THE UNIVERSITY OF MELBOURNE

FACULTY OF BUSINESS & ECONOMICS

8th April 2024

ACCC
Supermarkets Inquiry 2024-25

Dear ACCC

Submission to Supermarkets Inquiry 2024-25

Please find attached my submission to the ACCC Supermarkets Inquiry 2024-25. The objective of the submission is to provide some high-level evidence based on a large sample of the worlds supermarkets as to what is the normal level of profits for a supermarket. This may assist the ACCC in some of its deliberations. More analysis can be provided upon request.

Sincerely,

[redacted]

Professor Matthew Pinnuck
Department of Accounting
Faculty of Business and Economics
The University of Melbourne
[redacted]

Summary

The ACCC supermarkets inquiry has an interest in whether there is effective competition between supermarkets and the broader competitive dynamics.

If competition is effective then supermarkets should be making ‘normal’ profits. However, very little evidence has been provided as to what normal profits should be. To provide a benchmark we analyse the profitability of Australian supermarkets against the largest supermarkets in OECD countries across the 3-year period 2021 to 2023.

Given that that supermarkets have large fixed and sunk costs, margins alone (the focus of much of the commentary) are insufficient to determine if profitability is excessive. Rather an assessment is required of the:

- return on capital (ROC),
- the magnitude of fixed-cost investment, and
- the margins necessary to recover fixed costs.

Across all metrics the evidence is consistent with Australian supermarkets being highly competitive, providing significant infrastructure benefits to Australian consumer (e.g. a large variety of offerings and on-line distribution platforms) and that shareholders are only making normal profits.

Return-on-Capital

The ROC of Woolworths Group and Coles of 13.2% and 14.6% is comparable to the median ROC for OECD supermarkets of 12.3%. The frequency distribution of ROC across the world shows that the ROC of Woolworths and Coles is clearly in the middle of the distribution among the world’s supermarkets. See Figure 1.

Fixed Cost Investments and Quality of Service

One of the primary bases on which supermarkets compete for consumers’ business is investment to improve service quality and expansion of product variety (e.g. on-demand delivery, gluten-free, kimchi, organic food). This requires investment in fixed and sunk costs such as large new stores, store renewals, convenience stores, supply chain facilities and warehouses, on-line distribution technology and on-demand delivery, etc. If there were no competition, there would be no need to make these risky fixed and usually sunk cost investments.

The magnitude of capital investment provides an indicator of investment in fixed costs. Capital investment to sales is 4.0% for Woolworths and 3.3% for Coles. This is substantially greater than the median capital investment for OECD supermarkets of 2.6%. As illustrated in the frequency distribution, the median capital investment by Woollies and Coles is greater than that of 75% of OECD supermarkets). See Figure 2.

The magnitude of fixed investments by Australian supermarkets is strongly suggestive of a tightly contested market.

Margins

Consumers benefit substantially from these risky fixed cost investments. However, there is no evidence that Woolworths Group and Coles are charging excessive margins to recover these fixed costs. The EBIT margins of Woolworths and Coles of 4.7% and 4.7% is comparable to the median EBIT margins for OECD supermarkets of 4.4%. See Figure 3.

A further implication of the significant investment in fixed costs is that year-on-year changes in margins cannot be used in isolation as evidence of price gouging. With fixed costs, increased sales lead to higher EBIT margin due simply to fixed costs being spread over a greater volume.[1] The sales of both Coles and Woolworths increased significantly in 2023 implying that changes in margins are at least partly explained by the effects of operating leverage.

Summary

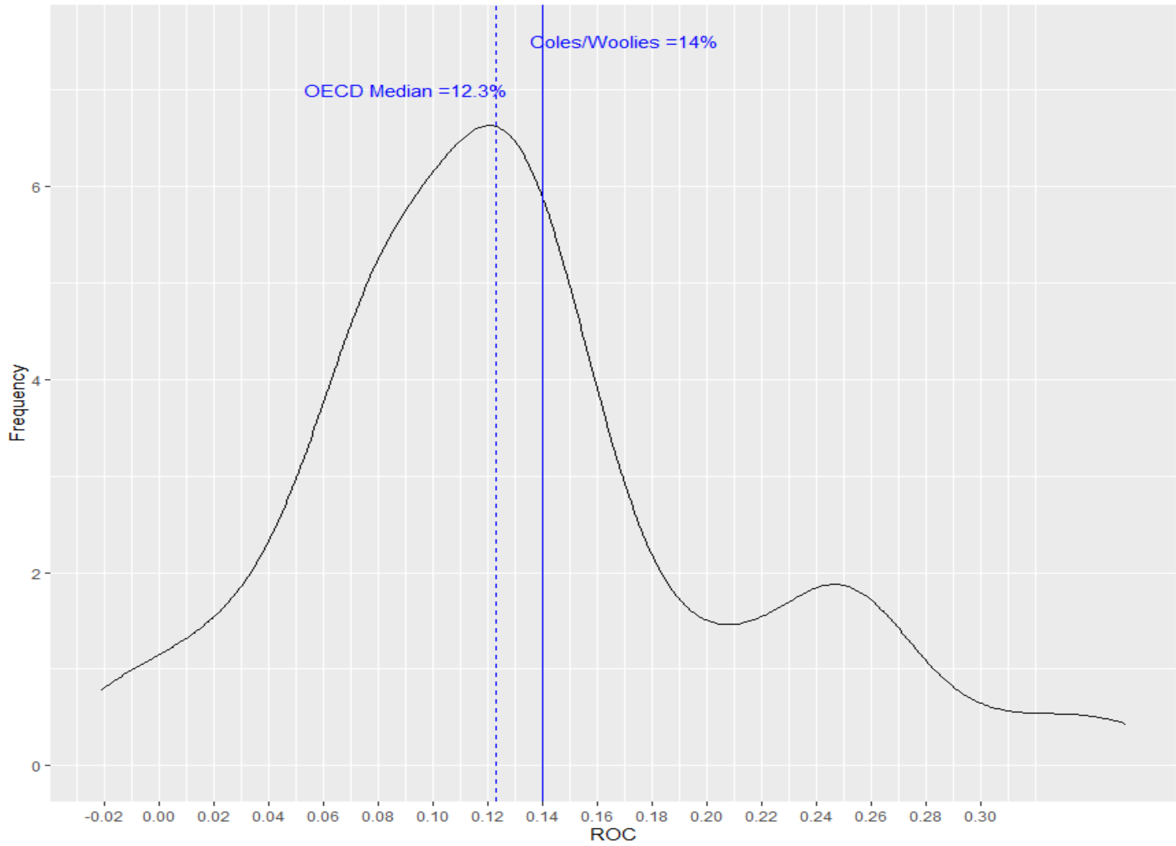
The magnitude of the fixed cost investments by Australian supermarkets is both strongly suggestive of a tightly contested market and requires sufficient margins to recover these fixed costs. The ROC and EBIT margins of Coles and Woolworth Group do not appear excessive relative to comparable OECD supermarkets.

Caveats and Limitations

The reported figures in this analysis are based on group profits for supermarket companies which may include the effects of some non-food divisions.

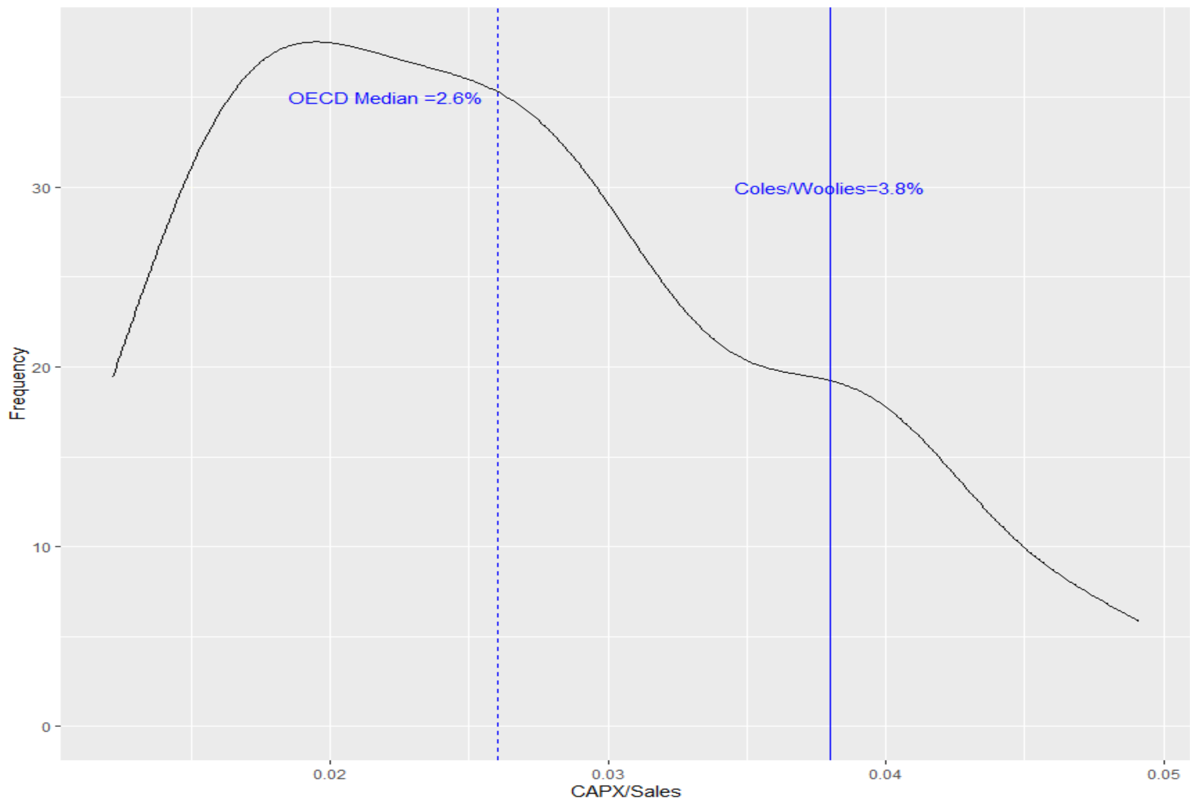
[1] Commonly referred to as the effects of operating leverage.

Frequency Distribution of Return on Capital across OECD Supermarkets 2021:2023 (Figure 1)



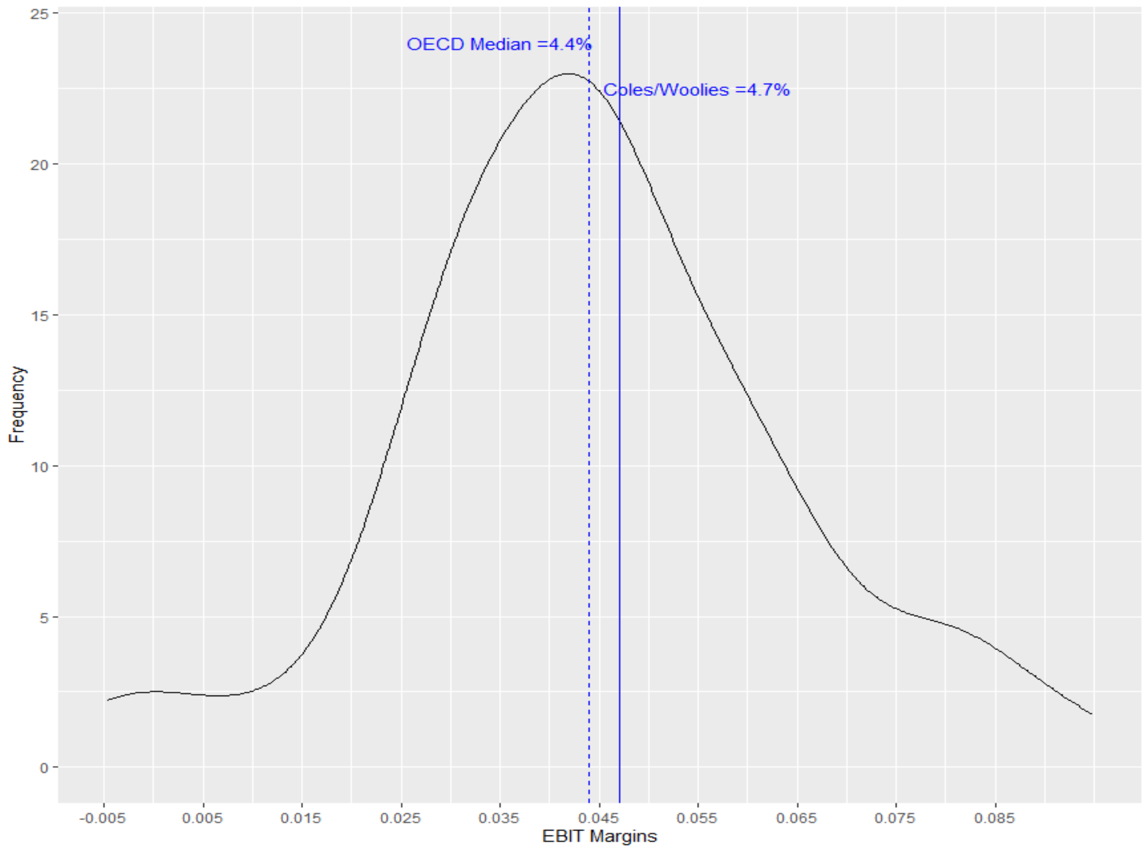
Coles/Woolies is the median of both Coles and Woolworths Group ROC 2021:2023

Frequency Distribution of CAPX/Sales across OECD Supermarkets 2021:2023 (Figure 2)



Coles/Woolies is the median of both Coles and Woolworths Group CAPX/Sales 2021:2023

Frequency Distribution of EBIT Margins across OECD Supermarkets 2021:2023 (Figure 3)



Coles/Woolies is the median of both Coles and Woolworths Group EBIT Margins 2021:2023