independent supermarkets*, media release, 1 July 2005.

26 However, under clause 5 of the charter, a party may enter into an agreement to supply an independent supermarket retailer that contains a restriction on sales to third parties if the party has provided assistance to the independent supermarket retailer.

two transactions, the sale of Franklins in 2001 and Foodland in 2005, rather than through a series of acquisitions of smaller independent supermarkets by the MSCs.

Table 19.1 sets out the proportion of supermarkets opened by Coles and Woolworths, over the last 15 years, on sites previously operated by a competing grocery retail business compared to the development of new sites.

**Table 19.1 Coles and Woolworths—store openings in the past 15 years**

	1993–97	1998–2002	2003–05	2006–07	Overall
Development of a new site	73%	46%	67%	90%	61%
Site previously occupied by a supermarket: Franklins and Action acquisitions	—	21%	13%	—	13%
Site previously occupied by a supermarket: store openings other than the Franklins and Action acquisitions*	27%	33%	20%	10%	26%

\*Note: this figure is likely to slightly overstate the level of acquisitions of single independent stores because it includes a small number of acquisitions of small supermarket chains; for example, Woolworths' acquisition of nine Cannons stores in 1996.

Based on this data, an overwhelming proportion of new growth for MSCs over the last five years has come from the development of new sites. This preference of the MSCs for the development of new sites is even more pronounced over the last two years, accounting for 90 per cent of store openings.

Although the MSCs have had substantial growth in store numbers over the last 15 years, including through acquisitions of competing businesses, they have not increased their share of grocery retail stores around or above 1000 m<sup>2</sup>. Their growth has approximately been matched by the expansion of ALDI and independent grocery retailers (see chapter 3). However, although there are a substantial number of supermarkets above 1000 m<sup>2</sup> competing with the MSCs, most of these are mid-sized (between 1000 m<sup>2</sup> and 2000 m<sup>2</sup>) rather than large format supermarkets. In comparison, around 60 per cent of MSC stores are above 3000 m<sup>2</sup> in sales area and the MSCs have a stated preference for larger stores. The MSCs therefore would likely have increased their share of total grocery retailing floor space over this period.

### Application of s. 50 to the acquisition of new sites

The inquiry has also revealed a misconception held by some industry players that the ACCC can only analyse transactions where there is an acquisition of an existing supermarket business. This is incorrect.

The ACCC considers that leases of sites, acquisitions of leases currently held by other parties and acquisitions of sites that are currently empty or used for other purposes can all be considered acquisitions of assets under s. 50 or other provisions in Part IV of the Act. The ACCC has reviewed acquisitions of development sites in the past, but has not found any acquisition in breach of s. 50. For instance, the ACCC conducted an analysis of the effect of Woolworths acquiring several development sites as part of its consideration of the Foodland Associated Limited transaction in 2005.<sup>27</sup> The ACCC

<sup>27</sup> ACCC, public competition assessment, Woolworths' proposed acquisition of 22 Action stores and development sites (19 October 2005), [www.accc.gov.au](http://www.accc.gov.au).

will continue to review such acquisitions of sites or leases for the future development of supermarkets if it is brought to its attention that there are competition issues associated with those acquisitions.

It is important to note that many proposals involving the acquisition or establishment of new supermarket sites (that is, where there is an acquisition or lease of a site that did not previously operate as a supermarket, as opposed to the acquisition of an existing supermarket) are not likely to raise significant concerns under the substantial lessening of competition standard in Part IV of the Act. Generally speaking, such new supermarket developments are unlikely to harm competition and are more likely to be pro-competitive. There will only be isolated circumstances where the evidence put before the ACCC indicates that a substantial lessening of competition is likely. The ACCC will tend to focus on those new developments where:

- the site is in a built-up area where there is limited availability of alternative sites for potential competitors in the local market
- the proposed supermarket operator already has a significant presence in the local market, and
- if the proposed supermarket did not open on the site, then an alternative competitive supermarket would be likely to open on that site.

The ACCC has written to the MSCs, major independents and significant retail landlords, to reiterate that s. 50 applies to leases or acquisitions of empty sites and non-supermarket sites, as well as the acquisition of existing supermarket businesses. The ACCC has encouraged acquirers of such sites to act prudently and advise the ACCC in advance if any such acquisitions may give rise to potential competition concerns.

As there is no compulsory notification merger regime in Australia, the ACCC encourages parties who have concerns about particular acquisitions of new supermarket sites to advise the ACCC. The ACCC can then consider whether there are competition concerns that warrant review under s. 50. The ACCC would expect parties who have concerns about an acquisition to put to the ACCC credible evidence that the 'counterfactual scenario' (that is, the future without the proposed acquisition) is likely to involve a competitive supermarket opening on the site. Credible evidence would include where an independent supermarket identifies well-progressed plans to develop a large-format and competitive supermarket in a built-up area, but one of the MSCs (which already has one or more supermarkets in the local area) secured the necessary rights to develop the site instead.

### Overall ACCC view

Section 50 of the Act allows the ACCC to review individual acquisitions of supermarkets on their own merits based on analysis of local retail and wider wholesale markets, not on a creeping acquisitions approach. The ACCC's recent opposition to Woolworths' proposed acquisition of the Karabar supermarket was based on a conventional single acquisition analysis. The ACCC considers that local retail markets are capable of being 'substantial' markets for the purpose of s. 50 of the Act.

However, the ACCC considers that s. 50 is unlikely to be able to deal with the cumulative impact of acquisitions of smaller independent supermarkets that individually do not raise competition issues.

The ACCC considers that such acquisitions do not appear to be a significant current concern in the supermarket retailing industry. Most of the new growth by MSCs in recent years has not come from acquisitions of independent supermarkets. No specific evidence has been provided to show that acquisitions of existing businesses have caused significant competitive detriment in the grocery industry in recent years.

Although such acquisitions do not appear to be a significant current concern in the supermarket retailing industry, the ACCC maintains its support for the introduction of a general creeping acquisition law. The ACCC considers that the supermarket industry is one where creeping acquisitions could potentially become a concern, due to particular structural features of the market, including:

- the need to obtain good sites being a significant barrier to entry, particularly given the financial resources of the MSCs and the leverage they wield over lessors of suitable sites
- the existence of broader barriers to entry and expansion created through the need to obtain economies of scale and efficient wholesaling operations
- the existence of two major supermarket chains
- a situation where there are many small business units (that is, retail stores or potential retail sites) that could be acquired or leased one by one or in small groups.

The ACCC can consider all acquisitions of assets, including leases of sites, acquisitions of leases currently held by other parties and acquisitions of sites that are currently empty or used for other purposes. However, many proposals involving the acquisition or establishment of new supermarket sites, as opposed to the acquisition of an existing supermarket, are unlikely to raise significant concerns under the Act.

The information the ACCC has received throughout the inquiry has been and will continue to be of significant assistance in analysing proposed transactions and supermarket developments. The inquiry has emphasised the high level of barriers to entry and expansion in grocery retailing due to the difficulty in obtaining large and well-located supermarket sites.

## 19.3 Predatory pricing

Predatory pricing, particularly against independent retailers by the MSCs, has been raised as a concern during this inquiry. Predatory pricing occurs, broadly, when a company sets its prices at a sufficiently low level with the purpose of damaging or forcing a competitor to withdraw from the market.

Section 46 of the Act is the key provision that addresses behaviour that may constitute predatory pricing, although it does not deal with predatory pricing exclusively. Under s. 46 corporations with a substantial degree of market power are prohibited from taking advantage of that market power for an anti-competitive purpose. The recent Birdsville amendment to s. 46, and in particular s. 46(1AA), prohibits a firm with a substantial market share from undertaking sustained below-cost pricing for an anti-competitive purpose.

This provision is designed to protect and foster competition in Australian markets. Importantly, however, it does not exist to shield inefficient business operators from the rigours of fair competition, or prohibit below-cost pricing outright.

### 19.3.1 Submissions

During the inquiry the ACCC has heard broad allegations of the MSCs engaging in predatory pricing directed at independent retailers operating in their local area. However, apart from these broad allegations, the ACCC has only been presented publicly with a small number of specific allegations of predatory pricing. As discussed further below, the ACCC considers that these specific allegations of predatory pricing fall short of conduct prohibited by s. 46. Confidential submissions raising predatory pricing allegations have also been investigated in an appropriate manner.

Many of the specific allegations provided to the ACCC were borne out of a misunderstanding of the legal concept of predatory pricing. In particular, many of the concerns related to instances of vigorous price competition by the MSCs that independent retailers struggled to match. Such vigorous price competition in itself would not ordinarily raise concerns under the Act. The ACCC notes that vigorous price competition is generally likely to be pro-competitive and deliver benefits to consumers. The specific examples are discussed in further detail below.

## General submissions

A number of interested parties submitted that predatory pricing conduct was an issue. For example, FoodWorks submitted that MSCs will, on entering an independent's catchment area, reduce prices on top-selling products and then, 'once the independents business become [sic] non-viable and closes, the MSC have the ability to put prices up again.'<sup>28</sup> It further submitted that there 'have been numerous examples over the years of what we would maintain have been predatory tactics to force smaller retailers out of business or to sell out'.<sup>29</sup> Brismark also submitted that independent retailers were at risk of predatory pricing by the MSCs.<sup>30</sup> The Master Grocers Association (MGA) submitted that 'current market divisions also give rise to predatory pricing concerns'.<sup>31</sup> Harris Farm markets submitted that it had evidence of predatory pricing behaviour by the MSCs.<sup>32</sup>

Various interested parties, including FoodWorks, NARGA, the MGA and the National Farmers Federation (NFF) submitted that there have been significant problems in the application of s. 46 to instances of alleged predatory pricing, that possible examples of predatory pricing could not be made out under the existing s. 46 and/or that changes needed to be made to s. 46 to better address issues relating to predatory pricing.<sup>33</sup>

The MGA stated that 'there are always certain difficulties with distinguishing between anti-competitive pricing, aimed at eliminating competitors or raising barriers to entry, and competitive pricing designed to benefit the consumer and legitimately compete in the market'.<sup>34</sup> It submitted that the 'legislation would be of more assistance with specific reference to predatory pricing, particularly firmer guidelines as to how to distinguish competitive pricing from predatory pricing, and how to view below cost pricing in this respect'.<sup>35</sup>

Interested parties such as NARGA noted the Birdsville amendments to s. 46 as stating an important principle that predatory pricing conduct is not acceptable. However, NARGA submitted that demonstrating 'substantial share of a market' and an offer 'for a sustained period of time' of a product at a price 'below the relevant cost of supply' for an anti-competitive purpose would be difficult to prove.<sup>36</sup> In contrast, the NFF supported those amendments to s. 46.<sup>37</sup>

A submission from William Edwards expressed the view that the low pricing of fresh produce in Woolworths' Fresh Food People campaign was predatory pricing.<sup>38</sup>

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28 Australian United Retailers Limited (FoodWorks), submission no. 90, p. 27.

29 Australian United Retailers Limited (FoodWorks), submission no. 90, p. 38.

30 Brismark, submission no. 68, p. 16.

31 Master Grocers Association, submission no. 96, p. 7.

32 Harris Farm Markets, submission no. 227, p. 3.

33 Australian United Retailers Limited (FoodWorks), submission no. 90, p. 40; Master Grocers Association, submission no. 96, p. 7; NARGA, submission no.129, p. 6, 37; National Farmers Federation, submission no. 137, p.13.

34 Master Grocers Australia, submission no. 96, p. 7

35 Master Grocers Australia, submission no. 96, p. 7

36 NARGA, submission no. 129, p 37

37 National Farmers Federation, submission no. 137, p. 13.

38 William Edwards, submission no. 229, p 9.

## Specific examples

The ACCC received a limited number of submissions about specific allegations of predatory pricing.

FoodWorks submitted that, following rationalisation of the grocery sector, there is no longer a need for sustained predatory conduct by the MSCs. However, in contrast, it also submitted that the MSCs' selling of Victoria Bitter beer from Fosters could be considered an example of possible predatory pricing.<sup>39</sup> FoodWorks submitted that the MSCs sold the product at 10 per cent below cost. The WA Independent Grocers Association (WAIGA) also submitted that an example of predatory pricing had occurred in the mid-1990s in Bunbury.<sup>40</sup>

The ACCC is not considering the sale of liquor in the course of this inquiry, but can consider allegations of predatory pricing in the course of its normal functions. In relation to the mid-1990s Bunbury example raised by WAIGA, the ACCC considers that given the age of the example it will not follow up that allegation further.<sup>41</sup>

NARGA made submissions raising allegations of predatory pricing by a Woolworths store in Cootamundra.<sup>42</sup> Specifically, the concerns related to a six to eight week period starting in February 2008 where it was alleged that Woolworths had advertised and offered deeply discounted prices on some items in response to the upgrading and refurbishment of an IGA store. The Koundouris Group also provided another example, previously raised with the ACCC, of similar conduct relating to the opening of a Supabarn store in Wanniasa.<sup>43</sup>

The ACCC has examined both of these allegations of predatory pricing, and in so doing has used the information-gathering powers available to it under the Act. The ACCC sought information from Woolworths about the pricing policies of its Cootamundra store and the costs of supplying the discounted products over the period of the promotion. Although the information provided suggests that Woolworths sold some of the relevant goods at below its cost of supply, the ACCC notes that this only occurred for a limited period, the purpose of which was to vigorously compete with a refurbished store reopening. The information did not suggest that the conduct was directed at or could have resulted in eliminating, or substantially damaging, the newly refurbished competitor. The Wanniasa complaint was similarly related to conduct for a limited period relating to the opening of a competing store.

Woolworths stated that its advertising strategy for the Cootamundra store was consistent with its general practice and that of its competitors. This practice is that, when a new store opens in a local area, specific specials are offered by existing stores for a number of weeks in an attempt to maintain their customer base.<sup>44</sup>

In its hearing evidence, NARGA stated that it was aware of two other locations where concerns regarding predatory pricing had been raised in recent months.<sup>45</sup> After the hearing the ACCC contacted NARGA and requested that it provide details of these two locations. NARGA responded that there

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39 Australian United Retailers Limited (FoodWorks), submission no. 90, p. 40.

40 WA Independent Grocers Association, submission no. 89, p. 13.

41 Section 77 of the Act sets a six-year time limit for the ACCC to seek a pecuniary penalty for conduct in breach of Part IV (there is an equivalent six-year limit on damages actions: s. 82). Given the age of the complaint, the six-year period has expired. The ACCC would be able to seek relief, such as an injunction or order in relation to the conduct (s. 87), but there is limited benefit from those remedies for conduct which has ceased. The ACCC also notes the significant evidentiary problems that would arise with investigating a complaint of this age.

42 NARGA, submission no. 129, p. 69; ACCC, public hearing transcript, Canberra, 9 April 2008, p. 12.

43 Koundouris Group, submission no. 35, p. 3.

44 ACCC, public hearing transcript, Melbourne 19 May 2008, pp. 99–100.

45 ACCC, public hearing transcript, Canberra, 9 April 2008, p. 14.

were at least two other sites where predatory pricing concerns had been raised, but that it did not have details of which stores were involved.

A further example of alleged predatory pricing was put to the ACCC which alleged that Woolworths had engaged in the below-cost selling of a fruit item in a store that was directly competing with a fresh fruit and vegetable retailer. The evidence available to the ACCC suggested that while there was below-cost selling of the item occurring for some of the period in question, it was not for a sustained period or for the purpose of eliminating or substantially damaging a competitor. The ACCC considers that below-cost pricing of a single product is generally unlikely to have significant effects on a competitor, unless it is a very significant product. In this case the product made up less than one-tenth of 1 per cent of the Woolworths supermarket's annual sales, although the ACCC notes that sales of that product may have been a larger proportion of sales for the competitor.

### 19.3.2 Predatory pricing and the role of s. 46

#### Current legislation

Before the recent amendments to s. 46 in 2007 there were no provisions in the Act which specifically addressed predatory pricing concerns. However, in 2003 the High Court in the case of *Boral Besser Masonry v ACCC* did consider alleged predatory pricing behaviour in the context of s. 46(1) of the Act.<sup>46</sup> Section 46(1) states that a corporation with a substantial degree of market power shall not take advantage of its power for three proscribed purposes. It provides:

A corporation that has a substantial degree of power in a market shall not take advantage of that power in that or any other market for the purpose of:

- a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;
- b) preventing the entry of a person into that or any other market; or
- c) deterring or preventing a person from engaging in competitive conduct in that or any other market.

On 25 September 2007, as part of a number of amendments to s. 46, s. 46(1AA) came into effect with the purpose of 'targeting anti-competitive below-cost pricing by corporations with a substantial market share.'<sup>47</sup> This provision has become known as the 'Birdsville amendment'. Section 46(1AA) provides that:

A corporation that has a substantial share of a market must not supply, or offer to supply, goods or services for a sustained period at a price that is less than the relevant cost to the corporation of supplying such goods or services, for the purpose of:

- a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;
- b) preventing the entry of a person into that or any other market; or
- c) deterring or preventing a person from engaging in competitive conduct in that or any other market.

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<sup>46</sup> *Boral Besser Masonry v ACCC* (2003) 215 CLR 374.

<sup>47</sup> Trade Practices Legislation Amendment Bill (No.1) 2007, supplementary explanatory memorandum, p. 1.

A new s. 46(4A) was also enacted as part of the Birdsville amendments. This provision sets out certain matters a court may consider when assessing an allegation of predatory pricing under s. 46(1). Section 46(4A) contains terms that are also used in s. 46(1AA). Section 46(4A) provides:

Without limiting the matters to which the Court may have regard for the purpose of determining whether a corporation has contravened subsection (1), the Court may have regard to:

- a) any conduct of the corporation that consisted of supplying goods or services for a sustained period at a price that was less than the relevant cost to the corporation of supplying such goods or services; and
- b) the reasons for that conduct.

As a consequence of the 2007 amendments, the ACCC may consider allegations of predatory pricing under two provisions of the Act—s. 46(1) and s. 46(1AA). The two provisions have similarities but also significant differences. The first significant difference is that:

- s. 46(1) prohibits certain conduct by a corporation with substantial market **power**
- s. 46(1AA) prohibits certain conduct by a corporation with substantial market **share**.

Although potentially related, market power and market share are distinct legal concepts.

The second significant difference is that s. 46(1) states that a corporation must not 'take advantage' of its market power. This term does not appear in s. 46(1AA), which instead states that a corporation with substantial market share must not supply for a 'sustained period' at a price below 'relevant cost'.

Both ss. 46(1) and 46(1AA) prohibit a corporation from acting with one of the three anti-competitive purposes. Under both sections, the market that is the subject of a corporation's anti-competitive purpose does not have to be the market in which the corporation has substantial market power or market share.

### Proposed changes to the current Act

On 26 June 2008, the government introduced the Trade Practices Legislation Amendment Bill 2008 to parliament. Among other proposed amendments to the Act, this Bill proposes a number of amendments to s. 46. These include:

- stating that a corporation may be found to have breached s. 46 even if it had no ability to recoup losses from the conduct
- amending s. 46 to clarify the meaning of 'take advantage'
- amending s. 46(1AA) to refer to market power, not market share, and to introduce the concept of 'take advantage' of market power to s. 46(1AA)
- repealing s. 46(4A).

Section 46 is currently silent on the issue of recoupment. The ACCC considers that it is currently unclear whether a firm's ability to recoup losses from predatory pricing (that is, by charging higher prices once competition has been eliminated) is necessary to establish a breach of s. 46. In relation to this recoupment issue, the bill proposes to replace the existing s. 46(1AB) with the following new provision:

A corporation may contravene subsection (1AA) even if the corporation cannot, and might not ever be able to, recoup losses incurred by supplying the goods or services at a price less than the relevant cost to the corporation of the supply.

The ACCC considers that the proposed amendment is desirable to clarify that a finding of expectation or likely ability to recoup losses is not required to demonstrate a breach of s. 46.

The bill also proposes to introduce the concept of 'take advantage' to the prohibition in s. 46(1AA). The ACCC welcomes this reform as it is likely to help address concerns that genuine competitive pricing behaviour could be inadvertently caught by s. 46(1AA). These concerns arose from the absence of a requirement of a nexus between the existence of the relevant market share and the conduct in question.

By introducing the concept of 'take advantage' into s. 46(1AA), and replacing the concept of 'market share' with 'market power', the bill proposes to make s. 46(1AA) consistent with s. 46(1). The ACCC considers that the current use of both 'market share' and 'market power' in s. 46 creates uncertainty. It will take time for the courts to consider the application of the newly introduced 'substantial market share' concept. However, there is already a significant body of case law about s. 46(1) and the concept of taking advantage of a substantial degree of market power. The replacement of 'substantial market share' in s. 46(1AA) with the concept of 'substantial degree of market power' will remove the uncertainty of having both terms in the Act.

The bill also sets out a non-exhaustive list of matters that a court may consider in determining whether a corporation has taken advantage of its substantial degree of market power. These matters, in the draft s. 46(6A), are:

- a) whether the conduct was materially facilitated by the corporation's substantial market power
- b) whether the corporation engaged in the conduct in reliance on its substantial market power
- c) whether it is likely that the corporation would have engaged in the conduct if it did not have substantial market power
- d) whether the conduct is otherwise related to the corporation's substantial market power.

The ACCC has previously advocated the introduction of such a provision, which it considers would clarify that, where a corporation's market power drives its conduct, this will be sufficient to establish that the corporation has taken advantage of its market power.

Together with the other amendments described above, the bill's proposed repeal of s. 46(4A) would remove the dual prohibition of predatory pricing. In effect, s. 46(1AA) will become the provision which specifically prohibits predatory pricing.

### ACCC's view on the legislation

Predatory pricing is not a clear or easily defined concept. The difference between predation and genuine competitive pricing behaviour can be a subtle one. The ACCC considers that the existing s. 46(1AA) may run the risk of discouraging genuine competitive behaviour given, in particular:

- the uncertainties introduced by the substantial market share concept
- the lack of requirement of a nexus between the existence of a substantial market share and the conduct in question.

The ACCC considers that the proposed amendments to s. 46 will better allow the ACCC to address examples of actual predatory pricing but not discourage genuine competitive pricing behaviour.

### 19.3.3 ACCC's view on predatory pricing in grocery retailing

The ACCC recognises that predatory pricing is of concern to a number of participants in the grocery retailing industry and notes that the structure of the industry may create incentives for such conduct to take place. Predatory behaviour could significantly damage the competitive structure of local markets if efficient businesses were targeted. The ACCC accordingly takes alleged predatory pricing conduct seriously.

In addition to forcing out existing efficient competitors, predatory pricing behaviour may also distort new competitive entry and capital outlay by causing incorrect signals about the potential profitability of operating in a particular area. Where a potential competitor may see high potential profits based on existing prices in an area, but on entry is subject to price competition that does not allow a profit, significant capital outlays may be lost.

However, the ACCC considers that no persuasive evidence was provided to the inquiry of attempts by large firms to eliminate smaller efficient firms by engaging in predatory pricing behaviour. Based on the ACCC's analysis of the specific complaints made to it, competitive discounting by the MSCs is often mistaken by smaller competitors for predatory pricing and misuse of market power.

The ACCC notes again that the difference between predatory pricing and genuine competitive pricing behaviour can be subtle. Because of this, predatory pricing (as well as misuse of market power more generally) is not a well understood concept. Firms that struggle to compete with more efficient or innovative rivals may not be well placed to distinguish between fair competition that delivers benefits to consumers and unfair competition. This is particularly the case for smaller firms competing with larger firms that are better placed to exploit economies of scale and sell goods and services at a lower price on an ongoing basis. Given this potential for confusion, the ACCC considers that a number of issues relating to allegations of predatory pricing, and its difference from competitive behaviour, should be clarified.

First, it is important to note that a large supermarket operator who has achieved economies of scale or favourable trading terms from its suppliers may have lower costs of supply than a smaller competitor. When the larger operator supplies goods at a price below that at which the smaller rival can profitably supply the same products (as was the case for the majority of products in the allegation against Woolworths Cootamundra), they have not necessarily breached the Act. The relevant cost of the large operator must be considered rather than that of the alleged victim of the conduct.

Second, the cost of supply is not the only relevant factor in assessing the likely predatory nature of discount pricing. The duration of below-cost pricing must also be considered in distinguishing between legitimate price discounting and anti-competitive predatory pricing. Sections 46(1AA) and 46(4A) (as currently enacted) specifically refer to the supply of goods or services at below cost for a sustained period. A retailer offering a weekend or short-term price special or occasionally reducing its prices to sell excess stocks of perishable goods is most likely engaging in legitimate competitive conduct that should not be discouraged.

Third, the supply of goods for a sustained period below a firm's own cost is not in itself a breach of s. 46. In balancing the competitive benefit to consumers of lower prices with the anti-competitive risks associated with predatory behaviour, the law requires that the alleged predator possesses an anti-competitive purpose behind its discounting. If the purpose of conduct is to temporarily respond to a competitive threat resulting from a new store opening or improved competitor offering, the relevant anti-

competitive purpose is unlikely to be present. An imprecisely worded prohibition on predatory pricing may inadvertently deter or capture genuinely competitive discounting and therefore reduce benefits to consumers.

The ACCC notes the conclusions made in chapters 4 and 5 that substantive price competition in grocery retailing principally occurs as competition on KVIs and promotions. Promotional discounting in particular could be restricted by an imprecisely worded prohibition, as such promotions may involve significant reductions in price and occasionally supply below cost.

Deep price discounts can deliver significant benefits to consumers, and a blanket ban on selling below cost could therefore create significant negatives for consumers. Accordingly, the ACCC does not support any blanket prohibitions on selling below cost. The economic literature outlines both theoretical and empirical evidence that suggests that banning such pricing can in fact significantly dampen competition (especially in one-stop retailing) and lead to a reduction in welfare and consumer benefit.<sup>48</sup> Banning such pricing is also argued to lead to a reduction in retailers' incentives to invest in increased efficiency.<sup>49</sup> Finally, there is some evidence that the impact of below-cost pricing on smaller retailers can vary significantly. Some smaller retailers adjoining larger retailers can exploit the increased store traffic generated by the larger store to sell a larger volume of higher value items. This allows them to exploit higher volumes generated in 'niche' products and avoiding direct competition with the larger retailer.<sup>50</sup>

The key challenge for the ACCC in applying s. 46 to predatory pricing complaints is to ensure the section is applied in a manner that captures true predatory pricing conduct without stifling legitimate competitive discounting that will enhance competition. The purpose and duration of below-cost pricing are the key considerations in distinguishing between legitimate price discounting and anti-competitive predatory pricing under s. 46(1AA).

The ACCC has only received a small number of specific predatory pricing complaints during this inquiry and considers that the vast majority of the complaints involved instances of legitimate pricing strategies, which were pro-competitive in nature or were lacking the evidence needed to prove a contravention of s. 46. This can be contrasted with the evidence provided in 1999 to the Baird inquiry, which noted a 'significant body of evidence' regarding predatory pricing in grocery retailing.<sup>51</sup> This perhaps may signal that predatory pricing is less of a concern currently than ten years ago.

Given the lack of evidence that predatory pricing is causing damage to the competitive process in the grocery industry, the ACCC has not made any specific recommendations about predatory pricing arising from this inquiry. However the ACCC continues to advocate broad improvements to s. 46. It supports the proposed amendments that will enact s. 46(6A) and clarify how s. 46(1AA) is to operate, and considers that these changes will better allow it to address actual predatory pricing conduct.

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48 See, for example, Organisation for Economic Cooperation and Development (2006), 'Resale below cost laws and regulations', DAF, 23 February 2006.

49 See R Inderst, and T M Valletti (2008), 'Buyer power and the waterbed effect', CEIS research paper no. 107.

50 See for example, A Dukes, V Singh, and T Zhu (2005), 'Local competition and impact of entry by a dominant retailer', mimeo.

51 Joint Select Committee on the Retailing Sector, *Fair market or market failure? A review of Australia's retailing sector*, 1999, executive summary, chapter 6.

## 19.4 Price discrimination

Price discrimination involves selling the same product to different customers at different prices, where the differences in price do not reflect the differences to the supplier in the cost of serving those customers. Price discrimination has been raised in four different contexts during the inquiry:

- different prices charged in different stores owned by the same MSCs
- suppliers supplying on better terms to the MSCs compared to Metcash and other wholesale operations
- the same wholesaler or supplier supplying some independent retailers with dry groceries on different terms to other independent retailers
- different pricing and labelling of products that are essentially the same.

Price discrimination that had or was likely to have the effect of substantially lessening competition was previously prohibited by s. 49 of the Act, which was repealed in 1995.<sup>52</sup>

### 19.4.1 Submissions

The ACCC received a number of submissions that commented on price discrimination. The introduction of private label milk products by MSCs was one example cited of better prices being extracted from suppliers by MSCs.<sup>53</sup>

While interested parties acknowledged that not all price discrimination is anti-competitive and should be prohibited, NARGA and the MGA argued that certain price discrimination can nevertheless be detrimental to suppliers, competitors and consumers.<sup>54</sup>

NARGA argued that price discrimination that favours the MSCs can arise in a number of ways. NARGA submitted that price discrimination can disadvantage smaller suppliers when the MSCs force the smaller suppliers to accept a lower price for a product than they would otherwise obtain for supply to other retailers or wholesalers.<sup>55</sup> NARGA submitted that the MSCs are then able to exploit this cost advantage to target competitors in particular areas.<sup>56</sup> NARGA contends that price discrimination can be a form of 'above cost predation' and that 'it is quite clear that price discrimination is undertaken with the intention of injuring or destroying competitors.'<sup>57</sup> Coles denied that it forced suppliers to engage in price discrimination between itself and other retailers.<sup>58</sup>

NARGA submitted that there is a clear benefit in small businesses being able to source products at or near the prices paid by supermarket chains, and to customers being able to pay similar prices for key product lines no matter where they shop.<sup>59</sup> It submitted that any potential economic efficiency gains do not outweigh these clear benefits, and that the views in the Hilmer report, which led to the repeal of s. 49, are accordingly incorrect. NARGA also submitted that a price discrimination provision would not prevent suppliers from providing purchases with genuine discounts that result from lower costs of

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52 An unrelated version of s. 49 has subsequently been enacted.

53 ACCC, public hearing transcript, Canberra, 9 April 2008, p. 22.

54 NARGA, submission no. 129, p. 37; Master Grocers Association, submission no. 96, p. 8.

55 NARGA, submission no. 129, p. 38.

56 NARGA, submission no. 129, p. 39.

57 NARGA, submission no. 129, p. 39.

58 Coles, submission no. 225, p. 34.

59 NARGA, submission no. 129, p. 42.

supply. In support of its position, NARGA cited examples of laws prohibiting price discrimination from the EU, UK and USA. It submitted that the former s. 49 should be reinstated or that a similar provision should be enacted.<sup>60</sup>

The Southern Sydney Retailers Association (SSRA) submitted that Australia is one of the few countries without any effective prohibition against price discrimination, and that this has resulted in the deterioration of Australia's international competitiveness and consumers paying higher prices.<sup>61</sup> The SSRA contended that smaller independent retailers are 'suffering from price discrimination where they cannot obtain their business inputs at a competitive price.'<sup>62</sup>

The SSRA also submitted that geographic price discrimination, where consumers may pay different prices for goods in different regions, should be prohibited in Australia.<sup>63</sup> In support the SSRA referred to the Canadian Competition Act, which prohibits geographic price discrimination that has the effect or tendency of substantially lessening competition, and which the SSRA submitted had proven successful in Canada in controlling inflation.<sup>64</sup>

The MGA submitted that there was some reasonable concern about the bargaining power of the MSCs and the potential for power in the retail market to be exerted in upstream markets.<sup>65</sup> In particular, the MGA submitted that the MSCs are forcing suppliers to charge lower prices to the MSCs, leading the suppliers to increase the prices they charge to independent retailers or wholesalers. It submitted that this in turn may reduce the competitiveness of independent retailers. Although the MGA acknowledged the potential for s. 46 to address such anti-competitive price discrimination, it submitted that a prohibition on price discrimination should nevertheless be re-enacted.<sup>66</sup>

Dee Margetts submitted that the repeal of the prohibition against price discrimination had constituted a weakening of the Act.<sup>67</sup> Margetts submitted that the repeal of s. 49, along with other changes, had in practice strengthened the market power of the MSCs and also provided them with incentives to abuse market power and allowed them to increase market share.

## 19.4.2 Background on the repealed s. 49

Under the now-repealed s. 49, a corporation was prohibited from discriminating between purchasers of goods of like grade and quality in relation to:

- the prices charged for the goods
- any discounts, allowances, rebates or credits given or allowed in relation to the supply of the goods
- the provision of services in respect of the goods or
- the making of payments for services provided in respect of those goods
- where the discrimination was of such magnitude or of such a recurring or systematic character that it had or was likely to have the effect of substantially lessening competition in the market for goods.

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60 NARGA, submission no. 129, p. 45.

61 SSRA, submission no. 150, p. 3.

62 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 129.

63 SSRA, submission no. 230, p. 3.

64 SSRA, submission no. 230, p. 2.

65 Master Grocers Association, submission no. 96, pp. 7–8.

66 Master Grocers Association, submission no. 96, p. 9.

67 Dee Margetts, submission no. 48, pp.1–2.

The former s. 49 also prohibited knowingly inducing or attempting to induce a corporation to engage in illegal price discrimination.

The former s. 49 contained two defences to price discrimination:

where the discrimination made reasonable allowance for differences in costs of manufacture, distribution, sale or delivery resulting from the differences in places or methods of delivery or quantities in which the goods are supplied to the purchasers

where the discrimination was the result of an act of good faith for the purpose of meeting a price or benefit offered by a competitor.

The former s. 49 was in force between 1974 and 1995. During that time, the Trade Practices Commission (the predecessor of the ACCC) did not institute any proceedings which alleged a contravention of s. 49.

In 1981 the court recognised that conduct in breach of s. 49 may also contravene other provisions of the Act. In *Cool & Sons v O'Brien Glass Industries*, Justice Keely noted the following submission:

There is some overlapping between the different sub-sections of the Trade Practices Act. In particular, in the present case, it is alleged that the same conduct of the respondent constitutes both exclusive dealing contrary to Section 47 of the Act and price discrimination contrary to Section 49 of the Act. In other words, the giving of a substantial discount on certain conditions can be price discrimination and also, constitute exclusive dealing contrary to Section 47. Indeed, in the applicant's submission, it is the combination of the large systematic discounts and the exclusive dealing condition which greatly increases the adverse anti-competitive effects in the present case ...<sup>68</sup>

In that case the Federal Court found breaches of both ss. 47 and 49 of the Act.

In 1993 the Hilmer Committee recommended that s. 49 be repealed.<sup>69</sup> The recommendation echoed concerns of previous inquiries, including the 1976 Swanson review and the 1979 Blunt review. The concern was that s. 49 generally discouraged competitive prices and worked against economically efficient outcomes. The committee concluded that price discrimination generally enhances economic efficiency, except in cases that might be dealt with by ss. 45 or 46 of the Act, and that s. 49 had reduced price competition. The committee accordingly recommended that such a provision be removed from national competition policy. Section 49 was repealed by the *Competition Policy Reform Act 1995* (Cwth). In the accompanying second reading speech to the Senate for this legislation on 29 March 1995, Senator Crowley stated:

The prohibition against price discrimination is to be repealed as the provision is largely redundant, and the conduct it is designed to address is adequately covered by other provisions of the Act.

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68 [1981] FCA 95 (13 July 1981).

69 The independent inquiry into a national competition policy, chaired by Professor Frederick Hilmer, was established in October 1992 following agreement by all Australian governments on the need for a national competition policy. The Independent Committee released its *Report by the Independent Committee of Inquiry into a national competition policy for Australia* in August 1993.

### 19.4.3 ACCC assessment

#### Price discrimination in grocery retailing

As submitted by the ACCC to the Dawson Review Committee<sup>70</sup> and the 2004 Senate Economics References Committee inquiry into the effectiveness of the Act in protecting small business<sup>71</sup>, conduct constituting price discrimination may be anti-competitive or pro-competitive in nature. It will be anti-competitive when it is used to create a barrier to entry to the market or to force competitors from the market. On the other hand, price cutting, even if it is in favour of a large buyer and therefore discriminatory, may be more pro-competitive than anti-competitive. It may engender competition from rival suppliers or in the market generally. As the Swanson Committee observed in 1976, price flexibility is at the heart of competitive behaviour and a general prohibition against price discrimination would substantially limit price flexibility.<sup>72</sup>

While lower prices charged by suppliers to their larger customers may indicate price discrimination, it does not follow that this is necessarily anti-competitive. The ACCC has received submissions that the MSCs pay lower prices for products than other retailers or Metcash. The evidence provided to the inquiry indicated for the most part that such differences in price reflected discounts negotiated on wholesale prices for factors such as volumes purchased and ability to execute promotional support of the supplier's product. The volumes of sales through the MSCs would generally be larger than through Metcash-supplied retailers. Similarly, the vertically integrated MSCs may be better able to execute promotions than Metcash, given that Metcash does not directly control the operation of the retailers it supplies.

Metcash also varies the price at which it sells to the independent retailers that it supplies, based on the volume of product purchased. Given the variety of buying and banner groups supplied by Metcash, differences in prices would be expected. Wider issues about the competitive position of Metcash-supplied retailers (other than related to price discrimination) were discussed in chapter 7.

Price differences can also occur at the retail level, such as between different stores of the one retailer. Chapters 4 and 5 discussed reasons for these price differences, including the level of local competition and demographics. The costs of operating specific stores are also likely to be important, with issues such as freight costs potentially leading to price differences between stores.<sup>73</sup> The ACCC does not consider that there is anything inherently anti-competitive in the notion that stores charge different prices in different areas according to the degree of local competition. In fact, this indicates the importance of local competition on prices paid and that any policy that lowers barriers to entry into supermarket retailing and therefore encourages the establishment of local competition should have positive outcomes for consumers. Similarly, the ACCC does not consider that there is anything inherently anti-competitive in charging more in higher-income demographic areas in comparison to lower-income areas. Prices should be driven by market conditions. The ACCC considers that it is appropriate for an MSC or other retailer to charge different prices in different demographic areas where this is driven by demand and supply conditions. Provided the purpose of the difference in pricing is

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70 In May 2002 the then Treasurer announced the membership and terms of reference of the Committee of Inquiry into the competition provisions of the *Trade Practices Act 1974*, and their administration, the first comprehensive review of Part IV since the Hilmer Committee reported in 1993. The committee was chaired by Sir Daryl Dawson.

71 The Senate Economics References Committee inquiry into *The effectiveness of the Trade Practices Act 1974 in protecting small business*, March 2004.

72 In April 1976 the Fraser government established the Trade Practices Act Review Committee (known as the Swanson Committee), parliamentary paper no. 228/1976 is the committee's report to the Minister for Business and Consumer Affairs.

73 For example, ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 52, where Woolworths identified 13 stores, such as Nhulunbuy, where 'exorbitant' freight costs were passed on in higher prices.

not to eliminate a competitor, then the ACCC considers it appropriate that retailers price to meet the competition in a given area.

Price discrimination can also occur where products, which are essentially the same, are labelled differently and sold at different prices within the same store. This form of price discrimination raises the same fundamental issues as other forms of price discrimination. As long as the labelling is not misleading, the ACCC will generally not have a concern with such practices. This is because consumers have different 'willingness to pay' for products, and this form of price discrimination can have potential benefits in allowing end users to obtain goods at more accessible prices.<sup>74</sup> The ACCC has not been presented with evidence that, where price discrimination occurs between products, the cheaper form of such products is unavailable or that consumers are forced to buy the more expensive product. Accordingly it is generally open to consumers to buy the cheaper product. However, retailers may be able to obtain more money from those who are willing and able to pay the higher charge.

### Existing provisions of the Act relevant to price discrimination

As noted above, the ACCC considers that price discrimination will often not be anti-competitive. However, it is relevant to consider the instances where anti-competitive price discrimination could contravene the Act.

Interested parties expressed mixed views on the ability of the Act to address anti-competitive price discrimination. The MGA was of the view that there is scope for anti-competitive price discrimination to be addressed under s. 46.<sup>75</sup> In contrast, NARGA submitted that s. 46 is ineffective in catching price discrimination behaviour that results in a substantial lessening of competition.<sup>76</sup> It submitted that the *Boral* case has rendered s. 46 ineffectual as the High Court required that a corporation could later raise prices unilaterally without losing market share for s. 46 to be breached.<sup>77</sup>

Section 46 of the Act does not specifically address price discrimination, but it can prohibit anti-competitive price discrimination. To contravene s. 46, a corporation is required to have substantial market power and must take advantage of its market power for an anti-competitive purpose. However, a corporation needs some degree of market power if it is to successfully implement a price discrimination strategy. If a company has no market power but is able to negotiate a better price from a supplier or chooses to price discriminate between its customers, it is difficult to see why such behaviour should be prohibited. Without market power, the corporation's pricing structure could be undermined by its competitors. Accordingly, the ACCC can see no compelling case for price discrimination per se to be prohibited.

Parties have contented that price discrimination can be a form of predation undertaken with the intention of destroying competitors. Section 46 will capture such conduct if it results from a misuse of market power. This would particularly address situations where, for example, an MSC might lower prices in a particular geographic area served by an independent retailer in an attempt to put that retailer out of business. The ACCC acknowledges NARGA's submission that issues raised by the *Boral* case about the ability to recoup may have restricted the applicability of s. 46 in such cases. The ACCC considers the proposed amendments to s. 46 discussed above about recoupment and predatory pricing may address this issue.

74 This can be illustrated by an example. If a single price for a product is set according to the demand-supply balance, at say \$1, then only those consumers who are willing to pay \$1 or more for the product will purchase the product. However, if the same product can be sold in one package for 80 cents and in another package for \$1.20, then consumers who are willing or able to pay 80 cents for the product are able to make the purchase.

75 Master Grocers Association, submission no. 96, p. 8.

76 NARGA, submission no. 129, p. 45.

77 NARGA, submission no. 129, p. 45.

Sections 45 and 47 of the Act may also have a role in relation to price discrimination arrangements that are alleged to be anti-competitive. Under certain circumstances, pricing arrangements between wholesalers and retailers could amount to an exclusive dealing arrangement under s. 47 or an agreement that substantially lessens competition under s. 45.

In its 2003 report on the competition provisions of the Act, the Dawson Committee recommended no change to the Act on price discrimination and concluded that<sup>78</sup>:

- the effect of price discrimination on competition needs to be assessed on a case-by-case basis
- section 46 of the Act provides an appropriate means to tackle anti-competitive price discrimination, and there is no case for the reintroduction of a prohibition against price discrimination—the principle of like terms for like customers does not of itself offer a suitable basis for regulation in the grocery industry
- there are reasons for differences in prices in the grocery industry that do not involve anti-competitive practices.

The ACCC concurred with the Dawson review findings and continues to hold the view that there is no case for the reintroduction of a specific price discrimination provision.

The ACCC recognises that interested parties have submitted that some overseas jurisdictions have legislative provisions in force, similar to the repealed s. 49, that specifically prohibit anti-competitive price discrimination. While this observation is correct, the ACCC considers that consideration should be given to the development of attitudes towards price discrimination in the US.

Section 49 of the Act was based on the Robinson-Patman Act 1939 (US), which makes price discrimination an offence if it substantially lessens competition, tends to create a monopoly, or injures, destroys or prevents competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them.<sup>79</sup> However, US law acknowledges that price discrimination is generally lawful, particularly where it reflects the different costs of dealing with different buyers or where it results from a seller's attempts to meet a competitor's prices or services.

In commenting on the future of competition policy in the US, the Federal Trade Commission's (FTC) then chairman, Timothy Muris, stated:<sup>80</sup>

Competition policy succeeds when it serves consumer interests—for example, by pressing producers to offer lower prices or to improve product quality. The true measure of our contribution to the economy is our progress in increasing consumer welfare. Public antitrust enforcement has not always achieved this objective. In some cases, the departure from a consumer-oriented focus resulted from conscious policy choices that equated the well-being of individual firms with consumer interests. From the mid-1930s through the 1960s, enforcement of the Robinson Patman Act was the FTC's foremost antitrust concern. In many instances, the Commission's Robinson-Patman enforcement paid insufficient attention to the effect of the challenged conduct on competition, market efficiency, and consumer welfare. Almost all economists and antitrust lawyers agree that much of that enforcement harmed consumers.

While the Robinson-Patman legislation is still in force in the United States, it has been criticised for being complex, lacking a consumer welfare focus, deterring price competition and promoting price

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78 Report by the Dawson Review Committee into the competition provisions of the Trade Practices Act (the Dawson Committee) 2003, *Review of the competition provisions of the Trade Practices Act*, Parliament of the Commonwealth of Australia, Canberra.

79 15 USC §13(a-f).

80 Timothy J Muris, *Looking forward: the Federal Trade Commission and the future development of U.S. competition policy*, for the Milton Handler Annual Antitrust Review, 10 December, 2002.

uniformity.<sup>81</sup> The ACCC understands that the approach of the FTC has been to use the Robinson-Patman Act less and to now take action against price discrimination under the broader competition law framework (e.g. § 2 of the Sherman Act 1890), and only where the practices involved can be considered to be an attempt to monopolise.<sup>82</sup> The ACCC considers that this is similar to the existing situation in Australia.

### Overall ACCC view

At this time the ACCC does not recommend any changes be made to the Act regarding price discrimination, but notes that it has been an issue raised by industry participants. The ACCC considers that there can be significant economic efficiency and competition benefits resulting from price discrimination and is of the view that the various existing provisions of the Act are able to address concerns about anti-competitive price discrimination. Accordingly it does not consider that the re-introduction of the former s. 49, or the amendment of current provisions in the Act, is necessary to address issues of price discrimination.

## 19.5 Conclusion

The ACCC has considered the submissions above about mergers and acquisitions, predatory pricing and price discrimination. The ACCC recognises that all three issues may have significant ramifications for the grocery retailing industry depending on the context. However, the ACCC considers that these issues do not require laws that specifically apply to the grocery industry.

In relation to mergers and acquisitions, the ACCC maintains its support for a general creeping acquisitions law that would better allow it to address creeping acquisitions more generally. While creeping acquisitions do not currently appear to be a concern in grocery retailing, the ACCC recognises the potential for creeping acquisitions to be an issue in the grocery sector in the future.

Regarding predatory pricing, the ACCC recognises that predatory pricing is a significant concern to a number of interested parties. The ACCC supports the proposed amendments to the existing s. 46 of the Act to better clarify the section's operation and application to circumstances that may constitute predatory pricing. However, the ACCC considers that the specific allegations provided during the inquiry did not appear to constitute predatory pricing.

Regarding price discrimination, the ACCC considers that the existing provisions in the Act are able to address circumstances where anti-competitive price discrimination may occur. It does not consider that there is a need to reintroduce a specific price discrimination law. The ACCC recognises that there can be genuine economic efficiency reasons for price discrimination. No evidence was presented to the inquiry that demonstrated any significant structural problem in the grocery industry that resulted from price discrimination.

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81 See for example, Calvani, Terry and Breidenbach, Gilde 'An Introduction to the Robinson-Patman Act and its enforcement by the Government', (1991) 59 *Antitrust Law Journal*, pp. 765, 772; Calvani, 'Effect of current developments on the future of the Robinson-Patman Act', 48 *Antitrust Law Journal*, 1980, pp. 1692, 1695.

82 See, for example, M Briley, 'Price Discrimination under the Robinson-Patman Act', 27 (winter) *University of Toledo Law Review*, 1996, pp. 401, 402.

## 20 Unit pricing

### Key points

- Unit pricing should apply in a consistent manner to standard grocery items sold through significant supermarkets, including Coles, Woolworths, ALDI and large independent stores. Such consistency should extend to product coverage, unit of measure and display characteristics.
- Significant benefits would flow from the mandatory introduction of unit pricing through its promotion of the price searchability of consumers.
- The body responsible for introducing unit pricing should have the flexibility to make binding decisions regarding the precise application of unit pricing.
- A public education campaign should accompany the introduction of unit pricing to ensure that unit pricing has the greatest possible impact.

### 20.1 Introduction

This section deals with unit pricing—the practice of displaying the price by unit of measure (e.g. per litre or kilogram) along with the total sale price for each item. In those countries where unit pricing is currently in use, the unit price is typically displayed on the same shelf label as the sale price. In the terms of reference for the inquiry the ACCC has been asked to consider ‘the representation of grocery prices to consumers’.<sup>1</sup> The ACCC considers that unit pricing is therefore highly relevant to the inquiry.

In Australia the major supermarket chains (MSCs) do not include unit pricing information on packaged grocery items. Products sold by weight are an exception as it is required under state and territory legislation to display unit prices.<sup>2</sup> Examples of products for which there is currently unit pricing include unpackaged fruit and vegetables, meat and deli products. During the inquiry, Coles and Woolworths announced to the ACCC that they intend to introduce unit pricing and both support its mandatory introduction. Woolworths initiated a trial of unit pricing in its Baulkham Hills store in April 2008. ALDI introduced unit pricing in its Australian stores in 2007.

### 20.2 Overseas experiences

#### 20.2.1 European Union

In 1998 the European Commission (the executive branch of the European Union) adopted the unit prices directive (UPD) which requires traders to indicate both the selling price and the price per unit on all products they offer consumers.<sup>3</sup>

The aim of the UPD is to facilitate price comparison and improve consumer information. It requires the pricing information to be unambiguous, clearly legible and easily identifiable. When advertising mentions a selling price it must include the unit price.

An appraisal of the UPD was completed in August 2004 which covered the implementation by the 15 EU member states (before 1 May 2004). Although most of the EU member states were late in enacting

1 See appendix A.

2 See, for example, Part 4 of the *Trade Measurement Act 1995* (Vic).

3 See [http://ec.europa.eu/consumers/cons\\_int/safe\\_shop/price\\_ind/index\\_en.htm](http://ec.europa.eu/consumers/cons_int/safe_shop/price_ind/index_en.htm).

the required new legislation, the appraisal found that there was generally good compliance with the UPD and that most enterprises that are legally required to indicate the unit price, do so.<sup>4</sup> With the exception of France, the EU member states adopted lists containing product categories that waived the obligation to indicate unit price. Implementation of the UPD included a derogation for small retail businesses in recognition that the obligation to display unit prices may be an excessive burden for some retailers.

## 20.2.2 United States

Mandatory provision of unit pricing is required in some states of the US, including New York and Florida. In New York the provisions do not apply to retail stores with annual gross sales of consumer commodities of less than \$2.5 million. Florida has enacted the Consumer Unit Pricing Act, which requires mandatory unit pricing. A number of US states refer to the Uniform Unit Pricing Regulation from the National Institute of Standards and Technology, which stipulates that unit prices must be provided unless the package is smaller than one ounce or costs less than \$0.50, or there is only one brand in one size on sale at that establishment.

## 20.2.3 New Zealand

While not currently a legal requirement, unit pricing is common in New Zealand, including in Woolworths stores where it has been displayed for the past few years.

## 20.3 Submissions

Submissions to the ACCC grocery inquiry that discuss unit pricing have generally supported its introduction. Most submissions that do not support the mandatory introduction of unit pricing do, however, acknowledge that it does provide benefits.

The following section summarises several of the submissions most relevant to unit pricing.

### 20.3.1 ALDI

ALDI adopted unit pricing in November 2007 and has found that the practice has not resulted in any additional costs for consumers. It also stated that:

Consumers are often confused when attempting to compare prices between retailers or different sized products. Unit pricing is an effective way of overcoming these difficulties and immediately introduces transparency for consumers helping them make an informed buying decision.<sup>5</sup>

### 20.3.2 CHOICE (Australian Consumers Association)

CHOICE stated that unit pricing should be introduced into Australian supermarkets as a matter of urgency and believes that there is a lack of transparency on pricing for many basic grocery items. CHOICE stated:

... 89 per cent of consumers said they would find comparison product pricing very useful or somewhat useful.<sup>6</sup>

4 EIM Business and Policy Research, Appraisal of Directive 98/6/EC on consumer protection in the indication of unit prices of products offered to consumers, final report, August 2004.

5 ALDI, submission no. 81, p. 8.

6 CHOICE, submission no. 143, p. 3.

CHOICE noted that unit pricing has the potential to improve price comparability both within a store and between stores, through:

- better price comparability across brands and sizes within a product category at a retail outlet and
- better price comparability across grocery outlets.<sup>7</sup>

CHOICE also believed that it is vital that unit prices are displayed consistently across retailers.

### 20.3.3 Coles

In its initial submission Coles did not state whether it supported the introduction of unit pricing. It did, however, recognise that the display of unit pricing will improve the information provided to consumers regarding the relative prices of products, but noted that it will also impose additional costs on retailers.<sup>8</sup> Coles also provided the ACCC with a late submission in which it supported the mandatory introduction of unit pricing. Coles' estimates of the costs involved with introducing unit pricing are discussed in a later section.

### 20.3.4 Consumers Action Law Centre

The CALC submission showed that it is supportive of a national, uniform and compulsory unit pricing system. CALC stated that the important elements of a unit pricing system, such as the format and prominence of display of the unit price, need to have detailed minimum standards set out in legislation. CALC believes that to facilitate price comparisons between stores, unit pricing should also extend to advertising and online purchasing. CALC also believes that consumer education is needed to inform consumers of the benefits of unit pricing.<sup>9</sup>

### 20.3.5 FoodWorks

FoodWorks supported the practice of displaying unit prices on the grounds that it assists consumers to compare prices. FoodWorks considers that the introduction of unit pricing would represent a competitive advantage, and for that reason would rather see grocery retailers free to choose whether or not to implement it. FoodWorks also stated that the integrated chains have an advantage over independents as they have consistency in their back office IT software.

### 20.3.6 Metcash

While not directly stating a position on unit pricing, Metcash claimed it would cost independent retailers at least \$9.9 million to implement, including:

Changes to the IT systems used in price calculation and label printing activities (at a cost of \$1.2 million).

A one-off change of all price labels in the store as the labels need to be uniform (i.e. it's unlikely that customers would accept a gradual change of signage in a store to unit prices, so that some products have unit prices and some do not.) This will result in a further labour cost of \$8.8 million.

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7 *ibid.*, p. 4.

8 *ibid.*, p. 11.

9 CALC, submission no. 124, p. 6.

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

Even higher costs are likely to eventuate if changes to the shelf label size are required.<sup>10</sup>

Metcash requested that the ACCC undertake a comprehensive cost-benefit analysis before mandating unit pricing.

### 20.3.7 National Association of Retail Grocers of Australia

NARGA does not believe that the display of unit pricing allows for direct and useful comparison between two products, and submitted that unit pricing is of limited use due to the quality differential between different products. It provided the example of olive oil as a category where price varies with the quality of the product. NARGA stated that unit pricing is irrelevant, and the only valid use of unit pricing is to compare two different sizes of the same brand product.<sup>11</sup> NARGA argued that unit pricing is misleading because it ignores quality differences between products and states that a price conscious consumer is, 'by definition—most likely to choose the cheapest item on the shelf ...'.<sup>12</sup>

### 20.3.8 Queensland Consumers Association

The QCA provided several submissions that call for the introduction of a mandatory unit pricing scheme. It included in its submissions a list of ten minimum requirements for unit pricing:

1. Unit prices must be displayed prominently and clearly on all in-store price signs and be located in close proximity to the product—fonts used must be whichever is the greatest of either a specified percentage of that used to show the selling price or a specified minimum size.
2. Measurements used to indicate unit price must be uniform and easily understood and usable by consumers—applies to products sold by weight, volume etc. and those sold by count/number/item.
3. The same unit of measure must be used for all sizes of the same product.
4. The unit price must be shown even if the unit price and the selling price are identical—i.e. when the package is the same size as the basic unit of measurement.
5. Unit prices must be provided for maximum possible number of grocery products, with minimum exemptions.
6. Unit prices must be shown for products sold on 'special' or other 'promotions' as well as at regular prices.
7. Unit prices must be shown clearly on printed advertisements showing the price of a product sold by measurement.
8. Unit prices must be provided for groceries ordered on the internet as well as those purchased in-store.
9. Minimum standards must be set and monitored regarding accuracy, measurement units used, etc.
10. Initial and on-going consumer education programs must be undertaken.<sup>13</sup>

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<sup>10</sup> Metcash, submission no. 181, p. 59.

<sup>11</sup> NARGA, submission no. 129, p.50.

<sup>12</sup> *ibid.*

<sup>13</sup> QCA, submission no. 38, attachment 2.

### 20.3.9 Woolworths

Although Woolworths did not comment on unit pricing in its submissions to the inquiry, its CEO Michael Luscombe stated during the public hearing process that Woolworths intends to implement unit pricing, and that it supports its mandatory introduction.<sup>14</sup> Woolworths also provided cost estimates of the introduction of unit pricing which are discussed in section 20.4.

### 2.3.10 Other submissions

Many other submissions supported the introduction of unit pricing, including:

- The Cancer Council NSW
- Consumers' Association of South Australia
- Dieticians Association of Australia
- Financial Counsellors Association of Queensland
- Population Health Branch, Queensland Health and
- Sydney Food Fairness Alliance.

## 20.4 Costs and benefits of unit pricing

Proponents of unit pricing have identified a range of benefits that its introduction will deliver to both consumers and the broader grocery sector. Several academic studies have attempted to quantify these benefits, with several studies stating that unit pricing can lead to as much as one per cent saving in expenditure on grocery items.<sup>15</sup> A 2003 study conducted in the United Kingdom (where unit pricing is mandatory) found that over 50 per cent of people frequently use unit pricing, with the figure jumping above 60 per cent for a new product.<sup>16</sup> However, the study also found that 31 per cent of consumers did not understand the benefits of unit pricing, and 35 per cent did not bother to use unit pricing information. Specifically, it identified five main reasons why consumers do not use unit pricing information:

- consumers lack the cognitive ability to make use of unit pricing
- consumers find unit pricing confusing
- the effort required to make comparisons
- consumers are not willing to spend time using unit pricing and
- consumers use other less demanding strategies to get the best value purchases.<sup>17</sup>

By far the main benefit put forward in submissions was that unit pricing will allow consumers to more easily compare prices across different sized products and also across different brands of substitute products.<sup>18</sup> It is claimed that this will lead to a reduction in expenditure on grocery items, especially as many standard groceries items are not sold in sizes that easily lend themselves to comparison.

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14 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 101.

15 See, for example, Russo, 'The value of unit pricing', *Journal of Marketing Research*, 1977.

16 V Mitchell, D Lennard and P McGoldrick, 'Consumer awareness, understanding and usage of unit pricing', *British Journal of Management*, vol. 14, 173–87, 2003, p. 177.

17 *ibid.*, p. 179.

18 For example, CALC, submission no. 124.

In its submission to the inquiry, the QCA stated that unit pricing would result in:

Easier, quicker and more accurate comparison of cost per unit of measure of package sizes within and between brands, between different forms of a product, and between substitute products.<sup>19</sup>

SPAR contended that unit pricing would represent a minimal improvement for consumers and would have little effect on lowering prices. It also stated that implementation costs would include changes to:

- supplier data files
- store data files and
- store labelling/systems.<sup>20</sup>

### ACCC's view

Unit pricing assists consumers by improving the pricing information available to them. Consumers often do not have the time, inclination or in some cases the ability to accurately analyse which product has the lowest unit cost in a timely manner. Unit pricing is a tool that would make it easier for consumers to acquire and process pricing information and assist them in engaging in a meaningful price search.<sup>21</sup> There appears to be broad support for unit pricing, with the ACCC's consumer survey finding that 76 per cent of consumers contacted consider that unit pricing would be helpful.<sup>22</sup>

Unit pricing is likely to be highly beneficial as a tool that can increase consumers' understanding of relative prices of substitute products within a store (intra-store comparisons). This would be the case particularly for those products that have multiple product sizes, such as Vegemite, which is sold in the following quantities: 145, 150, 220, 400 and 600 grams.

Furthermore, manufacturers will from time to time change packet sizes. For example, the 600 gram Vegemite was introduced in September 2007, shortly after the deletion of the 910 gram size.<sup>23</sup> Unit pricing will assist consumers in deciding whether the new pack size is a more cost effective purchase. Even for products where a per kilo/litre comparison may be fairly easy for many consumers, for instance, comparing the price between a 500 gram pack and a one kilo pack, unit pricing can still be beneficial to the consumer as it highlights the relative per unit prices of the two products.

Unit pricing is also useful in comparing prices across other brands using different sized packs; however, clearly consumers will also have to make their own judgment on whether the quality of the different brands justifies any price differential. In its submission, NARGA stated that unit pricing is misleading as it does not account for the differences in quality between products.<sup>24</sup> However, the ACCC considers that consumers are faced with the task of determining the difference in quality of products with or without unit pricing. The fact that quality varies across brands does not reduce the value of the information provided to consumers in the display of unit pricing.

Unit pricing is likely to provide some assistance to consumers in comparing prices between retailers (inter-store comparisons). Consumers may be more likely to remember a single unit price of a product (e.g. when shopping at a different store and comparing prices) than when they have to remember both the size and the price of an item.

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<sup>19</sup> QCA, submission no. 38, p. 21.

<sup>20</sup> SPAR, submission no. 195, p. 7.

<sup>21</sup> R Smith, 'The Australian grocery industry: a competitive perspective', *Australian Journal of Agricultural and Resource Economics*, 2006, p. 48.

<sup>22</sup> ACCC, Survey of grocery consumers, April 2008.

<sup>23</sup> Kraft, email to ACCC, 6 June 2008.

<sup>24</sup> NARGA, submission no. 195, ch. 14.

Unit pricing in catalogues and in other forms of advertising would also assist inter-store price comparisons. The results of the ACCC's consumer survey indicate that the inclusion of unit pricing in advertising would likely improve the quality of price information available to consumers. The survey found that 77 per cent of those people who consider price an important factor when choosing where they shop do in fact compare prices advertised in brochures and letter drops.<sup>25</sup>

The implementation of unit pricing would involve several distinct costs to retailers including updating IT systems and labour costs. Both Coles and Woolworths have informed the ACCC that costs associated with unit pricing would decrease as the implementation period was lengthened. Metcash's submission to the inquiry provided a high level estimate of these costs, stating that the implementation cost to independent retailers would be at least \$9.9 million, incorporating \$1.2 million for changes to the IT systems and \$8.8 million in labour costs for a one-off change to all in-store price labels.<sup>26</sup> Metcash did not comment on how it believes this cost would change if a longer timeframe for implementation was allowed.

Woolworths CEO, Michael Luscombe, said during the inquiry's public hearing that Woolworths anticipates the cost of implementing unit pricing to be about \$4 million.<sup>27</sup> Mr Luscombe said this cost would depend on the timeframe that was permitted for the introduction, and that it would not represent any additional cost if Woolworths was given a 12-month period to implement unit pricing. Mr Luscombe stressed that if Woolworths were required to change its 'shelf stripping' to accommodate mandated font size, the capital cost would be around \$6 million to \$7 million.<sup>28</sup> Coles estimates the costs of introduction would be \$20 million if immediate implementation were required, decreasing to between \$5 million and \$10 million if a 12- to 18-month timeframe was allowed.<sup>29</sup> It is unclear why there is such a large discrepancy between the cost estimates of Coles and Woolworths.

The main costs identified in implementing unit pricing are:

- IT
- labour
- printing new price tickets and
- changing shelf stripping (if required to accommodate a mandated size label).

From the evidence provided it appears that costs will be higher if unit pricing was to be implemented in a shorter timeframe, as a greater number of shelf labels would all have to be replaced solely for the purpose of implementing unit pricing. If unit pricing could be implemented over a longer timeframe, then the old shelf labels would simply be replaced over time with the unit pricing shelf labels in the normal course of business.

The ACCC notes the divergence in cost estimates provided by several parties. However, the ACCC is not in a position to provide either a robust estimate of these costs or estimate how the likely costs may change relative to the time period allowed for implementation.

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25 ACCC, Survey of grocery consumers, April 2008.

26 Metcash, submission no. 181, p. 58.

27 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 101.

28 *ibid.*

29 Coles, submission no. 225, p. 10.

## 20.5 Should unit pricing be voluntary or mandatory?

Several submissions address the issue of whether unit pricing should be introduced on a mandatory basis or left to individual retailers to implement voluntarily. As noted above, ALDI has already implemented unit pricing, and during the course of the inquiry Coles and Woolworths have announced their intention to implement unit pricing.

The ACCC received several submissions that opposed the introduction of unit pricing on a mandatory basis. Many of the submissions opposed to unit pricing did recognise that it could benefit consumers, but stated that the greatest benefit would be achieved in a non-regulated setting where unit pricing could be used as a competitive advantage.<sup>30</sup>

In its initial submission to the inquiry, Coles did not state a preference for or against the introduction of unit pricing, but submitted that while price is important to consumers, many other factors were taken into account at the point of purchase. To this end Coles submitted that:

Competitive pressure will continue to ensure innovative and different approaches to marketing to customers that will deliver more benefit to customers than any mandated approach to unit pricing.<sup>31</sup>

Coles also outlined some of the 'significant practical challenges' that would result from a mandated approach to unit pricing, including:

Difficulties with definition, different technology platforms and different approaches to marketing and innovation consistent with competing brand propositions.<sup>32</sup>

However, Coles stated during the ACCC public hearing that it would prefer to see unit pricing adopted universally by all supermarkets and food retailers across Australia.<sup>33</sup> In expressing his support for the mandatory introduction of unit pricing, Coles COO, Mick McMahon, stated that, 'we would prefer to see [unit pricing] for all retailers ... because otherwise it adds costs for some and not for others ...'.<sup>34</sup> Coles also expressed a concern about double spending if it introduced unit pricing on a voluntary basis; only to later have a different, mandatory standard imposed requiring further expenditure.

In support of a mandatory unit pricing scheme, Coles stated in its supplementary submission 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.<sup>35</sup>

Although Woolworths did not comment on unit pricing in its submission to the inquiry, its CEO, Michael Luscombe, stated during the public hearing process that Woolworths intends to implement unit pricing, and that it supports its mandatory introduction.<sup>36</sup>

The QCA argued that it is critical to introduce unit pricing on a mandatory basis. It provided examples from overseas, claiming that when unit pricing was introduced by retailers on an ad hoc basis the benefits to consumers have been lower and in some cases the costs to business higher.<sup>37</sup> The QCA submitted that the rationale for mandatory introduction is to ensure that all consumers have access to

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<sup>30</sup> See, for example, FoodWorks submission no. 90, p. 22; and George Weston Foods Limited, submission no. 138, p. 5.

<sup>31</sup> Coles, submission no.225, p. 11.

<sup>32</sup> *ibid.*

<sup>33</sup> ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 5.

<sup>34</sup> *ibid.*, p. 65.

<sup>35</sup> Coles, submission no. 225, p. 10.

<sup>36</sup> ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 101.

<sup>37</sup> QCA, submission no. 38, p. 7.

unit pricing, and that it is displayed in a consistent manner across retailers.<sup>38</sup> It identified the following advantages of an early and compulsory introduction rather than voluntary take up:

- unit pricing will be provided more widely and quicker
- there will be less across-store variation in the system provided, and compliance can be monitored
- the government is more likely to fund consumer awareness campaigns
- implementation costs are likely to be lower, especially if numerous voluntary systems are established which require significant modification to comply with subsequent compulsory systems.<sup>39</sup>

### ACCC's view

The ACCC considers that a voluntary unit pricing regime is unlikely to be as beneficial to consumers as a mandatory regime.

In a competitive environment, if unit pricing is seen by consumers as beneficial, then retail stores that wish to compete effectively will introduce unit pricing and their competitors are likely to feel pressure to follow. However, without a mandatory system, implementation is likely to be ad hoc and inconsistent between stores. Given that both Coles and Woolworths have committed to the introduction of unit pricing and the Queensland Government has announced its intention to introduce the practice in September 2008, the ACCC notes there is a risk that achieving consistency may come at a price. If retailers are required to comply with a state-based scheme, or have already introduced unit pricing voluntarily, only to have to adapt to a national scheme at a later stage, the compliance costs will be greater if there are inconsistencies between the two schemes.

Differences in the approach to unit pricing between stores may mislead consumers (for example, some stores may unit price certain products on a per kilo basis, and others on a per 100 gram basis). Furthermore, retail chains may selectively choose to use unit pricing only for those products showing them to be competitive. Those retailers not required to display unit pricing, but that choose to do so on a voluntary basis, must be required to adhere to the mandatory standards.

The ACCC also considers that retailers need certainty regarding any possible obligations relating to unit pricing as soon as possible. An outcome where the MSCs introduce unit pricing in a particular style, which then must be changed to meet mandated requirements, would be inefficient and incur greater costs. This inefficiency would also occur if unit pricing was introduced on a state/territory basis, as those retailers who operate across several states would have the burden of complying with several, possibly inconsistent state/territory based regimes.

## 20.6 Implementation issues

If unit pricing was to be introduced, the ACCC recognises that there are several issues that need to be considered more fully before implementation. In particular, there are several methods by which unit pricing could be introduced on either a voluntary or mandatory basis, including:

- amendment to the current state and territory trade measurement legislation
- inclusion in the proposed national trade measurement legislation which is set to replace the state and territory legislation from 1 July 2010

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<sup>38</sup> *ibid.*

<sup>39</sup> *ibid.*

- inclusion in stand-alone consumer legislation, linked to the Trade Measurement Act and
- a voluntary or mandatory industry code under s. 51AE of the Trade Practices Act.

Currently, trade measurement legislation is the responsibility of the states and territories that have enacted uniform legislation. However, in April 2007 the Council of Australian Governments (COAG) formally agreed that the federal government should assume responsibility for trade measurement; and in December 2007 the National Measurement Institute issued a discussion paper on this transitional process.<sup>40</sup> The QCA recommended in its submission to the inquiry that a mandatory unit pricing scheme should be based in this new federal trade measurement legislation.

The ACCC considers it is important to ensure that appropriate legislative mechanisms are implemented to ensure that a mandatory unit pricing regime is nationally consistent. These mechanisms should also be sufficiently flexible to enable:

- the agency responsible for the regime to issue legislative instruments which clearly delineate which stores and products are and are not included in the unit pricing regime; and
- to allow for appropriate compliance monitoring and enforcement.

### Timeframe for implementation

If grocery retailers were required to implement unit pricing, consideration would have to be given to the timeframe for which the implementation was allowed. As stated earlier, both Coles and Woolworths indicated that they believe the implementation cost would be significantly higher if retailers were required to implement unit pricing in a short timeframe. The ACCC understands that a rapid compulsory implementation may impose greater costs on many retailers; however, a gradual and protracted introduction may have lower benefits if it leads to confusion and a lower take-up of unit pricing information.

## 20.6.1 Application of unit pricing

### Stores

In defining which grocery stores would be required to display unit pricing, the key question appears to be to what extent smaller operators should be included, and on what basis should coverage be determined? There are several options available to determine the application of unit pricing. One possible way is to only introduce it into stores above a certain size or above a certain turnover. While consumer benefits would increase with wider coverage, smaller operators may face a much higher cost relative to turnover than larger stores. Operators with several stores may also receive the benefit of economies of scale.

The ACCC considers that the unit pricing regime apply to all significant supermarkets, including but not limited to Coles, Woolworths, ALDI and large independent stores. As the majority of grocery sales are purchased in large format stores, this would ensure that unit pricing information was available to consumers at the time the majority of groceries were purchased.

The incremental benefits of unit pricing are likely to decrease as store size decreases due to the smaller range of substitute products in small stores. Further, smaller stores will face higher implementation costs relative to turnover compared to larger stores. Therefore the ACCC considers that before unit

<sup>40</sup> The National Measurement Institute is established under the *National Measurement Act 1960* (Cwth) and is responsible for the coordination of Australia's national measurement system. The discussion paper can be found at [www.measurement.gov.au](http://www.measurement.gov.au).

pricing is introduced a detailed cost-benefit analysis should be undertaken to determine which stores unit pricing should apply to.

It is also important that the administrative body has discretion to exempt certain stores in specific circumstances.

If consumers value unit pricing information, it is likely that it would be viewed by retailers as a competitive advantage and other stores may want to implement it. Therefore smaller stores should be allowed to introduce unit pricing on a voluntary basis, provided they complied with the legislative standards.

## Products

It is also necessary to define what products unit pricing applies to. The ACCC considers the aim should be to ensure that unit prices are displayed on as many standard grocery items as possible. However, there may be isolated instances where it is not practical to display unit pricing and for this reason it is essential that the administrative body has the authority to exempt certain products where unit pricing is deemed inappropriate.

### 20.6.2 Unit of measure

The QCA identified consistency in the unit of measurement as one of the most important elements of a unit pricing scheme, and stated that prices should be displayed either per kilo, litre, metre, square metre, cubic metre, or per item for products sold by count.<sup>41</sup> While the ACCC considers that consistency is paramount, the most appropriate unit of measure may vary depending on the product, and the responsible body should have the discretion to define what unit of measure would apply in particular circumstances.

### 20.6.3 Education

CALC states that 'to best achieve its objectives, a unit pricing system should be accompanied by a consumer education strategy'.<sup>42</sup> Several other parties, including the QCA, submit that an educational program is essential for unit pricing to be most effective.<sup>43</sup> UK studies also support the need for targeted education campaigns to ensure that the maximum number of consumers understand and make use of the unit pricing information.<sup>44</sup> The ACCC considers that an education campaign is likely to be useful in assisting consumers to take advantage of unit pricing information and ensuring that its benefits are fully realised.

## 20.7 ACCC's conclusion – unit pricing

The ACCC concludes that significant benefits to consumers would flow from the mandatory introduction of unit pricing, but recognises that a number of implementation costs would result. Accordingly, while the ACCC expects that the benefits to consumers would be likely to outweigh costs, it would be prudent for a detailed cost benefit analysis to be undertaken to examine practical implementation issues with a view to minimising the costs of introduction.

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41 QCA, submission 38, p. 33.

42 CALC, submission no. 124, p. 9.

43 QCA, submission no. 38, p. 33.

44 V Mitchell, D Lennard and P McGoldrick, 'Consumer awareness, understanding and usage of unit pricing', *British Journal of Management*, vol. 14, 173–87 (2003) at 177.

## 20.8 ACCC's recommendation – unit pricing

- The ACCC recommends that a mandatory, nationally-consistent unit pricing regime be introduced for standard grocery items both on in-store price labels and in print advertising. The ACCC recommends that the unit pricing regime apply to significant supermarkets, including Coles, Woolworths, ALDI and large independent stores. Smaller stores will face higher implementation costs relative to turnover compared to larger stores. The ACCC therefore considers that before unit pricing is introduced a detailed cost-benefit analysis should be undertaken to determine which stores unit pricing should apply to.<sup>45</sup> Grocery outlets not required to comply with the unit pricing regime should be allowed to display unit prices on a voluntary basis. If they choose to do so, they should be required to comply with the mandatory requirements.
- The ACCC has heard evidence that implementation costs will vary depending on the time allowed for implementation. The ACCC considers that a six- to 12-month implementation period will sufficiently reduce costs, while ensuring that unit pricing is implemented in a timely manner. The ACCC recommends that the relevant administrative body or Australian Government, consult with industry participants and examine how cost varies depending on the implementation timeframe.
- The ACCC recommends that any legislative mechanisms implemented should also be sufficiently flexible to enable the agency responsible for the regime to issue legislative instruments which clearly delineate which stores and products are and are not included in the unit pricing regime and allow for appropriate compliance monitoring and enforcement.
- The ACCC also recommends that a public education campaign be established to ensure that unit pricing is fully understood by consumers and has the greatest possible impact.

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<sup>45</sup> Further, an assessment of the extent to which unit pricing should apply to non-print advertising and internet retailers that do not have a physical retail store should be conducted.

# Appendix A:



**ASSISTANT TREASURER  
AND MINISTER FOR COMPETITION POLICY  
AND CONSUMER AFFAIRS**

PO BOX 6022  
PARLIAMENT HOUSE  
CANBERRA ACT 2600

Telephone: 02 6277 7360  
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<http://assistant.treasurer.gov.au>

22 January, 2007

**Mr G Samuel AO  
Chairman  
Australian Competition and Consumer Commission  
GPO Box 5203  
MELBOURNE VIC 3001**

Dear Mr Samuel

I am writing to require the Australian Competition and Consumer Commission (ACCC) to hold a public inquiry into the competitiveness of grocery prices pursuant to subsections 95G(2) and 95H(1) of the *Trade Practices Act 1974* (TPA).

I enclose a notice under subsection 95H(1) of the TPA identifying the matters the inquiry is to consider and when the inquiry is to be completed.

The terms of reference also include evaluation of the effectiveness of the Horticulture Code of Conduct (the code) and whether the inclusion of other major buyers such as retailers would improve the effectiveness of the code. Given that policy responsibility for the code resides with the Minister for Agriculture, Fisheries and Forestry, I ask that the ACCC, along with Treasury, liaise closely with the Minister's department to determine how the effectiveness of the code can best be evaluated.

The final report is required to be submitted to the Government by the 31<sup>st</sup> July 2008.

Furthermore, I seek your advice to me by the 29<sup>th</sup> February 2008 on how the ACCC may deliver a periodic survey of grocery prices at supermarkets for a typical shopping basket; and how best to establish a dedicated website on grocery prices as well as any other methods that could be used to provide information to the public.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Chris Bowen', written over a horizontal line.

**CHRIS BOWEN**  
Enc

*Trade Practices Act 1974*

**INQUIRY INTO GROCERY PRICES**

I, Chris Bowen, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, pursuant to subsection 95H(1) of the *Trade Practices Act 1974*, hereby require the Australian Competition and Consumer Commission to hold an inquiry into the competitiveness of retail prices for standard groceries.

Matters to be taken into consideration by the inquiry shall include, but not be restricted to:

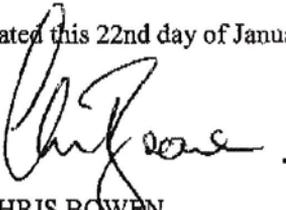
- the current structure of the grocery industry at the supply, wholesale and retail levels including mergers and acquisitions by the national retailers;
- the nature of competition at the supply, wholesale, and retail levels of the grocery industry;
- the competitive position of small and independent retailers;
- the pricing practices of the national grocery retailers and the representation of grocery prices to consumers;
- factors influencing the pricing of inputs along the supply chain for standard grocery items;
- any impediments to efficient pricing of inputs along the supply chain; and
- the effectiveness of the Horticulture Code of Conduct, and whether the inclusion of other major buyers such as retailers would improve the effectiveness of the code.

In undertaking this inquiry the Commission will consult with retailers, businesses along the supply chain, farmers, consumer groups and other interested parties.

The inquiry is not to be an inquiry in relation to the supply of grocery items by any particular person or persons.

The inquiry is to be completed and a report submitted to me by 31<sup>st</sup> July 2008.

Dated this 22nd day of January 2008.



CHRIS BOWEN

Assistant Treasurer and Minister for Competition Policy and Consumer Affairs

# Appendix B:

## Public submissions

<b>NAME</b>	<b>NUMBER</b>
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Abrahams, Alan	127
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Allan, Sue	64
Anonymous	209
Anonymous no. 2	216
Ansell, Renfrey	171
Aparekka, Dananjaya	211
Apple and Pear Australia Limited	80
Armstead, John	42
Arnott's Biscuits Holdings Pty Ltd	53
Australian Beef Association	44
Australian Beef Association no. 2	146
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Australian Bureau of Statistics	245
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Australian Food and Grocery Council	73
Australian Honey Bee Industry Council	59
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Basso, Pauline	250
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Bramley, Elaine	115
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Brimblecombe, Julie and O'Dea, Kevin	154
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# Appendix C:

## List of public hearing attendees

LOCATION	DATE	ORGANISATION	SUBMISSION	SUMMONSED
Sydney	01/04/08	Australian Consumers Association	143	No
Sydney	01/04/08	Ingham Enterprises	NA	Yes
Sydney	01/04/08	Franklins Pty Ltd	104 and 148	No
Sydney	01/04/08	Nestle Australia Limited	NA	Yes
Sydney	01/04/08	George Weston Foods Limited	138	Yes
Sydney	01/04/08	Arnott's Biscuits Holding Pty Ltd	53	Yes
Sydney	01/04/08	Kiama Milk Supplier Collective	86 and 244	Yes
Sydney	02/04/08	Kimberly-Clark Australia Pty Limited	NA	Yes
Sydney	02/04/08	Stockland Corporation Limited	NA	Yes
Brisbane	03/04/08	Paradise Foods Industries Pty Ltd	NA	Yes
Brisbane	03/04/08	Parmalat Australia Ltd	NA	Yes
Brisbane	03/04/08	One Harvest	NA	Yes
Brisbane	03/04/08	Brisbane Markets Limited	68	No
Brisbane	03/04/08	Avacados Australia	NA	Yes
Brisbane	03/04/08	Queensland Citrus Growers Association	49	Yes
Cairns	04/04/08	Horticulture Australia Council and Horticulture Australia Limited	63 92	No
Cairns	04/04/08	Mareeba District Fruit and Vegetable Growers Association	NA	Yes
Cairns	04/04/08	NQ Banana Growers Co-operative Association Limited	NA	Yes
Griffith	07/04/08	The Riverina Citrus Committee	NA	No
Griffith	07/04/08	Amaland Agco	NA	Yes
Canberra	08/04/08	Koundouris Group	35	No
Canberra	08/04/08	Pace Farms	NA	Yes
Canberra	08/04/08	Australian Beef Association	44, 146 and 221	No
Canberra	08/04/08	National Farmers Federation	137	No
Canberra	08/04/08	Southern Sydney Retailers Association	3, 10, 108, 136, 141, 150, 161, 170, 186, 202 and 230	No
Canberra	09/04/08	National Association of Retail Grocers of Australia (NARGA)	14, 129, 159 and 197	No
Canberra	09/04/08	Colgate-Palmolive Pty Limited	NA	Yes
Canberra	09/04/08	Australian Table Grape Assoc Incorporated.	NA	No
Canberra	09/04/08	Golden Circle Ltd	NA	Yes
Canberra	09/04/08	Australian Pork Limited	75 and 147	No
Canberra	30/04/08	National Farmers Federation	137	No
Hobart	10/04/08	Capilano Honey Limited	NA	Yes
Hobart	10/04/08	Tassal Group	NA	Yes
Hobart	10/04/08	Tasmanian Independent Retailers	NA	Yes

<b>LOCATION</b>	<b>DATE</b>	<b>ORGANISATION</b>	<b>SUBMISSION</b>	<b>SUMMONSED</b>
Launceston	14/04/08	Tasmanian Farmers and Graziers Association	NA	No
Launceston	14/04/08	French's Youngtown Supermarket	NA	No
Launceston	14/04/08	Tamar Valley Dairies Pty Ltd	NA	Yes
Shepparton	14/04/08	Mr Bob Katter MP	180	No
Shepparton	14/04/08	Apple and Pear Association Ltd	80	No
Shepparton	14/04/08	Fruit Growers of Victoria Ltd	71	No
Darwin	21/04/08	Australian Mango Industry Association Ltd	NA	No
Darwin	21/04/08	Northern Territory Department of Health and Community Services	34	No
Perth	22/04/08	NOVO Foods Limited	166	Yes
Perth	22/04/08	Mercer Mooney	NA	Yes
Perth	22/04/08	Pastoralists and Graziers Association of Western Australia; Western Australian Meat Industry Authority; and Western Australian Farmers Federation (Inc.)(red meat)	82	No
Perth	22/04/08	Western Australian Farmers Federation (Inc.) (grain)	106	No
Perth	22/04/08	Mrs Mac's Pty Ltd	152	Yes
Bunbury	23/04/08	Western Australia Farmers Federation (Inc.) (dairy )	106	No
Bunbury	23/04/08	Chamber of Commerce and Industry of Western Australia and Industry and Retail Traders Association of Western Australia	65	No
Bunbury	23/04/08	Red Meat Action Group	NA	No
Bunbury	23/04/08	V&V Walsh Pty Limited	NA	Yes
Bunbury	23/04/08	CA and CC Scott	NA	No
Adelaide	28/04/08	South Australian Farmers Federation	156	No
Adelaide	28/04/08	Adelaide Produce Markets Ltd	NA	No
Adelaide	28/04/08	ABB Grain	NA	Yes
Adelaide	28/04/08	Fruitorama and the South Australian Potato Company	NA	Yes
Adelaide	28/04/08	R Ceravolo & Co	NA	Yes
Port Lincoln	29/04/08	Port Lincoln Tuna Processors Pty Limited	NA	Yes
Port Lincoln	29/04/08	Clean Seas Tuna Limited	NA	Yes
Port Lincoln	29/04/08	Eyre Regional Development Board	NA	No
Melbourne	12/05/08	Australian Pork Limited	75 and 147	No
Melbourne	12/05/08	Teys Bros Pty Limited	NA	Yes
Melbourne	12/05/08	Victorian Farmers Federation (Chicken Meat Group)	70 and 126	No
Melbourne	12/05/08	Westfield Group	NA	Yes
Melbourne	15/05/08	National Foods	133	Yes

<b>LOCATION</b>	<b>DATE</b>	<b>ORGANISATION</b>	<b>SUBMISSION</b>	<b>SUMMONSED</b>
Melbourne	15/05/08	Costa Group	NA	Yes
Melbourne	15/05/08	Mr Doug Chant	NA	No
Melbourne	15/05/08	Australian United Retailers Limited (Foodworks)	90	No
Melbourne	15/05/08	Colonial First State	NA	Yes
Melbourne	19/05/08	Woolworths Limited	134, 232, 233, 237 and 246	No
Melbourne	26/05/08	Coles Group Limited	157 and 225	No
Melbourne	30/05/08	Produce and Grocery Industry Code Administration Committee	50	No
Melbourne	30/05/08	Lamanna Group	NA	Yes
Melbourne	30/05/08	Fonterra Brands (Australia) Pty Ltd	85	Yes
Melbourne	30/05/08	Bakers Delight	NA	No
Melbourne	02/06/08	Sunny Queen Farms	NA	Yes
Melbourne	02/06/08	Metcash Limited	74, 181 and 217	No

# Appendix D:

## Empirical analysis of Woolworths and Coles local store pricing

### Introduction

The purpose of this appendix is to report on the empirical analysis undertaken by the ACCC on Woolworths and Coles local store pricing—major supermarket chain (MSC) local pricing. The primary aim of this work is to analyse the effects of local competition in grocery retailing on MSC local pricing.

As noted in chapter 5, the MSCs use a two-tiered approach to setting grocery prices. The first tier or level is the MSC head office. The second tier is the local store manager. Local competition can affect the setting of grocery prices at both levels.

The head office sets standard shelf prices for most of its products in each of its stores. The MSCs do not set the same standard shelf price for the same products across all stores. Although there is a high degree of standardisation of standard shelf prices across stores, the MSCs do vary these prices based on factors including freight costs (especially for remote stores) and the degree of local competition. The head office also sets promotional prices. These are the prices of products being promoted or on special. Not all stores necessarily have the same promotions at any one time.

The local store manager can reduce prices below the standard shelf price or promotional price in a range of circumstances including clearances of discontinued stock and stock approaching its use-by date and as a response to local competition. The MSCs allow local store managers to match the prices of local competitors primarily for known value items (KVIs). Local competitors can be other supermarket chains or specialty retailers.

The purpose of this study is to analyse the effects of local competition in grocery retailing on store-by-store differences in pricing. This is achieved by comparing the prices consumers paid for the same products in different Woolworths supermarkets and, in a separate exercise, by comparing the prices consumers paid for the same products in different Coles supermarkets. The prices consumers paid in Woolworths supermarkets are not compared with the prices consumers paid in Coles supermarkets.

It is important to recognise that this analysis is not designed to estimate the effect that competition in grocery retailing has on national or state prices set by the MSCs—for instance, if ALDI produces a pricing response from all Woolworths stores (or all Woolworths stores within a state), it will not necessarily show up in this analysis. As a result, this analysis does not provide a complete picture of price competition in grocery retailing. However, to the extent that there are local pricing responses to local competition, it provides valuable insight into the competitive process.

## Data

Four types of data were combined to undertake this analysis:

- store price data
- data on store characteristics
- local market data
- local population and demographic data.

### Store price data

As part of this inquiry, the ACCC requested that the MSCs provide retail prices on a product-by-product basis for each of their supermarkets. Consistent with this request, the MSCs provided the ACCC with the average selling price (excluding GST) for an extensive number of products sold over four separate periods<sup>1</sup>:

- Week 1: Week ending 25 March 2007
- Week 2: Week ending 28 October 2007
- Week 3: Week ending 18 May 2008
- Year ending 31 December 2007.<sup>2</sup>

Average selling prices (ASPs) for each product were calculated as sales value divided by sales volume.<sup>3</sup> Average selling price is the average price that consumers paid for the product (excluding GST) in the store during the period. As a result, it reflects promotional prices, temporary markdowns, price matching of local competition, as well as standard shelf prices.

For each MSC, the products included in the store price data were products in the MSC's top 10 000 stock keeping units (SKUs) by national sales value in 2007.<sup>4</sup> Tobacco and liquor products were excluded. These SKUs represent the majority of grocery products by value sold by the MSCs.

### Store characteristics

The MSCs provided the ACCC with store characteristics such as the net trading area and the date of store opening.

### Local market data

The ACCC contracted with MapInfo to provide a range of information on the number of supermarkets and the distances between supermarkets across locations throughout Australia.

For example, for all Woolworths supermarkets, MapInfo provided the ACCC with data on the distance to the nearest supermarket by chain—for example, the distance to the nearest Coles supermarket, the distance to the nearest ALDI store, etc. Data was also supplied on the number of supermarkets within 1 km, 3km and 5km by chain. Straight-line distances were used.

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1 Each week was from Monday to Sunday. The MSCs typically review standard shelf prices and promotional prices weekly.

2 Data analysis for the year ending 31 December 2007 only includes stores that were operating for the entire year.

3  $ASP_{jt} = \text{sales value}_{jt} / \text{quantity sold}_{jt}$  where sales value<sub>jt</sub> is the \$ value of sales (excluding GST) of product j in store i in period t, and quantity sold<sub>jt</sub> is the volume of product j sold in store i in period t.

4 No individual store sold all of the 10 000 SKUs in any one of the weeks (or year). There were two reasons for this. Not all of the 10 000 products were stocked by all stores in each of the weeks (or year) and not all stocked products were sold.

## Local population and demographic data

Demographic data on the local population was obtained from the Australian Bureau of Statistics (ABS) 2006 Census (see table D.16 for details). A range of demographic data, including the age and income profile of the local population, was sourced on a postcode basis. This was matched with each supermarket's postcode to provide a demographic profile of each store's local area.

## Methodology

The ACCC separately analysed store-by-store pricing for Woolworths and Coles for each of the four periods listed above. The analysis aims to address the question: Are differences in the prices consumers paid for grocery products across stores associated with differences in local market structure?

The analysis involved two steps.

### *(i) Determination of aggregate differences in grocery prices across stores*

In the first step, aggregate differences in prices across Woolworths stores and across Coles stores were constructed using the store price data provide by the MSCs. These price differences were separately calculated for all Woolworths and all Coles stores. Coles and Woolworths stores were limited to those with a net trading area of 1000 m<sup>2</sup> or greater. Separate price differences were calculated for each of the four periods listed previously.

The aggregate price difference for a particular Woolworths store (say for Week 1) is a weighted average of the percentage difference between the store's average selling price for each product it sold in Week 1 and the average selling prices for each of these products across all Woolworths stores in Week 1. Calculating the average price difference for a Woolworths store (for example, Box Hill) in Week 1 involved calculating:

- the average selling price of each product or SKU sold by the Box Hill Woolworths in Week 1
- the average selling price of each of those products or SKUs across all Woolworths stores in Week 1
- the percentage difference between the average selling price of each product sold by the Box Hill Woolworths in Week 1 and the average selling price of the same product across all Woolworths stores in Week 1
- a weighted average of the percentage price differences across all of the products the Box Hill Woolworths sold in Week 1.<sup>5</sup>

The product weights were designed to place greater importance on products that consumers across the nation spend more on. In the above examples, the product weights were based on the proportion of sales of the product across all Woolworths stores in Week 1. It is important to recognise that no Woolworths stores sold all of the 10 000 products in any of the periods. As a result, it was necessary to adjust the weights on a store-by-store basis so they summed to one for each store.<sup>6</sup>

This approach calculates a weighted average of the percentage differences between the average price paid for each of the products sold by an individual store and the average price paid for the same products across all of the MSCs' stores. In this way, the aggregate price differences are based on 'like-for-like' comparisons.

5 In algebraic terms, the aggregate price difference for Woolworths store  $i$  in period  $t$  is  $APD_{it} = \sum_j w_{jt} [(ASP_{it} - ASP_{jt}) / (ASP_{jt})]$ , where  $ASP_{it}$  is the average selling price of product  $j$  sold in Woolworths store  $i$  in period  $t$ ,  $ASP_{jt}$  is the average selling price of product  $j$  across all Woolworths stores in period  $t$ ,  $w_{jt}$  is the weight for product  $j$  for store  $i$  in period  $t$  (based on product  $j$ 's share of Woolworths sales across all stores). APDs were put in percentage terms by multiplying by 100.

6 This is best explained by an example. Say a particular Woolworths store sold 8000 products in Week 1. Each of the 8000 products sold by the Woolworths store would receive a weight based on the product's share of sales across all Woolworths stores of the same 8000 products.

The aggregate price differences measure differences across Woolworths stores. For example, say the aggregate price difference for the Box Hill Woolworths store in Week 1 was -1.2 per cent. This means that on average consumers shopping at the Box Hill Woolworths store paid prices that were on average 1.2 per cent lower than the prices paid by consumers shopping for the same products at a hypothetical national average Woolworths supermarket.

Aggregate price differences were calculated separately for Coles and Woolworths supermarkets in each of the four periods. Aggregate price differences were also separately calculated for each of Coles and Woolworths trading departments, as well as for KVIs and for products the MSCs price compare with ALDI (ALDI price check items).

*(ii) Examination of the possible reasons for price differences across stores*

The second step involved analysing the possible causes of the price differences across stores. The potential causes include store-specific cost factors (such as transport costs), the characteristics of the store's customer base (such as average household income in the local area) and local market structure.

The empirical model took the following form:

$$APD_i = \alpha + \beta(Mstructure)_i + \gamma X_i + \varepsilon_i$$

where  $i$  denotes a particular store

$APD_i$  is a weighted average of the percentage differences between the average prices consumers shopping at store  $i$  paid for products and the average prices consumers paid for the same products across all stores in the supermarket chain, as described above

$Mstructure_i$  are variables capturing the structure of the local market in which store  $i$  is located (such as the distance to the nearest competing supermarkets)

$X_i$  are variables that are also likely to affect store pricing (e.g. store-specific costs, local demand characteristics, etc.)

$\varepsilon_i$  is an error term

This analysis was undertaken for all products within the top 10 000 SKUs sold in 2007 by the supermarket as well as for subsets of products, such as KVIs and product groups (such as produce and dry groceries).

The model was estimated separately for each period and for each MSC.

## Price differences across supermarkets

The analysis found differences in the prices consumers paid for the same products across supermarkets.

For example, as shown in table D.1, in the week ending 18 May 2008, the prices paid by consumers at the Woolworths store at the 75th percentile were on average 1.23 per cent higher than the prices paid by consumers at the Woolworths store at the 25th percentile.

These price differences across stores could be caused by:

- differences in standard shelf prices
- differences in promotional activities across stores on a week by week basis
- differences in quality for like items (such as for produce)
- differences in stock availability
- store level clearance activity for merchandise approaching use-by dates and excess deleted stock
- price matching by local store managers
- errors in the recording of sales.

Larger price differences between stores were found for meat and produce. This is consistent with greater variation in the quality and local supply costs for those product categories.

**Table D.1 Percentage price differences within Coles and Woolworths stores**

% price difference between stores at the 25th percentile and the 75th percentile				
Period	Woolworths		Coles	
	All products	Dry groceries	All products	Dry groceries
Week end 18 May 2008	1.23	0.59	1.27	0.82
Week end 28 October 2007	1.24	0.71	1.31	0.85
Week end 25 March 2007	1.51	1.11	1.83	1.22
Year end 31 December 2007	2.06	1.25	2.20	1.78

Note: Woolworths and Coles stores were separately ordered from the store where the prices paid by consumers were on average the lowest to the store where the prices paid by consumers were on average the highest. The Woolworths store at the 25th percentile is the store where 25 per cent of Woolworths stores consumers paid prices that were on average lower and 75 per cent of Woolworths stores consumers paid prices that were on average higher. The opposite is the case for the Woolworths store at the 75th percentile. Percentiles for Coles stores were obtained the same way.

As shown in tables D.2 and D.3, there is a high degree of correlation between the price differences across stores in each of the periods examined. This indicates, for example, that the Woolworths stores in which consumers paid above average prices in one week were in most cases the same Woolworths stores in which consumers paid above average prices in other weeks.

**Table D.2 Correlation of price differences across periods: Woolworths**

<b>Period</b>	<b>Week ending 18 May 2008</b>	<b>Week ending 28 Oct 2007</b>	<b>Week ending 25 Mar 2007</b>	<b>Year ending 31 Dec 2007</b>
<b>All Products</b>				
Week ending 18 May 2008	1.00			
Week ending 28 October 2007	0.85	1.00		
Week ending 25 March 2007	0.87	0.88	1.00	
Year ending 31 December 2007	0.79	0.86	0.84	1.00
<b>Dry grocery products</b>				
Week ending 18 May 2008	1.00			
Week ending 28 October 2007	0.93	1.00		
Week ending 25 March 2007	0.94	0.94	1.00	
Year ending 31 December 2007	0.75	0.75	0.73	1.00

Note: excludes Woolworths supermarket in Weipa. Only includes stores operating in all four periods.

**Table D.3 Correlation of price differences across periods: Coles**

<b>Period</b>	<b>Week ending 18 May 2008</b>	<b>Week ending 28 Oct 2007</b>	<b>Week ending 25 Mar 2007</b>	<b>Year ending 31 Dec 2007</b>
<b>All Products</b>				
Week ending 18 May 2008	1.00			
Week ending 28 October 2007	0.91	1.00		
Week ending 25 March 2007	0.72	0.77	1.00	
Year ending 31 December 2007	0.83	0.84	0.72	1.00
<b>Dry grocery products</b>				
Week ending 18 May 2008	1.00			
Week ending 28 October 2007	0.92	1.00		
Week ending 25 March 2007	0.68	0.77	1.00	
Year ending 31 December 2007	0.72	0.76	0.68	1.00

Note: only includes stores operating in all four periods.

### Examination of possible reasons for price differences across stores

A range of factors could contribute to differences in the prices consumers pay for the same products across Coles stores and across Woolworths stores. Both MSCs have stated that they set higher prices in stores located in remote areas to at least partly recover the higher freight costs to these stores. Both MSCs have also stated that they adjust prices on a store basis or on a state basis depending on the local competition they face. Local costs, such as store lease costs, can also play a role in price differences across stores, as can promotions associated with the opening of a new store.

The purpose of this section is to examine the role of local competition in determining Coles and Woolworths store-by-store pricing. To this end, the empirical model detailed above is estimated separately for Coles and Woolworths stores using data for each of the four periods.

The regressions included a range of variables capturing store, demographic and regional characteristics which may influence local store pricing. These variables are listed in table D.16. Table D.4 and following tables report the signs of the estimated effects of these variables on local store pricing and whether or not the variables were found to be statistically significant. The selection of many of these variables for inclusion in the analysis was based on statements made by the MSCs on what influences their pricing decisions on a store basis and variables capturing the characteristics of local demand.

The regressions also included variables reflecting local market structure. The local market structure variables are the distance to the nearest competing supermarket of 1000 m<sup>2</sup> or greater, for each supermarket chain. The estimated effects are reported in tables D.4 and D.5.

### Interpreting the results

The estimated coefficients in table D.4 and following tables are interpreted as follows. In table D.4 consider the estimated value of  $-0.19$  in the second column in the Nearest Coles (0–1 km) row. This estimate was calculated using Woolworths pricing data for the week ending 18 May 2008. Consider two Woolworths stores: Woolworths store 1 has a Coles store within 1 km. Woolworths store 2 has no Coles store within 5 km. The estimates indicate that the prices consumers paid for grocery products were on average 0.19 per cent lower in Woolworths store 1 than Woolworths store 2, holding other factors constant.<sup>7</sup> The analysis takes into account or ‘controls for’ a range of other factors that may affect the local pricing of Woolworths stores. This includes the location of other (but not all) competing grocery retailers, the regional location of the store, whether the store recently opened and a range of characteristics of the local population. The estimate indicates that after removing the influence of all these other factors on Woolworths local store pricing, the prices consumers paid at a Woolworths store with a Coles within 1 km were estimated to be 0.19 per cent lower than the prices consumer paid at a Woolworths store without a Coles within 5 km. This effect was statistically significant.

The value of 0.03 in the (1–3 km) row indicates that after removing the influence of all these other factors on Woolworths local store pricing, the prices consumers paid at a Woolworths store with the closest Coles store within 1 to 3 km were estimated to be 0.03 per cent higher than the prices consumers paid at a Woolworths store without a Coles within 5 km. This effect was not statistically significant.

### Local price competition between the MSCs

Coles and Woolworths are each other’s ‘closest’ competitors. Around 80 per cent of Coles supermarkets have a Woolworths supermarket within 3 km. The same is the case for Woolworths supermarkets. Coles and Woolworths retail a very similar range of products and have similar depth of brands.

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<sup>7</sup> A strict interpretation of the coefficient is that it represents the estimated difference between the aggregate price differences (APD) for the two different stores (after controlling for other factors). That is, strictly the coefficient is the difference in percentage points between the prices paid by consumers in each store relative to a hypothetical national average Woolworths or Coles supermarket. Note this difference will be approximately equal to the percentage difference in prices paid by consumers at each store, the interpretation described in this section. This slight relaxation in interpretation is used throughout and improves the exposition considerably.

## What the results indicate about the effects of competing MSCs on MSC local store pricing

### *Local presence of a competing MSC has a significant effect on MSC local store pricing*

The analysis indicates that the local presence of a competing MSC supermarket has a significant effect on Coles and Woolworths local pricing. For example, in 2007 consumers shopping at a Coles stores with a Woolworths supermarket within 1 km, paid prices that were on average 1.36 per cent<sup>8</sup> lower than the prices paid by consumers at Coles stores without a Woolworths within 5 km (see table D.5). Although a 1.36 per cent price difference may appear small, it is significant in comparison to Coles' EBIT margin of between 3 per cent and 4 per cent. Around 50 per cent of Coles stores are located within 1 km of a Woolworths stores.

The effects of the local presence of a Coles store on Woolworths local pricing are also significant, but not as large. In 2007 consumers shopping at a Woolworths supermarket with a Coles supermarket within 1 km paid prices that were on average 0.7 per cent lower than the prices paid by consumers at a Woolworths supermarket without a Coles within 5km (see table D.4). Around 50 per cent of Woolworths supermarkets are located within 1 km of a Coles supermarket.

Given the similarity in offers and their presence in many of the same local areas, it is likely that price competition between the MSCs also affects prices across all of their stores. That is, it is likely that price competition between the MSCs affects their pricing on a national or state basis in addition to their local pricing. This is more likely to be the case in the future given Woolworths move to more uniform store pricing (see discussion below). The effects of price competition between the MSCs on local pricing described above are in addition to any national or state effects.

### *Effects of the local presence of a competing MSC on Coles and Woolworths local pricing is similar to the effect of ALDI*

The average effect of MSCs on local store pricing is similar to or only slightly above that of ALDI, despite ALDI offering a far smaller product range (see tables D.4 and D.5). ALDI stocks around 900 products. A typical MSC store stocks over 25 000 SKUs.

### *Local presence of a competing MSC effects Coles and Woolworths local pricing across many trading departments*

The effects of the local presence of Coles on Woolworths local pricing appear to be more concentrated on dry groceries, produce and perishables (see table D.6). The local presence of a Woolworths store affects Coles local pricing across all of its trading departments (see table D.7).

As shown in tables D.8 to D.11, the presence of a competing MSC on Coles and Woolworths local store pricing are larger in produce than in dry groceries. This does not necessarily mean that the MSCs discount more heavily on produce than dry groceries. The effects reported in the tables are the average effects of the local presence of an MSC across all dry groceries and across all produce. It is likely that many less frequently purchased dry groceries are rarely discounted for the purposes of meeting local competition. A similar number of promotions in each category would have a bigger effect in produce as there are fewer produce products.

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<sup>8</sup> This is an average of 1.36 per cent across a large number of products, some of which will have price differences of greater than 1.36 per cent, some less.

### *Local presence of a competing MSC affects KVIs and non-KVIs*

Local competition between the MSCs is at least partly about matching the prices of local competitors on known value items (or KVIs). As shown in tables D.12 and D.13, the local presence of a competing MSC on Coles and Woolworths local pricing are similar or larger for KVIs than non-KVIs. Interestingly, the local presence of a competing MSC lowers the prices consumers paid for both KVIs and non-KVIs. That is, there is no evidence that at the store level the MSCs increase the prices of non-KVIs to 'compensate' for price discounting of KVIs.

### *Effects of the 'price war' between Coles and Woolworths during the third quarter of 2007*

As noted in Chapter 5, there was a period of significant price discounting instigated by Coles during the third quarter of 2007. This price war may at least partly explain the larger effects of the local presence of a competing MSC on Coles and Woolworths local store pricing during the year ending 31 December 2007 (see tables D.4 and D.5) (noting that the price war had ended by mid October 2007). Specifically, during 2007 consumers shopping at a Woolworths store with a Coles within 1km paid prices that were on average around 0.7 per cent lower than the prices paid by consumers at a Woolworths store without a Coles within 5 km. This compares to around 0.3 per cent to 0.4 per cent for the weeks ending 28 October 2007 and 25 March 2007 (see table D.4).

### *Effects of Woolworths' move to more uniform pricing*

As discussed below, Woolworths is moving to more uniform pricing across most of its stores.

This move is consistent with the observation that the local presence of a Coles supermarket on Woolworths local pricing seems to be much smaller in 2008 than 2007 (see table D.4). Specifically, for the weeks ending 28 October 2007 and 25 March 2007, consumers shopping at a Woolworths store with a Coles within 1 km paid prices that were on average around 0.3 per cent and 0.4 per cent lower than the prices paid by consumers at a Woolworths store without a Coles within 5 km. This compares to around 0.2 per cent for the week ending 18 May 2008 (see table D.4).

## Local price competition from ALDI

ALDI entered grocery retailing in Australia 2001. It now has approximately 170 stores operating in New South Wales, Australian Capital Territory, Queensland and Victoria. The majority of ALDI stores are located in metropolitan and urban areas. ALDI stocks around 900 products in its stores, most of which are its own brand labels. ALDI stocks a wide range of products, but generally has a limited range of brands for each product type.

Coles head office sets lower prices for certain products in stores that have an ALDI store in close proximity. These products are principally private label products that Coles considers to be comparable to the products offered by ALDI. Coles allows its local store managers to price match with ALDI on certain KVIs.

During the ACCC's public hearings, Woolworths stated that it had changed its pricing practices over the preceding 12 months towards more uniform prices across a broad range of items. Before this, in practice, Woolworths set different prices for a range of primarily private label products in many stores with an ALDI store in the immediate vicinity. Woolworths stated that it has since lowered its pricing to a common price across individual states often virtually across the nation, including to all (or nearly all) of its supermarkets in eastern states, regardless of their proximity to an ALDI store.

### *What the results indicate about the effects of ALDI on MSC local store pricing*

The results provide a number of findings about the effects of ALDI on MSC local store pricing.

#### *ALDI's influence on MSC local store pricing is significant*

The local presence of an ALDI store lowers the prices consumers pay at the nearby MSC store (see Tables D.4 and D.5). For example, over 2007, consumers shopping at a Coles stores with an ALDI within 5 km, paid prices that were on average around 0.5 per cent to 0.8 per cent lower than the prices paid by consumers at Coles stores without an ALDI within 5 km (see table D.5). Around 50 per cent of Coles stores are located within 5 km of an ALDI store. Although a 0.8 per cent price difference may appear small, it is significant in comparison to Coles' EBIT margin of between 3 per cent and 4 per cent.

#### *MSC local pricing response to the presence of ALDI is particularly large for 'ALDI price check' items*

As noted above, the MSCs local price response to ALDI is primarily through lowering the prices of the products that they consider are comparable to the products ALDI has on offer (ALDI price check items). The items the MSCs consider to be comparable to the ALDI products are primarily selected from their own private label products. The local presence of an ALDI has very large effects on the prices consumers pay for these products at the nearby Coles.

For example, during 2007 consumers shopping at a Coles store with an ALDI within 1 km, paid prices for Coles' 'ALDI price check items' that were on average around 5.15 per cent lower than the prices for the same items paid by consumers at Coles stores without an ALDI within 5 km (see table D.15). The effect during 2007 in Woolworths stores was slightly smaller (see table D.14).

#### *Effect of ALDI on Woolworths local store pricing has changed significantly since 2007*

As noted above, Woolworths has been moving toward more uniform pricing. A component of this was to extend its 'ALDI pricing' to all or most of its supermarkets in New South Wales, Australian Capital Territory, Queensland and Victoria.

The effect of this change is clearly evident from the results presented in table D.14. The results indicate that during the week ending 18 May 2008 there were no significant store-by-store differences in Woolworths pricing of ALDI price check items. In contrast the local presence of an ALDI store had significant effects on the prices consumers paid for ALDI price check items at nearby Woolworths stores in the weeks ending 28 October 2007 and 25 March 2007. This is consistent with Woolworth's move to more uniform pricing.

This does not mean that ALDI no longer affects Woolworths pricing of ALDI price check items. Rather the effects are occurring at the state level (with lower prices in New South Wales, Australian Capital Territory, Queensland and Victoria).

Moreover, the local presence of an ALDI store still affects Woolworths local pricing on other products. For example, for the week ending 18 May 2008, consumers shopping at a Woolworths store with an ALDI within 1 km, paid prices for KVI's that were on average around 1.7 per cent lower than the prices for the same items paid by consumers at Woolworths stores without an ALDI within 5 km (see table D.12). This suggests that Woolworths still responds to the presence of ALDI at the local level, but possibly primarily through price matching of KVI's by Woolworths local store managers.

## Local price competition from Metcash-supplied independents

### What the results indicate about the effects of Metcash-supplied independents on MSC local store pricing

Metcash supply around 680 grocery retailers with sales areas of 1000 m<sup>2</sup> or greater. As discussed in chapter 7, grocery retailers of this size are more likely to be price competitive with the MSCs.

#### *Local presence of Metcash-supplied independent retailers appears to affect Woolworths local store pricing, particularly in produce*

The analysis suggests that Metcash-supplied independent retailers (with sales area in excess of 1000 m<sup>2</sup>) influence the pricing of local Woolworths stores. For example, over 2007, consumers shopping at a Woolworths store with the nearest Metcash-supplied independent retailer within 3 km, paid prices that were on average around 0.4 per cent lower than the prices paid by consumers at Woolworths stores without a Metcash-supplied independent store within 5 km (see table D.4). This effect was weaker in the week ending 18 May 2008.

Around 60 per cent of Woolworths stores are located within 3 km of a Metcash-supplied independent retailer.

This effect of the local presence of a Metcash-supplied independent retailer on Woolworths local store pricing appears to be weaker than the effect of the local presence of ALDI. The effect of a Metcash-supplied independent retailer was found to be greater for produce than dry groceries (see tables D.8 and D.10).

#### *Local presence of Metcash-supplied independent retailers appears to have little or no effect on Coles local store pricing*

The analysis suggests that Metcash-supplied independent retailers have little or no direct effect on Coles local store pricing (see table D.5). Where they do appear to have an effect is for produce (see table D.11), but the effect is small relative to the influence of the local presence of Woolworths or ALDI. As noted in chapter 7, Woolworths and Coles regularly monitor the prices of Metcash-supplied independents. It is possible that the effect Metcash-supplied independents have on Coles' pricing occurs across all Coles stores at the state level.

## Local price competition from Franklins

Franklins owns 74 stores and has six franchised stores, all of which are in New South Wales. Between 2001 and 2005, Franklins was supplied with dry groceries by Metcash. In 2005 Franklins established its own distribution and logistics capabilities and its own buying team after terminating its supply arrangements with Metcash. Franklins is now vertically integrated and all Franklins stores are supplied via its two distribution centres. Franklins usually operates out of medium and large format stores with approximately one third of Franklins stores being greater than 2000 m<sup>2</sup>.

### *Local presence of a Franklins store appears to affect Coles local store pricing, particularly for dry groceries*

Franklins influences the local pricing of Coles stores, particularly for dry groceries. For example, in 2007, consumers shopping at a Coles store with a Franklins store within 1 km, paid prices for dry groceries that were on average 0.75 per cent lower than the prices paid by consumers at Coles stores without a Franklins store within 5 km (see table D.9). For dry groceries, this effect on Coles local pricing is less than the effect of the local presence of a Woolworths store. However, it is larger than the effect of the local presence of an ALDI store.

The local presence of a Franklins store appears to have a limited effect on Coles local pricing of produce or meat. Its effect is inconsistent among other product groups (see table D.7).

### *Local presence of a Franklins store appears to have little or no effect on Woolworths local store pricing*

As shown in table D.6, Franklins appears to have little direct effect on Woolworths local store pricing in any trading department. This does not necessarily mean that Franklins has no impact on the prices Woolworths offers its customers. As noted in chapter 8, Woolworths and Coles regularly monitor the prices of Franklins. It is possible that the effect Franklins has on Woolworths' pricing occurs across all its stores in New South Wales, rather than at the store level.

## Other factors possibly affecting MSC local store pricing

As noted previously, a number of other factors that may affect local store pricing were included in the regression analysis. These variables are designed to capture differences in the characteristics of the demand for groceries across localities and differences in the cost of supply.

In most cases, these variables had the expected sign, although in many cases they were not statistically significant (see tables D.4 and D.5).

Some of the effects of these variables are discussed below.

**Opened in previous month** detects discounted pricing to attract customers to a new store. The estimated level of price discounting is large. For example, consumers paid prices that were on average 2 per cent lower in Woolworths supermarkets that opened in the previous month, relative to other Woolworths supermarkets.

**Remote stores** are stores located long distances from the MSCs' distribution centres or in areas that require the transport of goods by air or sea (in addition to road). The costs of transporting groceries to these stores are higher than other stores in the MSC networks. The prices consumers paid at these remote supermarkets were, for some supermarkets, significantly higher.

**Distribution centres** are variables indicating the distribution centre supplying all or the majority of groceries to individual supermarkets. Woolworths has eight major distribution centres. Coles has six. The costs of sourcing and distributing products from these centres can vary.

**Co-branded petrol sites** were included in the analysis to control for any potential effect of the MSC's petrol shopper docket (discount) schemes on local store pricing of products overall.

Three indicator variables were included in the regressions to capture the local presence of a co-branded petrol site. The first variable indicates that the closest petrol outlet accepting the MSC's petrol shopper dockets is within 1 km of the supermarket. The second variable indicates that the closest petrol outlet accepting the MSC's petrol shopper dockets is within 1 to 3 km of the supermarket. The

third variable indicates that the closest petrol outlet accepting the MSC's petrol shopper dockets is within 3 to 5 km of the supermarket. These allow a price comparison with the baseline of supermarkets with no co-branded petrol outlet within 5 km. These variables were used as a proxy for the propensity of shoppers at various supermarkets to use the shopper dockets to obtain petrol discounts.

The local presence of a co-branded petrol outlet appeared to have no statistically significant effect on Coles local pricing.

In most cases, the local presence of a co-branded petrol outlet appeared to have a positive but not statistically significant effect on Woolworths local pricing. Where it did have a statistically significant effect (for the week ending 18 May 2008), the estimates indicate the prices consumers paid for groceries at Woolworths supermarkets with a co-branded petrol outlet nearby were on average around 0.2 per cent higher than in other Woolworths supermarkets. However, unlike the results associated with the distance to the nearest competing supermarkets, this result does not appear to be robust. For example, when restricting the sample to metropolitan areas or dry groceries the local presence of co-branded petrol outlet was no longer statistically significant.

This potential effect was not a major focus for this inquiry. A more robust analysis of the potential effects of petrol shopper docket schemes on the MSCs grocery prices would require a fuller characterisation of the local market structure for petrol retailing than was performed here.

There is insufficient evidence from this analysis to cast doubt on the statements by Coles and Woolworths that their petrol shopper dockets schemes do not influence store pricing at the local level (see chapter 9).

### Cautions regarding the analysis

The analysis detailed in this appendix is based on a particular methodological approach and has a number of limitations.

### Specialty retailers

It is possible that factors influencing local store pricing of the MSCs have been omitted from the analysis. Such omissions could bias the estimated effects reported in the tables. One omission is the local presence of specialty retailers. The ACCC was unable to source accurate or comprehensive information on the location of specialty retailers. It is quite possible that Coles and Woolworths stores that are located close to other supermarkets are also located close to specialty retailers. If this is the case, the effects of the local presence of competing supermarkets on the MSCs local store pricing may also capture the effect of specialty retailers.

### Calculating the price of each item: volume weighted average

A key element of the approach is that this analysis has been performed using the average prices actually paid by consumers as reflected by scanner data obtained from the MSCs. That is, each product's price is based on a volume weighted average of the price paid for each item in that period. In particular, it is not based on a simple measure of the standard shelf price for the item.

The use of volume weighted average prices is appropriate because of the significant number and volume of products that are sold at prices other than the standard shelf price. Products can be sold at prices other than the standard shelf price for a variety of reasons including head office initiated promotions, local store based promotions and price cuts to clear deleted or damaged stock.

However, the use of a volume weighted price measure does affect the interpretation of the price differences analysed here in two important ways.

First, as discussed previously, is that the use of the word 'price' in this analysis refers to a volume weighted average of price paid for products. It does not refer to the average shelf price of the product.

Second is that the use of volume weighted prices incorporates two effects into the price measure. The first is the price mix for an item at a particular store. The second is the customer volume response to that price mix. For example, two stores can sell the same item at the standard shelf price for five days of the week and sell the item at the same promotional price for the remaining two days of the week. On a simple time weighted basis these stores have the same average price for the item. However, the volume of items purchased by customers at the standard shelf price and at the promotional price can vary between stores for a variety of reasons, such as customer price sensitivity and product stock availability. These can combine to give each store a different volume weighted average selling price for the product.

For the above reasons, it is important not to interpret this analysis as saying a store 'offers lower prices' or 'is cheaper'. The correct interpretation is to say that the prices paid by customers in the time period were higher or lower.

### Product mix: national purchasing pattern

The analysis was restricted to the top 10 000 SKUs sold by the MSCs in 2007. This represents a substantial proportion of products sold by the MSCs in 2007, both by number of products and by value of sales. However, these products do not represent the entire range offered by the MSCs, which typically offer 25 000 SKUs per store. Not all stores offer all products, nor are many products necessarily sold at all stores in a given timeframe because of stock availability or consumers not purchasing the product during the period. Missing values have been corrected by adjusting the weights used on a store-by-store basis so they sum to one.

Some of the top 10 000 SKUs in 2007 are no longer offered by the MSCs. For example, some products have been deleted and some private label products re-branded. Other products may no longer be in the top 10 000 SKUs because of declining sales and accordingly may currently have less importance to consumers than they did in 2007.

The aggregated price difference for a store weights each product's price difference for that store by that product's proportion of national sales. The measure could be put by the following question: 'If I bought a basket of the top 10 000 goods nationally, in similar proportion to that bought by consumers across all stores, how much would it cost at this store relative to the average store in the chain?' It is likely that local tastes for some products vary considerably from those reflected by the national purchasing pattern. For example, it is plausible that Northern Territory consumers may buy more sunscreen than most. In a similar but stronger way, individual consumers or households are likely to have very different baskets from those reflected by the national purchasing pattern. Accordingly, these results do not necessarily apply to any basket of products beyond the hypothetical national average basket based on the top 10 000 selling SKUs of each MSC in 2007.

## Timeframes

All of these analyses are based on restricted timeframes. The weekly analyses may be affected by the particular set of promotions engaged in by the MSC during that week. It is possible that some stores would encounter different consumer responses to promotions or different price levels available during the week. The annual data analysis is less affected by particular weekly promotions and is likely to be more robust.

## Diagnostic testing

Econometric diagnostic tests suggested heteroskedasticity for each regression in the tables. Possible unobserved variables contributing to this include pricing variation induced by factors beyond the controls included. Heteroskedasticity robust standard errors and inferences are used.

A key structural change in the east coast grocery market has been the entry of ALDI. The potential for the distance to the nearest ALDI to be an endogenous variable was examined for metropolitan New South Wales, Victoria and Queensland, using instrumental variable regression. Where good instruments were found, diagnostic testing indicated that the distance to the nearest ALDI could be assumed to be exogenous.

**Table D.4 Estimated effects of competition on Woolworths local store pricing: all products—estimated percentage differences in Woolworths local store pricing based on the distance to nearest competing supermarket chain**

<b>Woolworths—all products</b> <b>Dependent variable: APD</b>	<b>Week end</b> <b>18 May 2008</b>	<b>Week end</b> <b>28 Oct 2007</b>	<b>Week end</b> <b>25 Mar 2007</b>	<b>Year end</b> <b>31 Dec 2007</b>
<b>Distance to competitors:</b>				
Nearest Coles <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-0.19*	-0.30*	-0.37*	-0.70*
1–3 km	0.03	-0.01	-0.07	-0.05
3–5 km	0.09	0.04	-0.00	0.12
Nearest ALDI <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-0.29*	-0.45*	-0.75*	-0.67*
1–3 km	-0.16*	-0.25*	-0.46*	-0.33*
3–5 km	-0.02	-0.02	-0.19	-0.13
Nearest Franklins <sup>^</sup>	No	No	No	No
0–1 km	0.11	0.13	-0.02	-0.02
1–3 km	-0.06	0.00	-0.08	-0.20
3–5 km	0.12	0.01	0.16	0.16
Nearest Metcash-supplied <sup>^</sup>	Yes	Yes	No	Yes
0–1 km	-0.19*	-0.25*	-0.15	-0.37*
1–3 km	-0.16*	-0.23*	-0.16	-0.41*
3–5 km	-0.10	-0.08	-0.08	-0.21
<b>Controls:</b>				
Distribution centre <sup>^</sup>	Yes	Yes	Yes	Yes
CBD/Metro/Provincial/Rural <sup>^</sup>	No	Yes	Yes	Yes
Remote stores	+*	+*	+*	+*
Store trading area	-	-*	-	-
Opened in previous month	N/A	-*	-*	N/A
Proportion Australian born	+*	+*	+*	+*
Proportion 65 years or older	-	-	+	-
Persons per sq km	-	+	+	+
Average household size	-*	-*	-*	-*
Median household income	+*	+*	+*	+*
Unemployment rate	-*	-	-	-*
Avg motor vehicle/ dwelling	-*	-	-	-
Median weekly rent	+*	+	+	+*
Near co-branded petrol#	+*	+	Mixed	+
Number of observations	736	720	702	699
R <sup>2</sup>	0.91	0.88	0.87	0.81

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors. + (-) denotes the estimates indicate the variable has a positive (negative) effect on grocery prices paid by consumers.

<sup>^</sup> Yes or no denotes if the factor is jointly significant at the 5 per cent level. Individual coefficients only shown as significant if overall factor is significant. In these cases the individual coefficients give the percentage price differences relative to Woolworths stores without the competing store within 5 km.

# Joint test of significance at the 5 per cent level. + or - or mixed indicates that grocery prices paid are higher or lower or have mixed effects respectively when there is a co-branded petrol station nearby.

**Table D.5 Estimated effects of competition on Coles local store pricing: all products—estimated percentage differences in Coles local store pricing based on the distance to nearest competing supermarket chain**

<b>Coles— all products</b> <b>Dependent variable: APD</b>	<b>Week end</b> <b>18 May 2008</b>	<b>Week end</b> <b>28 Oct 2007</b>	<b>Week end</b> <b>25 Mar 2007</b>	<b>Year end</b> <b>31 Dec 2007</b>
<b>Distance to competitors:</b>				
Nearest Woolworths <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-0.55*	-0.69*	-0.93*	-1.36*
1–3 km	-0.29*	-0.43*	-0.75*	-0.77*
3–5 km	-0.16	-0.28	-0.38	-0.43
Nearest ALDI <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-0.55*	-0.79*	-1.00*	-0.81*
1–3 km	-0.38*	-0.43*	-0.72*	-0.54*
3–5 km	-0.36*	-0.51*	-0.58*	-0.65*
Nearest Franklins <sup>^</sup>	No	No	Yes	No
0–1 km	-0.18	-0.15	-0.53	-0.32
1–3 km	-0.30	-0.19	-0.84*	-0.48
3–5 km	0.11	0.25	0.16	0.36
Nearest Metcash supplied <sup>^</sup>	No	No	No	No
0–1 km	-0.08	0.03	-0.16	-0.09
1–3 km	-0.15	-0.15	-0.15	-0.23
3–5 km	-0.09	-0.01	-0.09	-0.05
<b>Controls:</b>				
Distribution centre <sup>^</sup>	Yes	Yes	Yes	Yes
CBD/Metro/Provincial/Rural <sup>^</sup>	Yes	Yes	Yes	Yes
Remote stores	+*	+*	+*	+*
Tasmania	+*	+*	+*	+*
Northern Territory	+*	+*	+*	+*
Store trading area	-	+	-*	+*
Opened in previous month	N/A	-*	-*	N/A
Proportion Australian born	-	+	+	+*
Proportion 65 years or older	-	+	-	-
Persons per sq km	+*	+*	+*	+*
Average household size	-	-	-	-*
Median household income	+	+	-	+*
Unemployment rate	-	-	-	-*
Avg motor vehicle/ dwelling	-	-	+	-
Median weekly rent	+	+	+	+*
Near co-branded petrol#	+	+	+	Mixed
Number of observations	694	693	670	675
R <sup>2</sup>	0.79	0.75	0.50	0.69

\* Significant at the 5 per cent level, Heteroskedasticity robust standard errors. + (-) denotes the estimates indicate the variable has a positive (negative) effect on grocery prices paid by consumers.

<sup>^</sup> Yes or no denotes if the factor is jointly significant at the 5 per cent level. Individual coefficients only shown as significant if overall factor is significant. In these cases the individual coefficients give the percentage price differences relative to Coles stores without the competing store within 5 km.

# Joint test of significance at the 5 per cent level. + or - or mixed indicates that grocery prices paid are higher or lower or have mixed effects respectively when there is a co-branded petrol station nearby.

**Table D.6 Estimated effect of supermarket chain on Woolworths local store pricing by Trading Department**

<b>Does a supermarket within 5 km of a Woolworths supermarket have the effect of reducing Woolworths local store pricing?</b>				
	<b>Week end 18 May 2008</b>	<b>Week end 28 Oct 2007</b>	<b>Week end 25 Mar 2007</b>	<b>Year end 31 Dec 2007</b>
All products	C, A, M	C, A, M	C, A	C, A, M
Groceries (dry)	C	A	A	C, A, M
Produce (fruit and vegetables)	C, A, M	C, A, M	C, A, M	C, A, M
Perishables	C	A	C, A	C, A
Bakehouse	–	–	–	–
Proprietary Bakery	M	C, A, F	C, A	C, A
Meat	–	C	–	C
Serviced Delicatessen	A	C, M	M	C, A, M
Seafood	–	–	–	–
General Merchandise	A	A	A	C, A

Key: C = Coles, A = ALDI, F = Franklins, M = Metcash-supplied independents

Supermarket chain name appears where the joint test of significance of distance dummies for that chain is significant at the 5 per cent level.

**Table D.7 Estimated effect of supermarket chain on Coles local store pricing by Trading Department**

<b>Does a supermarket within 5 km of a Coles supermarket have the effect of reducing Coles local store pricing?</b>				
	<b>Week end 18 May 2008</b>	<b>Week end 28 Oct 2007</b>	<b>Week end 25 Mar 2007</b>	<b>Year end 31 Dec 2007</b>
All products	W, A	W, A	W, A, F	W, A
Groceries (dry)	W, A, F	W, A	W, F	W, A, F
Fresh produce (includes fruit and vegetables)	W, A	W, A, M	W, A, M	W, A, M
Dairy	W, A	W, A	W, A	W, A
Bakehouse	W, A	W, A, F	W, A, F	W, A
Meat	–	W	W	W
Deli	W	W, F, M	W, F	W
General Merchandise	W	–	–	W

Key: W = Woolworths, A = ALDI, F = Franklins, M = Metcash-supplied independent

Supermarket chain name appears where the joint test of significance of distance dummies for that chain is significant at the 5 per cent level.

**Table D.8 Estimated effects of competition on Woolworths local store pricing: dry grocery products—estimated percentage differences in Woolworths local store pricing based on the distance to nearest competing supermarket chain**

<b>Woolworths— dry grocery products Dependent variable: APD</b>	<b>Week end 18 May 2008</b>	<b>Week end 28 Oct 2007</b>	<b>Week end 25 Mar 2007</b>	<b>Year end 31 Dec 2007</b>
<b>Distance to competitors:</b>				
Nearest Coles <sup>^</sup>	Yes	No	No	Yes
0–1 km	–0.04*	–0.01	–0.06	–0.46*
1–3 km	–0.01	0.02	–0.04	–0.16*
3–5 km	–0.00	0.02	–0.02	–0.09
Nearest ALDI <sup>^</sup>	No	Yes	Yes	Yes
0–1 km	–0.01	–0.18*	–0.18*	–0.18*
1–3 km	0.02	–0.16*	–0.15*	–0.13
3–5 km	0.01	–0.08*	–0.09*	–0.10
Nearest Franklins <sup>^</sup>	No	No	No	No
0–1 km	0.01	0.02	0.02	–0.17
1–3 km	–0.05	0.04	0.04	–0.13
3–5km	0.03	–0.07	0.10	0.06
Nearest Metcash-supplied <sup>^</sup>	No	No	No	Yes
0–1 km	–0.04	–0.05	0.02	–0.17*
1–3 km	–0.03	–0.04	0.01	–0.19*
3–5km	–0.03	–0.01	–0.02	–0.13
<b>Controls:</b>				
Distribution centre <sup>^</sup>	Yes	Yes	Yes	Yes
CBD/Metro/Provincial/Rural <sup>^</sup>	Yes	Yes	Yes	Yes
Remote stores	+*	+*	+*	+*
Store trading area	–*	–*	–*	+
Opened in previous month	N/A	–*	–*	N/A
Proportion Australian born	+*	+*	+*	+*
Proportion 65 years or older	+	–	–	–*
Persons per sq km	+	+*	+*	+
Average household size	–*	–*	–	–*
Median household income	+*	+	+*	+*
Unemployment rate	–	+	–	–
Avg motor vehicle /dwelling	–	+	+	–
Median weekly rent	–	+*	+	+*
Near co-branded petrol#	Mixed	–*	–	Mixed
Number of observations	736	720	702	699
R <sup>2</sup>	0.99	0.98	0.98	0.93

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors. + (-) denotes the estimates indicate the variable has a positive (negative) effect on the grocery prices paid by consumers.

<sup>^</sup> Yes or no denotes if the factor is jointly significant at the 5 per cent level. Individual coefficients only shown as significant if overall factor is significant. In these cases the individual coefficients give the percentage price differences relative to Woolworths stores without the competing store within 5 km.

# Joint test of significance at the 5 per cent level. + or - or mixed indicates that grocery prices paid are higher or lower or have mixed effects respectively when there is a co-branded petrol station nearby.

**Table D.9 Estimated effects of competition on Coles local store pricing: dry grocery products—estimated percentage differences in Coles local store pricing based on the distance to nearest competing supermarket chain**

<b>Coles— dry grocery products Dependent variable: APD</b>	<b>Week end 18 May 2008</b>	<b>Week end 28 Oct 2007</b>	<b>Week end 25 Mar 2007</b>	<b>Year end 31 Dec 2007</b>
<b>Distance to competitors:</b>				
Nearest Woolworths <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	–0.41*	–0.31*	–0.80*	–1.10*
1–3 km	–0.30*	–0.30*	–0.84*	–0.77*
3–5 km	–0.21	–0.24*	–0.44	–0.53*
Nearest ALDI <sup>^</sup>	Yes	Yes	No	Yes
0–1 km	–0.21*	–0.24*	–0.30	–0.25*
1–3 km	–0.09	–0.20*	–0.34	–0.24
3–5 km	–0.12	–0.17*	–0.29	–0.36*
Nearest Franklins <sup>^</sup>	Yes	No	Yes	Yes
0–1 km	–0.27*	–0.11	–0.54	–0.75*
1–3 km	–0.52*	–0.31	–0.95*	–0.85*
3–5 km	0.03	0.17	0.20	0.04
Nearest Metcash-supplied <sup>^</sup>	No	No	No	No
0–1 km	0.03	–0.00	–0.05	–0.15
1–3 km	0.01	–0.02	0.08	–0.08
3–5 km	–0.05	–0.04	–0.04	–0.12
<b>Controls:</b>				
Distribution centre <sup>^</sup>	Yes	Yes	Yes	Yes
CBD/Metro/Provincial/Rural <sup>^</sup>	Yes	No	No	Yes
Remote stores	+	+	+	+
Tasmania	+	+	+	+
Northern Territory	+	+	+	+
Store trading area	–	–	–	–
Opened in previous month	N/A	–	–	N/A
Proportion Australian born	+	–	+	+
Proportion 65 years or older	–	+	–	–
Persons per sq km	+	+	+	+
Average household size	+	+	+	–
Median household income	+	+	–	+
Unemployment rate	+	–	+	–
Avg motor vehicle/ dwelling	–	–	+	–
Median weekly rent	+	+	+	+
Near co-branded petrol#	Mixed	Mixed	Mixed	–
Number of observations	694	693	670	675
R <sup>2</sup>	0.76	0.74	0.40	0.65

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors. + (–) denotes the estimates indicate the variable has a positive (negative) effect on grocery prices paid by consumers.

<sup>^</sup> Yes or no denotes if the factor is jointly significant at the 5 per cent level. Individual coefficients only shown as significant if overall factor is significant. In these cases the individual coefficients indicate the percentage price differences relative to Coles stores without the competing store within 5 km.

# Joint test of significance at the 5 per cent level. + or – or mixed indicates that grocery prices paid are higher or lower or have mixed effects respectively when there is a co-branded petrol station nearby.

**Table D.10 Estimated effects of competition on Woolworths local store pricing: fresh produce products—estimated percentage differences in Woolworths local store pricing based on the distance to nearest competing supermarket chain**

<b>Woolworths— fresh produce products Dependent variable: APD</b>	<b>Week end 18 May 2008</b>	<b>Week end 28 Oct 2007</b>	<b>Week end 25 Mar 2007</b>	<b>Year end 31 Dec 2007</b>
<b>Distance to competitors:</b>				
Nearest Coles <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-0.92*	-1.50*	-2.77*	-2.42*
1–3 km	0.31	-0.23	-0.97	-0.11
3–5 km	0.76	0.16	-0.73	0.73
Nearest ALDI <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-3.02*	-2.67*	-4.61*	-3.41*
1–3 km	-1.59*	-0.66	-1.88*	-0.88
3–5 km	-0.49	0.21	-0.76	-0.31
Nearest Franklins <sup>^</sup>	No	No	No	No
0–1 km	0.60	0.78	-0.32	-0.11
1–3 km	0.02	0.43	0.08	-0.59
3–5 km	0.49	0.40	0.23	0.72
Nearest Metcash-supplied <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-0.84*	-1.44*	-1.09*	-1.64*
1–3 km	-1.16*	-1.21*	-1.50*	-2.17*
3–5 km	-0.79	-0.15	-0.31	-0.86
<b>Controls:</b>				
Distribution centre <sup>^</sup>	Yes	Yes	Yes	Yes
CBD/Metro/Provincial/Rural <sup>^</sup>	No	Yes	Yes	Yes
Remote stores	Various	Various	Various	Various
Store trading area	—*	—*	—*	—*
Opened in previous month	N/A	—	—*	N/A
Proportion Australian born	+*	+*	+	+*
Proportion 65 years or older	—*	—	+	—
Persons per sq km	—	—	—	+
Average household size	—*	—*	—	—*
Median household income	+*	+*	+*	+*
Unemployment rate	—*	—	—*	—*
Avg motor vehicle/ dwelling	—	+	—	+
Median weekly rent	+*	+	—	+
Near co-branded petrol#	+	+	+	Mixed
Number of observations	734	718	700	698
R <sup>2</sup>	0.65	0.65	0.67	0.64

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors. + (–) denotes the estimates indicate the variable has a positive (negative) effect on grocery prices paid by consumers.

<sup>^</sup> Yes or no denotes if the factor is jointly significant at the 5 per cent level. Individual coefficients only shown as significant if overall factor is significant. In these cases the individual coefficients give the percentage price differences relative to Woolworths stores without the competing store within 5 km.

# Joint test of significance at the 5 per cent level. + or – or mixed indicates that grocery prices paid are higher or lower or have mixed effects respectively when there is a co-branded petrol station nearby.

**Table D.11 Estimated effects of competition on Coles local store pricing: fresh produce products—estimated percentage differences in Coles local store pricing based on the distance to nearest competing supermarket chain**

<b>Coles—fresh produce products</b> <b>Dependent variable: APD</b>	<b>Week end</b> <b>18 May 2008</b>	<b>Week end</b> <b>28 Oct 2007</b>	<b>Week end</b> <b>25 Mar 2007</b>	<b>Year end</b> <b>31 Dec 2007</b>
<b>Distance to competitors:</b>				
Nearest Woolworths <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-1.11*	-1.45*	-1.41*	-2.14*
1–3 km	-0.03	-0.39	-0.55	-0.46
3–5 km	0.27	0.19	-0.14	0.40
Nearest ALDI <sup>^</sup>	Yes	Yes	Yes	Yes
0–1 km	-2.02*	-2.00*	-3.25*	-2.52*
1–3 km	-1.22*	-0.22	-1.42*	-0.98*
3–5 km	-1.09*	-0.82*	-0.86*	-1.11*
Nearest Franklins <sup>^</sup>	No	No	No	No
0–1 km	-0.20	-0.24	-0.55	0.09
1–3 km	0.04	0.23	-0.77	0.26
3–5 km	0.18	0.73	-0.14	1.61
Nearest Metcash-supplied <sup>^</sup>	No	Yes	Yes	Yes
0–1 km	-0.48	0.04	-0.77*	-0.02
1–3 km	-0.72	-0.75*	-1.05*	-0.87*
3–5 km	-0.39	-0.08	-0.81*	-0.04
<b>Controls:</b>				
Distribution centre <sup>^</sup>	Yes	Yes	Yes	Yes
CBD/Metro/Provincial/Rural <sup>^</sup>	No	No	Yes	Yes
Remote stores	Various	+	Various	+
Tasmania	-*	+	+	+
Northern Territory	+	+	+	+
Store trading area	-	+	-	+
Opened in previous month	N/A	-*	-*	N/A
Proportion Australian born	-	+	+	+
Proportion 65 years or older	-*	-	-	-
Persons per sq km	+	+	+	+
Average household size	-	-	-	-
Median household income	+	+	+	+
Unemployment rate	-*	-	-	-*
Avg motor vehicle/ dwelling	-	-	-	-
Median weekly rent	+	+	+	+
Near co-branded petrol <sup>#</sup>	Mixed	+	+	Mixed
Number of observations	694	693	670	675
R <sup>2</sup>	0.72	0.66	0.60	0.67

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors. + (-) denotes the estimates indicate the variable has a positive (negative) effect on grocery prices paid by consumers.

<sup>^</sup> Yes or no denotes if the factor is jointly significant at the 5 per cent level. Individual coefficients only shown as significant if overall factor is significant. In these cases the individual coefficients give the percentage price differences relative to Coles stores without the competing store within 5 km.

<sup>#</sup> Joint test of significance at the 5 per cent level. + or - or mixed indicates that grocery prices paid are higher or lower or have mixed effects respectively when there is a co-branded petrol station nearby.

**Table D.12 Estimated effects of a competing supermarket within 1 km on Woolworths local store pricing: known value items**

Dependent variable: APD	All Products			Dry groceries		
	All	KVI	Non-KVIs	All	KVI	Non-KVIs
<b>Using price data for the week ending 18 May 2008</b>						
Coles	-0.19*	-0.87*	-0.12 <sup>^</sup>	-0.04*	-0.11	-0.04
ALDI	-0.29*	-1.73*	-0.15*	-0.01	-0.14	-0.01
Franklins	0.11	0.52	0.07	0.01	-0.04	0.01
Metcash-supplied independents	-0.19*	-0.85*	-0.13*	-0.04	-0.02	-0.04
<b>Using price data for the week ending 28 October 2007</b>						
Coles	-0.30*	-1.24*	-0.20*	-0.01	-0.11	-0.01
ALDI	-0.45*	-3.07*	-0.18*	-0.18*	-1.32*	-0.13*
Franklins	0.13	0.49	0.10	0.02	0.11	0.02
Metcash-supplied independents	-0.25*	-1.17*	-0.16*	-0.05	0.09	-0.05
<b>Using price data for the week ending 25 March 2007</b>						
Coles	-0.37*	-2.07*	-0.21*	-0.06	-0.15	-0.05
ALDI	-0.75*	-5.47*	-0.32*	-0.18*	-2.08*	-0.13*
Franklins	-0.02	0.41	-0.05 <sup>^</sup>	0.02	0.39	0.01
Metcash-supplied independents	-0.15	-0.68 <sup>^</sup>	-0.11	0.02	0.26	0.02
<b>Using price data for the year ending 31 December 2007</b>						
Coles	-0.70*	-1.72*	-0.60*	-0.46*	-0.56*	-0.45*
ALDI	-0.67*	-4.11*	-0.32*	-0.18*	-1.87*	-0.13
Franklins	-0.02	0.27	-0.04	-0.17	0.06	-0.18
Metcash-supplied independents	-0.37*	-1.11*	-0.29*	-0.17*	0.01	-0.18*

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors.

Individual coefficients only shown as significant if overall category is significant. Where significant the individual coefficients indicate the percentage price differences relative to the baseline of Woolworths stores without the competing store within 5 km.

<sup>^</sup> denotes that individual coefficient is statistically insignificant at the 5 per cent level but that the overall factor of the distance to the nearest store of this type is statistically significant at the 5 per cent level.

**Table D.13 Estimated effects of a competing supermarket within 1 km on Coles local store pricing: Known value items**

Dependent variable: APD	All Products			Dry groceries		
	All	KVI	Non-KVIs	All	KVI	Non-KVIs
<b>Using price data for the week ending 18 May 2008</b>						
Woolworths	-0.55*	-0.66*	-0.54*	-0.41*	-0.38*	-0.41*
ALDI	-0.55*	-1.47*	-0.44*	-0.21*	-0.30*	-0.20*
Franklins	-0.18	-0.60	-0.14	-0.27*	-0.50*	-0.26*
Metcash-supplied independents	-0.08	-0.49	-0.02	0.03	-0.10	0.03
<b>Using price data for the week ending 28 October 2007</b>						
Woolworths	-0.69*	-1.02*	-0.64*	-0.31*	-0.39	-0.30*
ALDI	-0.79*	-2.83*	-0.54*	-0.24*	-1.20*	-0.17*
Franklins	-0.15	-0.53	-0.12	-0.11	-0.13	-0.11
Metcash-supplied independents	0.03	-0.30^	0.07	-0.00	-0.05	0.00
<b>Using price data for the week ending 25 March 2007</b>						
Woolworths	-0.93*	-1.74*	-0.83*	-0.80*	-2.13	-0.72*
ALDI	-1.00*	-4.28*	-0.64*	-0.30	-2.06*	-0.19
Franklins	-0.53^	-1.01^	-0.48^	-0.54^	-1.80^	-0.45^
Metcash-supplied independents	-0.16	-0.43	-0.13	-0.05	0.02	-0.05
<b>Using price data for the year ending 31 December 2007</b>						
Woolworths	-1.36*	-1.67*	-1.32*	-1.10*	-2.10*	-1.03*
ALDI	-0.81*	-2.91*	-0.56*	-0.25*	-1.27*	-0.17
Franklins	-0.32	-0.65	-0.28	-0.75*	-1.21*	-0.71*
Metcash-supplied independents	-0.09	-0.46*	-0.05	-0.15	-0.38	-0.13

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors.

Individual coefficients only shown as significant if overall category is significant. Where significant the individual coefficients indicate the percentage price differences relative to the baseline of Coles stores without the competing store within 5 km.

^ denotes that individual coefficient is statistically insignificant at the 5 per cent level but that the overall factor of the distance to the nearest store of this type is statistically significant at the 5 per cent level.

**Table D.14 Estimated effects of an ALDI supermarket within 5 km on Woolworths local store pricing: Items Woolworths price check with ALDI**

Dependent variable: APD		All Products			Dry groceries	
		All	ALDI price check items	Non-ALDI price check items	All	ALDI price check items
ALDI store within						
<b>Using price data for the week ending 18 May 2008</b>						
Joint significance?	Yes	No	Yes	No	No	No
0–1 km	-0.29*	-0.02	-0.31*	-0.01	-0.05	-0.01
1–3 km	-0.16*	0.06	-0.18*	0.02	0.04	0.02
3–5 km	-0.02	-0.01	-0.02	0.01	-0.01	0.01
<b>Using price data for the week ending 28 October 2007</b>						
Joint significance?	Yes	Yes	Yes	Yes	Yes	Yes
0–1 km	-0.45*	-2.63*	-0.32*	-0.18*	-2.59*	-0.06*
1–3 km	-0.25*	-2.39*	-0.13	-0.16*	-2.37*	-0.05
3–5 km	-0.02	-1.48*	0.07	-0.08*	-1.42*	-0.01
<b>Using price data for the week ending 25 March 2007</b>						
Joint significance?	Yes	Yes	Yes	Yes	Yes	No
0–1 km	-0.75*	-5.06*	-0.50*	-0.18*	-2.68*	-0.05
1–3 km	-0.46*	-4.61*	-0.23*	-0.15*	-2.47*	-0.03
3–5 km	-0.19*	-2.78*	-0.04	-0.09*	-1.48*	-0.02
<b>Using price data for the year ending 31 December 2007</b>						
Joint significance?	Yes	Yes	Yes	Yes	Yes	No
0–1 km	-0.67*	-4.02*	-0.49*	-0.18*	-2.57*	-0.06
1–3 km	-0.33*	-3.65*	-0.15	-0.13	-2.34*	-0.03
3–5 km	-0.13	-2.18*	-0.02	-0.10	-1.35*	-0.03

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors.

Individual coefficients only shown as significant if overall category is significant. Where significant the individual coefficients indicate the percentage price differences relative to the baseline of Woolworths stores without the competing store within 5 km.

**Table D.15 Estimated effects of an ALDI supermarket within 5 km on Coles local store pricing: Items Coles price check with ALDI**

<b>Dependent variable: APD</b>						
<b>ALDI store within</b>	<b>All Products</b>			<b>Dry groceries</b>		
	<b>All</b>	<b>ALDI price check items</b>	<b>Non-ALDI price check items</b>	<b>All</b>	<b>ALDI price check items</b>	<b>Non-ALDI price check items</b>
<b>Using price data for the week ending 18 May 2008</b>						
Joint significance?	Yes	Yes	Yes	Yes	Yes	No
0–1 km	–0.55*	–3.89*	–0.41*	–0.21*	–4.50*	–0.06
1–3 km	–0.38*	–3.19*	–0.26*	–0.09	–3.73*	0.04
3–5 km	–0.36*	–2.85*	–0.25*	–0.12	–3.36*	–0.01
<b>Using price data for the week ending 28 October 2007</b>						
Joint significance?	Yes	Yes	Yes	Yes	Yes	No
0–1 km	–0.79*	–5.45*	–0.60*	–0.24*	–6.45*	–0.02
1–3 km	–0.43*	–4.28*	–0.27*	–0.20*	–5.09*	–0.02
3–5 km	–0.51*	–3.74*	–0.38*	–0.17*	–4.25*	–0.02
<b>Using price data for the week ending 25 March 2007</b>						
Joint significance?	Yes	Yes	Yes	No	Yes	No
0–1 km	–1.00*	–5.78*	–0.84*	–0.30	–5.74*	–0.10
1–3 km	–0.72*	–4.84*	–0.59*	–0.34	–4.67*	–0.18
3–5 km	–0.58*	–4.04*	–0.46*	–0.29	–3.81*	–0.16
<b>Using price data for the year ending 31 December 2007</b>						
Joint significance?	Yes	Yes	Yes	Yes	Yes	No
0–1 km	–0.81*	–5.15*	–0.65*	–0.25*	–5.95*	–0.04
1–3 km	–0.54*	–4.25*	–0.41*	–0.24	–4.98*	–0.07
3–5 km	–0.65*	–3.47*	–0.55*	–0.36*	–4.02*	–0.23

\* Significant at the 5 per cent level. Heteroskedasticity robust standard errors.

Individual coefficients only shown as significant if overall category is significant. Where significant the individual coefficients indicate the percentage price differences relative to the baseline of Coles stores without the competing store within 5 km.

**Table D.16 Definition of variables**

<b>VARIABLE</b>	<b>DEFINITION</b>	<b>SOURCE</b>
Distance to competitors	For a given store, the distance in kilometres to the nearest store (>1000 m <sup>2</sup> ) of a particular type. This is coded by dummy variables. The dummy variable for 0-1km takes the value of 1 when the distance is between 0 and 1 km and takes the value of 0 otherwise. Dummy variables 1-3 km and 3-5 km are coded analogously. The baseline is a distance greater than 5 km.	MapInfo
Distribution centre	Each store is supplied by a particular distribution centre. These distribution centres were represented by dummy variables relative to the baseline case of the NSW distribution centre.	MSC
CBD/Metro/ Provincial/Rural	Geographic area classification. Coded as dummy variables relative to the baseline of rural stores.	MapInfo
Remote stores	Dummy variables for groups of stores treated as remote in the analysis. For Woolworths this is based on a list supplied by Woolworths. For Coles this is based on an ACCC assessment of Coles pricing zones. In each case the dummy variable for each remote store group takes the value of 1 for that remote store group and takes the value of 0 otherwise.	MSC
Tasmania	Dummy variable equal to 1 if the store is located in Tasmania and equal to 0 otherwise.	Coles
Northern Territory	Dummy variable equal to 1 if the store is located in the Northern Territory and equal to 0 otherwise.	Coles
Store trading area	For Woolworths this is "net trading area in m <sup>2</sup> ". For Coles this is "Selling area (excluding liquor) m <sup>2</sup> ".	MSC
Opened in previous month	This is a dummy variable equal to 1 if the store was opened in the month before the start of the time period of analysis and equal to 0 otherwise.	MSC
Proportion Australian born	Calculated from ABS data as the total persons born in Australia divided by the sum of the total persons born in Australia and the total persons born elsewhere.	ACCC calculation using ABS data
Proportion 65 years or older	Calculated from ABS data as the sum of total persons in the age groups: 65-74, 75-84 and 85 years and over; divided by total persons.	ACCC calculation using ABS data
Persons per sq km	Calculated from ABS data as the total persons divided by the area of the postal area in square kilometres.	ACCC calculation using ABS data
Average household size	The number of persons usually resident in occupied private dwellings.	ABS
Median household income	The median income of occupied private dwellings.	ABS
Unemployment rate	The number of unemployed persons expressed as a percentage of the total labour force.	ABS
Avge motor vehicle/ dwelling	Calculated as total number of motor vehicles, excluding motorbikes or scooters, divided by the total number of dwellings responding to the question. The total number of motor vehicles is derived from ABS data by multiplying the number of dwellings with "X' motor vehicles per dwelling" by 'X' and summing the results. Dwellings with "4 or more" motor vehicles were assumed to have "4 motor vehicles".	ACCC calculation using ABS data
Median weekly rent	The median weekly rent for an occupied private dwelling being rented.	ABS

<b>VARIABLE</b>	<b>DEFINITION</b>	<b>SOURCE</b>
Near co-branded petrol	For a given store, the distance in kilometres to the nearest co-branded petrol station. This is coded by dummy variables. The dummy variable for 0–1km takes the value of 1 when the distance is between 0 and 1 km and takes the value of 0 otherwise. Dummy variables 1–3 km and 3–5 km are coded analogously. The baseline is a distance greater than 5 km.	MapInfo

Sources: MapInfo refers to geographical information sourced under contract from MapInfo.  
 ABS refers to ABS 2006 Census of Population and Housing Basic Community Profile Release 2, cat no: 2069.0.30.001.  
 MSC refers to information supplied by MSCs under s. 95ZK of the Act.

# Appendix E:

## The wholesaling industry in Australia

In 1992 there were nine wholesalers that operated throughout Australia, generally on a state-wide basis rather than a national basis.<sup>1</sup> Currently there is one national wholesaler, Metcash.

A series of transactions, many of which have involved consideration by the ACCC, Federal Court and Trade Practices Tribunal (now the Australian Competition Tribunal), have been part of the development of Metcash as the only national wholesaler to independent supermarkets.

In 1992, Davids, a wholesaler of grocery items operating on the east coast of Australia, sought to acquire Queensland Independent Wholesalers (QIW). Davids intended the merged QIW/Davids Queensland entity to operate in the area serviced separately by QIW and Davids Queensland. The Trade Practices Commission (now the ACCC) decided not to intervene, even though acknowledging that the decision was ‘finely balanced’. The TPC stated that ‘the indirect competitive effect of wholesaling functions performed by major retail chain stores (mainly impacting indirectly through their retail prices) could not be ignored.’ The TPC decision triggered intervention by the Attorney-General of the Commonwealth<sup>2</sup>, who decided to seek an injunction restraining Davids from acquiring or offering to acquire directly or indirectly any share or assets of QIW, on the basis that each acquisition would contravene s. 50<sup>3</sup> of the *Trade Practices Act 1974* (the Act). The matter was considered by Justice Spender of the Federal Court.<sup>4</sup> He found that the acquisition would breach s. 50.

Justice Spender found that there was a market for the supply of wholesale groceries to independent retailers and post-merger, Davids would dominate that market. Justice Spender stated that:

What actually occurred when Davids entered into Australia [sic] in 1986 is instructive. The effect of that entry was to significantly lower prices. In an industry where the margins are generally very small, the lowering of prices was in the order of 2 to 3 per cent—a dramatic reduction. This experience on the evidence is mirrored in the position in Western Australia and I think it right to conclude that the margin charged by F.A.L. has resulted in the invitation by some independent retailers to Independent Holdings Limited to enter that market.<sup>5</sup>

The court declared that the proposed acquisition by Davids as lodged with the Australian Securities Commission on 17 June 1992 would be in contravention of s. 50 of the Act.

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1 Jewel Food Stores Group, Independent Holdings, John Lewis Foodservice, Campbells Cash & Carry, QIW, Composite Buyers, AIW, and Foodland Association Ltd and Davids Holdings.

2 See further *Attorney-General of the Commonwealth v Davids Holdings Pty Ltd & Anor* (no. 1) (1993) ATPR 41-210; *Attorney-General of the Commonwealth v Davids Holdings Pty Ltd & Anor* (no. 2) (1993) ATPR 41-211; *Attorney-General of the Commonwealth v Davids Holdings Pty Ltd & Anor* (no. 3) (1993) ATPR 41-212; *Attorney-General of the Commonwealth v Davids Holdings Pty Ltd & Anor* (no. 4) (1993) ATPR 41-213; *QIW Retailers Limited v Davids Holdings Pty Limited & Ors*; *Attorney General of the Commonwealth v Davids Holdings Pty Limited & Anor* (1993) ATPR 41-226.

3 Section 50, at the time, provided that an acquisition is prohibited if the acquirer ‘would be in a position to dominate the market’.

4 *QIW Retailers Limited v Davids Holdings Pty Limited & Ors*; *Attorney General of the Commonwealth v Davids Holdings Pty Limited & Anor* (1993) ATPR 41-226.

5 *QIW Retailers Limited v Davids Holdings Pty Limited & Ors*; *Attorney General of the Commonwealth v Davids Holdings Pty Limited & Anor* (1993) ATPR 41-226, p. 41145.

The decision was appealed and on 22 April 1994 the Full Federal Court<sup>6</sup> upheld the trial court decision affirming that:

There was clearly substitution by independent retailers in northern New South Wales and Queensland between Davids and QIW as their source of supply.<sup>7</sup>

In 1995 Davids sought to acquire Composite Buyers Limited. Composite Buyers Limited was a Victorian-based wholesaler to the independent sector. The ACCC authorised the proposed acquisition but that decision was appealed by QIW to the Trade Practices Tribunal. The tribunal affirmed the ACCC's decision to authorise the transaction. In the tribunal decision, the market was defined differently to the market defined in the Davids-QIW Federal Court cases. The tribunal found that the relevant market was not a market for the supply of wholesale groceries to independent stores but a national market for the distribution of grocery products to the consuming public via integrated retail chains and independent wholesalers supplying independent retailers. The tribunal found that:

... there is an Australia-wide or national market for the distribution of grocery products to the consuming public via integrated retail chains and independent wholesalers supplying independent retailers.<sup>8</sup>

This decision was critical, in that the key finding was that the major supermarket chains (MSCs) (which then included Franklins) constrained Davids, even though the MSCs did not have any significant role in the supply of groceries to independent retail stores and did not represent an alternative source of supply for independent retailers. The tribunal considered that constraint occurred because if Davids attempted to increase the price it supplied independent retail stores, those independent stores would then lose sales at the retail level to the MSCs. In this way, the MSCs constrained Davids' pricing to the independent stores. Consequently the tribunal authorised Davids to acquire Composite Buyers Ltd.

In 1996 the ACCC authorised the acquisition of QIW by Davids Holdings. The ACCC adopted the same approach as the tribunal in the Davids-Composite Buyers matter in making this decision.

Following this acquisition, with the exception of a minor wholesaler in the Australian Capital Territory and Australian Independent Wholesalers (AIW), which was operated by Woolworths, Davids was the dominant wholesaler on the east coast of Australia.

In December 1997 Davids sold around 15 per cent of the company to South Africa's Metro Cash & Carry (Metcash). Metcash continued to build up its stake in Davids, eventually holding more than 72 per cent of shares. Davids changed its name to Metcash in 2000.

## AIW

In April 2002 Woolworths wholesaling business, AIW, which supplied some independent stores, ceased its operations. One of AIW's key customers had been FoodWorks. When FoodWorks left AIW and moved its account to Metcash, the business became untenable for Woolworths. Metcash noted in its submission that:

As a result of a decision by FoodWorks to use Metcash as its primary supplier in 2002, AIW made a strategic decision to close its operations and sell its Queensland warehouse to Australian Retail Logistix Limited. As FoodWorks was the major customer of AIW, this resulted in significant losses in economies of scale that undermined the viability of AIW.<sup>9</sup>

6 *Davids Holdings Pty Limited & Ors v Attorney-General of the Commonwealth & Anor* (1994) ATPR 41-304.

7 *Davids Holdings Pty Limited & Ors v Attorney-General of the Commonwealth & Anor* (1994) ATPR 41-304, p. 42067.

8 Re: QIW application for review of a determination of the trade practices commission dated 29 May 1995 to grant an authorisation to Davids Ltd for the proposed acquisition of Composite Buyers Ltd.

9 Metcash, submission no. 181, 11 April 2008, p. 19.

## FAL

Foodland Associated Limited (FAL) had wholesale grocery operations and distribution centres in Western Australia and had expanded into Queensland. In Western Australia, FAL provided wholesaling services to independent supermarkets in addition to operating its own Action supermarkets. FAL also operated Action supermarkets in Queensland and northern New South Wales.

In 2005 FAL, Metcash and Woolworths announced that they had negotiated and agreed to the acquisition of FAL's businesses by Woolworths and Metcash. The proposed transaction would result in the acquisition by Metcash of FAL's franchise and wholesale supply operations and 60 Action stores. It also resulted in the acquisition by Woolworths of the FAL New Zealand business and 22 Action stores and development sites (16 in Western Australia, five in Queensland and one in northern New South Wales). On 27 January 2006 the ACCC indicated that it would not challenge the proposed acquisition of FAL, including Action stores, by Metcash.



## Appendix F:

### ACCC public reviews of mergers and acquisitions in grocery retailing since 2005

Since 2005 the ACCC has publicly reviewed 11 transactions resulting in the acquisition of a total of 88 supermarkets, three development sites and one wholesale grocery business. During the same period, the ACCC also assessed two proposed mergers on a confidential basis, involving the acquisition of two supermarkets.

Year	Acquirer	Target	No. of supermarkets/ wholesale businesses
2005	Metcash	Foodland	82 supermarkets (actually acquired 61) Foodland's Western Australia wholesale grocery business
	Woolworths	22 Foodland stores and development sites	19 stores; 3 development sites (actually acquired 18 stores and 3 development sites) <sup>1</sup>
	Coles Myer	Action supermarket, Busselton (WA)	1
	Woolworths	Eli Foodworks, Hervey Bay (Qld)	1
2006	Woolworths	Nardi's Foodworks, Bannockburn (Vic)	1
2007	Woolworths	Roger and Dale's IGA, Thurgoona (NSW)	1
	Woolworths	Supa IGA, Capalaba (Qld)	1
	Woolworths	Festival Jindabyne IGA (NSW)	1
2008	Woolworths	Mallam's Spar supermarket (NSW)	1
	Woolworths	Ritchies Super IGA, Kelvin Grove (Qld)	1
	Woolworths	Karabar Superbarn, Queanbeyan (NSW)	1

<sup>1</sup> Woolworth's had intended to acquire 22 Action stores, but decided not to proceed with the acquisition of the Spearwood store in Western Australia. Metcash ultimately acquired the Spearwood store.



# Appendix G:

## Matters taken by the ACCC under parts IV and V of the Trade Practices Act involving grocery retailers since 1999

### Woolworths Limited and Liquorland (Australia) Pty Ltd <sup>1</sup>

On 27 June 2003, the ACCC instituted legal proceedings in the Federal Court against Woolworths and Liquorland (a wholly owned subsidiary of Coles Group Ltd) for allegedly entering into and giving effect to anti-competitive agreements. The ACCC alleged that the conduct arose in circumstances where Woolworths and Liquorland objected to certain liquor licence applications by other parties and then proposed restrictive agreements with those parties aimed at limiting the extent to which the parties would compete with Woolworths and Liquorland, in return for withdrawing their objections.

On 31 May 2005, Liquorland admitted that it had entered into illegal agreements with five applicants for liquor licences and was subsequently penalised \$4.75 million by the Federal Court. On 30 June 2006, the Federal Court found that four agreements entered into by Woolworths with liquor licence applicants contravened s. 45 of the *Trade Practices Act 1974* (the Act). On 22 December 2006, the Federal Court imposed pecuniary penalties totaling \$7 million on Woolworths.

### Australian Safeway Stores Pty Ltd <sup>2</sup>

On 23 December 1996, the ACCC instituted legal proceedings in the Federal Court against Australian Safeway Stores Pty Ltd alleging that the company had a policy of removing a particular baker's products from sale when their products were on special at nearby independent stores. The ACCC alleged that the conduct of Safeway in 10 separate incidents involved, amongst other things, price fixing and misuse of market power.

On 21 December 2001, following a 92-day trial held in 1999, the Federal Court handed down its decision dismissing the ACCC's proceedings against Safeway.

The ACCC appealed to the Full Federal Court, which on 30 June 2003 unanimously agreed that the ACCC had established that Safeway had engaged in price fixing of bread to be sold at the Tip Top bakery store located in Preston Market. The majority of the court also found that Safeway had misused its market power in four of nine incidents pleaded.

Both the ACCC and Safeway sought special leave of the High Court for appeal of the Full Court decision. The High Court declined to entertain an appeal instead returning the matter to the Federal Court for determination of the contraventions found by the Full Federal Court. On 31 January 2006, a penalty of \$8.9 million was imposed on Safeway for fixing the price of bread and misusing its market power.

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<sup>1</sup> ACCC, *Woolworths penalised \$7 million for anticompetitive liquor deals*, media release, 22 December 2006.

<sup>2</sup> ACCC, *\$8.9 million penalty on Safeway for price fixing and misuse of market power in bread market*, media release, 31 January 2006.

## Woolworths (SA) Pty Ltd, Arnhem Club Incorporated and Rhonwood Pty Ltd<sup>3</sup>

On 11 December 2002, the ACCC instituted legal proceedings in the Federal Court against Woolworths, Rhonwood Pty Ltd (trading as the Walkabout Tavern) and the Arnhem Club, alleging that they had breached the price-fixing provisions of the Act in the market for takeaway alcohol in Nhulunbuy, Northern Territory, by agreeing to stop discounting those products.

On 16 December 2002, Woolworths and the Arnhem Club made court enforceable undertakings to the ACCC to donate \$300 000 to establish a service to address alcohol-related problems in Nhulunbuy. On 30 May 2003 the Federal Court made orders against Woolworths SA and the Arnhem Club, including restraining them from making or giving effect to arrangements regarding the price of certain takeaway alcohol beverages in Nhulunbuy. Woolworths and the Arnhem Club also admitted they had breached the price-fixing provisions of the Act and paid the ACCC's costs.

On 10 March 2004 Walkabout Tavern consented to court orders and gave a court enforceable undertaking to provide \$85 000 towards alcohol rehabilitation in the Nhulunbuy area.<sup>4</sup>

## Woolworths Ltd<sup>5</sup>

On 30 October 2001, the ACCC instituted legal proceedings in the Federal Court alleging false, misleading and deceptive conduct in Woolworths' newspaper advertising on the origin of its beef.

On 12 August 2002, the Federal Court ruled that advertisements entitled 'Beefing up the local economy' published by Woolworths mislead consumers as to the beef sold in some regional supermarkets in New South Wales being sourced from cattle in the north west New South Wales and New England regions in contravention of s. 53(eb) of the Act.

The Federal Court also declared that Woolworths had engaged in misleading and deceptive conduct in contravention of s. 52 of the Act regarding this beef, as well as regarding the grain used to feed the cattle.

The ACCC requested corrective advertising and injunctive orders against Woolworths; however, the Federal Court declined to grant these orders as the advertising was for a one-off event that occurred 18 months earlier. The Federal Court considered that, given the time that had passed since the advertisements were made, the misleading aspects of the advertisements had diminished. The Federal Court was also satisfied that Woolworths did not intend to repeat the advertisements.

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3 ACCC, *Federal Court makes orders against Woolworths and Arnhem Club over alcohol sales*, media release, 30 May 2003.

4 ACCC, *Additional \$85 000 for alcohol rehabilitation funding following court decision on N.T. price fixing agreement*, 10 March 2004.

5 ACCC, *Federal Court declares Woolworths beef advertising false and misleading*, media release, 21 August 2002.

## Franklins Supermarkets<sup>6</sup>

In August 2000, the ACCC finalised an investigation into overcharging on GST-free goods by Franklins. Franklins had inadvertently charged GST on 17 GST-free goods because of errors in its pricing systems; the goods included No Frills Weetbixs, No Frills Orange Juice, No Frills Apple Juice and Peats Ridge Natural Water.

As a result of the intervention, Franklins agreed to a number of remedies and the ACCC decided to take no further action. The remedies included full customer refunds, advertisements advising consumers of the overcharging, the development of a policy for handling any future GST problems and a three-week period in which the products were available at an 11 per cent discount.

## Coles Myer Ltd <sup>7</sup>

In November 1999, the ACCC concluded an investigation into the accuracy of representations made by Coles in relation to its Coles' Dollar Dazzlers 21st Birthday competition. The investigation followed consumer complaints that Coles had misrepresented the true value of the FlyBuys prizes offered as part of the competition. Following the ACCC's investigation Coles wrote to all 21 winners of FlyBuys points to apologies for the mistake and to provide each winner with an additional 399 000 points to bring the value of each prize to the worth stated on the competition entry form, \$4200. The valuation of other prizes on offer was not at issue.

Coles also put into place new checking and accountability procedures for the running of competitions.

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<sup>6</sup> ACCC, *Franklins Supermarkets*, media release, 3 August 2000.

<sup>7</sup> ACCC, *Coles corrects Dollar Dazzlers Competition*, media release, 16 November 1999.



# Appendix H:

## Collective bargaining

### What is collective bargaining?

Collective bargaining refers to an arrangement where two or more competitors in an industry come together to negotiate terms and conditions (which can include price) with a supplier or a customer. Collective bargaining arrangements will ordinarily raise concerns under the *Trade Practices Act 1974* (the Act) as they involve agreements between competitors, often relating to price.

However, in some circumstances collective bargaining arrangements may produce public benefits. The Act therefore allows immunity from legal action to be granted to parties to engage in collective bargaining when in the public interest.

In particular, it is recognised that small businesses face challenges when negotiating with larger businesses. At times, small businesses may feel that they have little or no bargaining power in their dealings with big business and little influence on terms and conditions, including prices.

It has been recognised that small businesses are often more likely to be heard on terms and conditions if they join together with other small businesses to collectively negotiate with a larger business, rather than one on one.

Immunity from the Act for collective bargaining arrangements can be obtained through an authorisation granted by the ACCC or through lodging a collective bargaining notification.

### Authorisation

The ACCC may authorise businesses to engage in anti-competitive arrangements or conduct when it is satisfied that the public benefit from the arrangements or conduct outweighs any public detriment.

The ACCC conducts a comprehensive public consultation process, inviting interested parties to comment on the merits of the application before making a decision to grant or deny authorisation.

Before issuing a final decision, the ACCC must issue a draft decision stating whether or not it proposes to grant authorisation, setting out reasons for its proposed decision. The applicant(s) and interested parties will then be invited to respond to the draft determination either with further submissions or by calling a pre-decision conference. Following careful consideration of the further information provided by the applicant(s) and interested parties, the ACCC will then issue a final determination which may grant authorisation, grant authorisation subject to certain conditions or deny authorisation.

Amendments to the Act, which came into effect on 1 January 2007, placed a six-month time limit on the ACCC's consideration of applications for authorisation and enable the ACCC to waive, in whole or in part, the lodgment fees for non-merger authorisations.

### Streamlined collective bargaining authorisation process

In 2006 the ACCC introduced a streamlined authorisation process for collective bargaining by small businesses. Under this process, the ACCC undertakes to issue a draft determination within 28 days of

receiving an application for authorisation and issue a final determination within three months of receiving the application.

For further information about the expedited authorisation process for collective bargaining arrangements, please consult the ACCC's short guide, *Streamlined collective bargaining processes for small businesses: more timely decisions/greater certainty of outcomes*.

For further information about the authorisation process, please consult the ACCC's *Guide to authorisation*.

## Collective bargaining notification process

In 2007 the Act was amended to provide an expedited process for small businesses to obtain immunity from legal action under the Act for collective bargaining arrangements by lodging a collective bargaining notification with the ACCC.

The immunity provided by a collective bargaining notification commences automatically 28<sup>1</sup> days after the notification is lodged and lasts for three years. The ACCC is able to remove the protection from legal action at any time if it is satisfied that the proposed collective bargaining arrangement is not in the public interest.

A collective bargaining notification can be lodged by a business within a collective bargaining group, or a nominated representative which is not a member of the collective bargaining group—for example, an industry association. However all members of the group must be identified at the time a notification is lodged and must reasonably expect to enter into a contract with the target where the value of the transactions under the collective arrangement are under \$3 million per annum.<sup>2</sup>

Upon receiving a valid collective bargaining notification the ACCC will contact interested parties, including the target, and invite submissions on the proposed arrangements.

The ACCC will then assess the proposed collective bargaining arrangement, weighing the public benefit likely to result from the arrangement against the potential public detriment. If the ACCC is satisfied that the public benefit will not outweigh the public detriment, it can remove the immunity provided by the notification.

For more information about collective bargaining notifications, please consult the ACCC's *Guide to collective bargaining notifications*.

## ACCC assessment of collective bargaining arrangements

While each proposal raises its own issues, there are public benefit and public detriment arguments common to many collective bargaining arrangements. The main public benefit arguments considered by the ACCC in its past consideration of collective bargaining arrangements are:

- increased input into contracts—providing a mechanism through which small businesses can provide greater input into their contracts, leading to improved efficiencies

1 After 31 December 2008 immunity from a collective bargaining notification will commence after 14 days.

2 The threshold amount has been varied for certain industries. For example the threshold for primary production is \$5 million per annum.

- transaction cost savings—where the cost of negotiations, for both the members of the collective bargaining group and the supplier or customer with whom they propose to negotiate, may be reduced
- improvements in information—providing a framework in which the flow of relevant information to both sides of the negotiation table is improved, leading to better informed decisions being made
- facilitation of market dynamics—enhancing the ability of the member of the collective bargaining group to supply new markets or increasing competition in their existing market.

In addition, when assessing the merits of any application the ACCC looks at various factors which may mitigate any detriment created as a result of the arrangements. These factors may include:

- the voluntary nature of the arrangements—the ACCC considers that voluntary participation by both members of the collective bargaining group and the target, whereby parties may exit the process at any time, will usually limit the detriment
- support of the target—while not necessary, a supportive target is usually more likely to facilitate productive and mutually beneficial outcomes and increase the likelihood of public benefits arising
- limited coverage—limiting such things as the number of participants in the group, the geographic area over which they trade or the number of targets with whom a collective bargaining group proposes to negotiate is likely to reduce the level of anti-competitive detriment
- absence of collective boycotts—the absence of features such as proposals to collectively withdraw goods or services.

## Recent collective bargaining authorisations and notifications

### Chicken meat growers

On 9 April 1997 the ACCC granted authorisation A90595 to Inghams Enterprises South Australian chicken meat growers to collectively negotiate the terms and conditions of growing agreements with Inghams. On 22 January 2003 the ACCC reauthorised the arrangements, subject to conditions, until 12 February 2008.

Subsequently, the ACCC has authorised a number of collective bargaining arrangements involving chicken meat growers in various states, including:

- Collective bargaining by Tasmanian chicken meat growers with Inghams. On 17 March 1999 the ACCC granted authorisation until 31 December 2004. On 19 May 2004 the ACCC reauthorised the arrangements for a further five years.
- Collective bargaining by South Australian chicken meat growers with Steggles Limited (now fully owned by Bartter) was authorised for five years on 20 May 1998 (A30183).
- Collective bargaining by Victorian chicken meat growers with various processors was granted authorisation for five years on 3 March 2005 (A90901–A90905).

### Premium Milk Ltd—A90745

On 12 December 2001 the ACCC granted authorisation allowing Premium Milk Supply Pty Ltd to collectively bargain farm gate prices and milk standards in negotiations with Pauls Limited until 1 July 2005. On 9 November 2005 the arrangements were reauthorised until 1 December 2010.

### Australian Dairy Farmers Federation—A90782

On 12 March 2002 the ACCC authorised dairy farmers to collectively bargain with dairy processors. The application was lodged by the Australian Dairy Farmers Federation (ADFF) on behalf of dairy farmers Australia wide. Authorisation was granted until 1 July 2005 subject to a number of conditions, including conditions limiting the size and scope of individual bargaining groups. On 26 April 2006 the ACCC reauthorised the arrangements for a further five years.

### Milk Vendors Association (SA) Inc.—A90927

On 27 April 2005 the ACCC authorised the Milk Vendors Association (SA) Inc, to collectively bargain on behalf of its members with National Foods Milk Ltd and Dairy Vale Foods Ltd (Dairy Farmers) regarding the terms and conditions of distribution contracts and dispute resolution services. Authorisation was granted until 19 May 2010 subject to conditions limiting common representation and sharing of information between individual bargaining groups.

### Dairy WA Limited—A90961-2

On 20 February 2006 the ACCC denied authorisation for Dairy WA Limited to establish a milk negotiating agency which would collectively bargain on behalf of dairy farmers the terms and conditions (including price) of supply and delivery of raw milk with processors and/or retailers. Having considered the information provided to it, the ACCC concluded that, if authorised, the arrangements could damage competition and industry participants, including dairy farmers themselves.

### Tasmanian Farmers and Graziers Association—A90914

On 17 November 2004 the ACCC authorised the TFGA's vegetable grower members to collectively bargain, through grower representatives on their various commodity group boards, terms and conditions of growing contracts with the processors to whom they supply, namely McCain Foods (Aust) Pty Ltd and Simplot Australia Pty Ltd. Negotiation was to occur on a commodity group by commodity group basis. Authorisation was granted until 2 December 2009.

### Victorian Potato Growers Council—A91048

On 27 June 2007 the ACCC granted authorisation to the VPGC to collectively negotiate on behalf of its current and future members the terms and conditions of contracts between VPGC members and Snackbrands Australia (Arnott's Snackfoods), McCain Foods, Smiths Snackfoods, Elders Limited and unidentified buyers of potatoes in the future. Authorisation was granted until 31 July 2012.

### South East Potato Growers Association—A91057

On 29 August 2007 the ACCC granted authorisation to SEPGA to collectively negotiate on behalf of its current and future members the terms and conditions of contracts between SEPGA members and McCain Foods and Safries. Authorisation was granted until 20 September 2012.

### Victorian Farmers Federation Victoria—A91064

On 12 December 2007 the ACCC authorised to VFF Sunraysia, and its present and future dried fruit grower members, to collectively negotiate terms and conditions (including price) of dried vine fruit with present and future dried vine fruit processors. Authorisation was granted until 3 January 2012.

## Nelson Enterprises—CB00001 and CB00002

On 23 August 2007 the ACCC released an assessment document not objecting to the notifications lodged by Nelson Enterprises. Protection afforded by the notifications allows three Queensland citrus growers to collectively negotiate the price and quantity of their supply of citrus fruit to Woolworths Limited and IGA Distribution Limited. Immunity for the notified arrangements commenced on 28 August 2007 and will cease on 31 July 2010.

## CSR Ltd—A90733

On 11 July 2001 the ACCC authorised CSR and sugar cane growers to collectively negotiate cane supply and expansion agreements at CSR's Invicta and Pioneer Sugar Mills in North Queensland for five years. Authorisation was granted until 31 July 2006.

## Non-collective bargaining authorisations and notifications concerning grocery products

### National Foods Milk Limited and Australian Co-operative Foods Limited (trading as Dairy Farmers)—A91051-3

On 13 September 2007 the ACCC authorised National Foods Limited and Australian Co-operative Foods Limited trading as Dairy Farmers to jointly tender out their raw milk transportation requirements in certain regions of South Australia. Authorisation was granted until 31 December 2014.

### AWB Ltd joint venture with GrainCorp Operations Ltd—A30233-5

On 15 April 2005 the ACCC authorised GrainCorp Operations Limited, AWB Limited and Export Grain Logistics Pty Ltd to create a joint venture to manage and coordinate the movement of their export grain in Queensland, New South Wales and Victoria. Authorisation was granted until 31 December 2009 on condition that within three months the applicants implement measures to protect confidential information provided to the joint venture by third parties.

### Woolworths Limited third line forcing notification—N93206

On 6 November 2007, Woolworths lodged a notification for conduct that may be characterised as:

- an offer by Woolworths to fresh produce suppliers of a right to earn a revenue stream on the condition that the suppliers hire plastic crates from CHEP Australia Limited
- a refusal by Woolworths to supply a revenue stream to fresh produce suppliers for the reason that the suppliers will not hire plastic crates from CHEP.

Immunity in respect of the notified conduct came into effect 14 days after the notification was lodged.

### Australian National Retailers Association—A91093

On 30 June 2008 the Australian National Retailers Association (ANRA) lodged an application seeking authorisation to conduct a pilot program, supported by the Victorian government, which will run for four weeks commencing in August 2008. Under the program, Woolworths, Coles and IGA retailers will collectively impose a charge of 10 cents per bag for lightweight plastic bags. A number of other

retailers, including FoodWorks, Target and Kmart, may also participate in the pilot program. The conduct will occur in three locations in Victoria: Fountain Gate Shopping Centre in Narre Warren and surrounds; Wangaratta and surrounds; and Warrnambool and surrounds.

ANRA is also seeking authorisation to allow for the dissemination of information and data obtained from the pilot program to ANRA and its members, any other retailers that participate in the pilot program, the Victorian government and the Environment Protection and Heritage Council.

On 17 July 2008, the ACCC issued a draft determination proposing to grant authorisation in respect of ANRA's application until 30 November 2008. The ACCC also decided to grant interim authorisation, to commence from 1 August 2008.

# Appendix I:

## The traditional concept of buyer power—monopsony power

In the economic literature, the first conception of buyer power is buyer market power, which is the ‘classic textbook’ definition of ‘monopsony’ (or ‘oligoposony’) market power.<sup>1</sup>

In the typical characterisation<sup>2</sup> of the monopsony power framework, buyer power is analysed as occurring in the context of a market relationship between buyers and sellers of a particular good or service. Trading of the good or service takes place in a single market context—that is, all sellers sell into, and all buyers buy from, a single market at a market price.<sup>3</sup> A single (monopsony) buyer, or a small number of concentrated (oligoposony) buyers, has market power in the purchase of the good or service. The buyer (or buyers, in the case of oligoposony) is able to exercise market power as a buyer, through its concentration on the demand-side of the market interface, against the sellers on the supply-side. The single buyer is, by virtue of this market power as a buyer, able to affect the price/conditions on which it buys inputs from the sellers in the market.

The buyer will typically (by virtue of it being a single buyer) face an upward-sloping supply curve. It will therefore be able to exercise its buyer market power by reducing the quantity of the item purchased—that is, withholding demand for the item—and thereby decreasing the price it pays for the item.

It is in this context and framework that buyer market power has been described as being ‘the ability to profitably set wages (or any input prices) below competitive levels’.<sup>4</sup> It has further been said that such a concept of buyer power as monopsony power is ‘simply the flip side of monopoly ... in both situations, a single firm recognizes that its actions affect the market price’.<sup>5</sup>

## Implications of monopsony power as a model of buyer power

There are a number of implications that arise from a monopsony power conception of buyer power in a market context.

Firstly, in this context a powerful buyer facing a number of less powerful sellers in a market framework can influence the price of the item in its favour. The powerful buyer, facing an upward-sloping supply curve, does this by withholding (decreasing) demand for the item. The decrease in the market quantity traded in the item brings about a restriction in the market price of the item.

Secondly, because (in this framework) trade in the item occurs in a market context, a reduction in price through a reduction in demand decreases the market price for all units traded of the good or service—that is, for all buyers and sellers of the item—and not just for the units purchased by the powerful buyer which withholds demand. For instance, in a market where there is one powerful buyer and a number

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1 Monopsony in the economic literature refers to where there is a single buyer in a market, who thereby has buyer market power (monopsony power). Oligoposony refers to where there are a small number of buyers in a market, one or more of which has buyer market power (oligoposony market). In this appendix hereafter, monopsony power and oligoposony power are jointly referred to as monopsony power, for the sake of ease of exposition. All references to monopsony power can therefore be understood as also applying conceptually to oligoposony situations.

2 See, for example, D Carlton and J Perloff, *Modern Industrial Organization*, Scott Foresman, Glenview IL, 1989.

3 This is in contrast to the series of many individual bilateral relationships that characterise the bilateral relationships view that is outlined in chapter 14 and which, in the ACCC’s view, better characterises grocery supply in Australia.

4 *Ibid.*, p. 116.

5 *Ibid.*, p. 114.

of other smaller buyers (who don't have market power) who jointly purchase from a number of small sellers, if the powerful buyer decreases demand, this will decrease the market price faced by all buyers, including the other smaller buyers who themselves do not have market power.

## Limitations of monopsony power as a model of buyer power

A monopsony power concept of buyer power can be useful when considering and analysing the interaction of a number of suppliers and a single buyer (or small number of large buyers) that interact in a wholesale market situation.

There are, however, several important limitations to the use of monopsony power as an analytical model of buyer power in grocery retail.

Firstly, the monopsony power model is underpinned by the assumption that trade takes place in a wholesale market framework resulting in a single trading price. It is not clear, however, that this adequately describes the structure of the upstream supply chain in the grocery retail market. Observation of this market bears out that many or most supplies to grocery retailers are purchased in the context of a range of bilateral one-on-one relationships between the suppliers and the buyers (that is, the grocery retailers), and that few grocery supplies are traded in wholesale commodity-style markets at single trading market prices.

Secondly, the monopsony power model implies that the principal means by which a buyer can drive down upstream prices is by withholding demand—that is, by purchasing lesser quantities of the input. The implication is that an exercise of buyer power would be observed in the market as a reduction in both the price and the quantity traded. However, empirical observation of grocery supply markets tends to show that, although input prices may be lower as a result of buyer market power, this is often not accompanied by any reduction in the quantity of the product traded. Rather, lower input prices are often accompanied by no reduction in input quantities traded. The monopsony power model of buyer power therefore is often not supported by the empirical observations.

Monopsony power can be a powerful tool for analysing buyer power where there are a number of sellers and one single buyer (or at least one powerful buyer) and trading occurs in a market environment and at a unified market price. There are, however, quite strong limitations to the applicability of the monopsony power model in the analysis of buyer power in many or most upstream market in grocery retail industry, as many of these markets are not well described by the single market interface model, either in terms of the structural characteristics of the markets or in terms of the empirical results that such a model would predict and the empirical results that are actually observed.

## Conclusion

Bargaining power is probably the better way to analyse buyer power in supplier-retailer relationships in the grocery industry

A bilateral bargaining power conception of buyer power is likely to be more appropriate for most retail buyer-seller relationships than a wholesale market monopsony power model of buyer power. Firstly, most retail supply more closely resembles a series of bilateral relationships rather than unified wholesale markets and, secondly, a bilateral bargaining framework more closely fits the empirical observation that lower retail input prices are not necessarily accompanied by lower quantities traded.

This inquiry therefore adopts, in most instances, a bilateral bargaining power model to analyse buyer power in grocery retail.

### A simple theoretical bargaining model

The bargaining model of buyer power is best illustrated by means of a simple example—a very simple, stylised bargaining setting.

Two parties, the seller, S, and the buyer, B, are negotiating over the sale price of an item.<sup>6</sup> If the deal is completed, the mutual benefit from the trade gives rise to a joint gross surplus (or profit) that S and B can jointly realise. This joint gross surplus has the value Z.

The question is: how will S and B divide this joint surplus Z between them? The key concept in the economic theory of bargaining is the notion of the ‘outside option’ pay-off, or the value of the next best alternative outcome that each party, S and B, can achieve if they walk away from the deal—for example, by finding the best alternative buyer or seller. The value of these outside walk away options can be regarded as the minimum that the respective parties will accept in bargaining between S and B.

To continue with the simple stylised example, let the values of these best outside options be  $V_S$  and  $V_B$  for S and B, respectively. This means that the joint net profit from the deal, shared between S and B, will be  $Z - V_S - V_B$ .

The amount of this joint net profit that each party will receive will be determined by way of negotiation between them. The relative bargaining power of each party, S and B, will significantly determine this outcome.

If S and B share the joint net surplus equally,<sup>7</sup>

- S will receive the value  $V_S + 0.5(Z - V_S - V_B) = 0.5(Z + V_S - V_B)$

- B will receive  $V_B + 0.5(Z - V_S - V_B) = 0.5(Z + V_B - V_S)$ .

Further, if one of the parties has greater relative bargaining power, then that party will be able to capture a commensurately greater share of the joint net surplus.

6 This example closely follows the similar example provided in R Inderst and N Mazzarotto, ‘Buyer power in distribution’, chapter in ABA Antitrust Section Handbook, *Issues in Competition Law and Policy*, W.D. Collins, forthcoming.

7 This is technically known in economic theory as the symmetric Nash Bargaining Solution. See for example KG Binmore, A Rubinstein and A Wolinsky, ‘The Nash bargaining solution and economic modelling’, *Rand Journal of Economics*, vol. 17, 1986, pp. 176–88.



# Appendix J:

## Shopper docket arrangements notified to the ACCC

### Types of shopper docket arrangements

Since their introduction in 1996, shopper docket arrangements have evolved from requiring a minimum purchase of groceries from a particular supermarket to a variety of other arrangements as described below:

- Grocery—discounted petrol may be tied to the purchase of a minimum amount of groceries from a specific supermarket or a specific supermarket chain or any supermarket or supermarket chain. Any of these arrangements may involve the major supermarket chains or independent stores or both. For example, in 1997 a number of notifications were lodged by individual service stations that offered to provide a discount on petrol when presented with a docket from any supermarket.
- Grocery plus—an additional discount on petrol may be tied to the purchase of a minimum amount of groceries and, for example, the use of a particular credit card to pay for the petrol or the presentation of a docket from a liquor outlet associated with the supermarket (or supermarket chain) from which the groceries must be purchased. This category also includes arrangements whereby the fuel voucher obtained as a result of a grocery purchase may be redeemed for a benefit other than a fuel discount, such as FlyBuys points. It is common for these types of arrangements to only be offered for a short time as an addition to an existing grocery arrangement.
- Other retailers—discounted petrol may be tied to the purchase of a good or service from a particular retailer (other than a supermarket) or retail location. For example, notifications have been lodged concerning initial purchases from video stores, butchers, hotels, automotive repair shops, greengrocers, hotels and building societies. The more comprehensive schemes involving independent service stations, such as the Servo Savers scheme, also generally involve other retailers.
- Petrol companies—a discount on petrol may be tied to the purchase of another good or service at the service station. For example, notifications have been lodged concerning the purchase of a carwash or the purchase of items from the on-site convenience store.

### Notifications

The first shopper docket notifications were lodged in 1996 by Australian Independent Retailers Pty Ltd (AIR) and related to Woolworths' entry into petrol retailing.<sup>1</sup> The arrangements concerned the offer by AIR of discounted petrol to customers buying at least \$30 of groceries or other products from Woolworths and Safeway supermarkets and Big W stores. In 2001 AIR and Woolworths lodged a further two notifications concerning the offer of discount petrol to customers buying a nominated product or products of not less than a nominated value from Woolworths and Safeway supermarkets and Big W stores.

Coles first notified its shopper docket arrangements in 2003 when Eureka Operations Pty Ltd<sup>2</sup> (Eureka) proposed to provide a discount in relation to the supply of petroleum products on condition that the

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<sup>1</sup> AIR is a wholly owned subsidiary of Woolworths Limited.

<sup>2</sup> Eureka is a wholly owned subsidiary of CML and trades as Coles Express.

customer has acquired goods of a specified value from Coles Supermarkets, BI-LO or Liquorland.

Coles and Woolworths have lodged additional notifications concerning extensions to their existing shopper docket arrangements. For example:

- In 2005 Coles notified an extension to its existing shopper docket arrangement to include an additional discount for customers who pay for petrol with a MasterCard. Coles also notified a further extension to its existing shopper docket arrangement to offer members of the FlyBuys program a discount on petrol on condition that they redeem a specified number of loyalty reward points from FlyBuys.
- In 2005 Woolworths notified a month-long extension to its existing shopper docket arrangement to include an additional discount for customers who pay for petrol with a Visa card.
- In 2006 Woolworths and AIR notified an extension to their existing shopper docket arrangement to include the offer of an additional discount on petrol to customers who have bought products of not less than a specified value from Dick Smith Electronics, Tandy or Dick Smith Powerhouse stores. In 2006 AIR also notified a further extension to Woolworths' shopper docket arrangement to include the offer of a discount on petrol to customers who buy products not less than a specified value from Calstores (or Caltex site operators).

Since 1996, the ACCC has received over 900 notifications concerning petrol shopper docket arrangements. Chart J.1 shows the number of notifications lodged each year since 1996 (as of 31 May 2008).

**Chart J.1 Number of notifications lodged: 1996–2008**

