

of stores identified in paragraph 5.50 above account for over seventy per cent of sales.<sup>31</sup> Significantly, these supermarkets represent a much larger percentage of sales, and indeed of stores, than was the case in Queensland (see paragraph 5.12). If the broader definition of supermarkets as stores over 5,000 sq ft proposed by the applicant is accepted, these stores account for close to ninety per cent of sales.<sup>32</sup>

5.53. While the majority of Davids and CBL sales are to retailers who are in direct competition with the chains, which would constrain the pricing of the merged company, a significant proportion of sales are to smaller independents who are in less close competition with the chains, leaving a range of pricing discretion for a monopoly wholesaler. There is scope for the merged firm to price discriminate between the different groups of retailers according to the degree of competitive constraint imposed by the chains. This can be achieved through the use of banner groups, which are organised according to floor space, product range and turnover. These different groups of retailers may be considered to be in different sub-markets.

5.54. Another factor which is significantly different in Victoria and New South Wales compared to Queensland, is that trading hours have been deregulated. The vertically integrated chains are now trading for extended hours, in some cases 24 hours. This has meant that supermarkets are now able to offer customers convenience of shopping hours in competition with other grocery retailers. To the extent that this factor is a relatively important determinant of grocery shopping, substitution possibilities between supermarkets and independent retailers may be greater in NSW and Victoria.

5.55. Market inquiries with independent retailers suggest that their turnover has been significantly reduced by the extension of the chains opening hours. This reflects a shrinking of their market, as demand shifts to the market for supermarket services, which is dominated by the vertically integrated chains. Furthermore, to the extent that extended trading hours make the chains a closer substitute for independent retailers, demand elasticity for the latter will have increased, lowering the profit maximising price for a monopolist of grocery wholesaling services. If this price is not significantly higher than the competitive price, then the market should be expanded to incorporate competition from the chains.

5.56. However, trading hours are only one characteristic which distinguishes the independents; a separate market may still remain for grocery retailing services which are more conveniently located for residential areas and which provide personal service. The consumers of these services place more importance on these factors than on price and opening hours, e.g. the growing number of older people living at home with limited mobility and the purchase of 'forgot' items. The Davids commissioned "Partners in Profit" study of the Foodtown banner group found that only thirty per cent of customers used the store for their main weekly grocery shopping.<sup>33</sup>

5.57. While the independent supermarkets are in close competition with the chains in metropolitan retail markets, this is often not the case in country towns. Coverage of the chains in these areas is more limited. Although non-metropolitan sales are less significant and distances between chain stores are probably less than in Queensland, significant parts of Victoria and NSW are not serviced by them. Jebb Holland Dimasi

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<sup>31</sup> This is consistent with both confidential and public information provided by Davids and CBL in relation to Authorisation No. A90553.

<sup>32</sup> Davids Ltd Submission, 3 March 1995, p.2.

<sup>33</sup> Davids Ltd Submission, 3 March 1995, p.3.

advised that in 1993, eleven and fourteen per cent of the populations of NSW and Victoria respectively were not directly served by the chains and that eight and nine per cent of their populations did not live within 50km of a chain store.<sup>34</sup> Although the applicants claim that chain store catchment areas extend for up to 150km, consumers outside their immediate trade areas would not be able to use them for convenience shopping and stores over 50km away would seem unlikely to provide any significant competitive constraint. Retail competition in these areas is limited to competition between independents, or the threat of competition from entry by another independent. A monopolist of independent wholesaling services to each of these retailers would be able to impose a significant price rise above competitive levels because of the absence of independently supplied downstream competition and the knowledge that a downstream entrant would have no alternative source of supply.

5.58. The QIW decision placed significant weight on the distribution of independent retailers across the various "price zones" as indicative that most do not compete directly with the integrated chains. Similar information is not available in relation to the independent grocery retailers supplied by Davids and CBL in Victoria and NSW. The majority of Davids' sales are to customers who maintain their own pricing fields. These correspond to the sales to independent supermarkets identified at paragraph 5.50. Davids' smaller customers use price fields provided by Davids and may mix and match price fields across the product range. CBL's customers also mix and match price fields. Data on the distribution of retailers across price fields was not available for either wholesaler.<sup>35</sup>

5.59. In summary, a number of factors bring independent retailers into closer competition with the vertically integrated chains in NSW and Victoria than was the case in Queensland. Supermarkets, which compete closely with the chains, comprise a significantly larger proportion of Davids' and CBL's customer base; extended trading hours have increased the role of the chains in provision of convenience shopping; and independent retailers are more likely to be located in the same geographic market as a chain store. Nevertheless, there still exists a degree of product and geographic differentiation between independent retailers and the chains. Furthermore, as Justice Spender and the Full Bench determined, even if independent retailers and the vertically integrated chains are in the same retail markets, this does not negate the existence of a separate wholesale market. Because wholesale margins comprise a relatively small proportion of the total cost of wholesale supply, a significant increase in these margins and the profits of wholesalers can be achieved by relatively small increases in the total cost of wholesale supply; an increase which independent retailers or their customers are likely to absorb.

5.60. Hence, the Commission considers that despite the differences between Queensland, NSW and Victoria, Justice Spender's decision in *QIW* is still relevant and consequently grocery wholesaling must be considered a separate functional market in these states.

5.61. In conclusion, the Commission considers that the relevant markets are the Victorian, NSW and Tasmanian markets for the wholesale supply of groceries from independent wholesalers to independent retailers. Geographic market boundaries are

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<sup>34</sup> Jebb Holland Dimasi (1993) Provision of Chain Supermarkets - NSW and Victoria, report to the Trade Practices Commission.

<sup>35</sup> FAL supplementary submission, 15 December 1993. Information confirmed with CBL and Davids.

determined by transportation costs rather than political boundaries and hence do not coincide exactly with states. Hence northern New South Wales is supplied from Brisbane and the ACT forms part of the New South Wales market.

5.62. Based on confidential information provided by the applicant, the Commission estimates the value of sales in each of the Victorian and NSW markets for the supply of groceries by independent wholesalers to independent retailers to be in excess of \$1.2 billion. These sales account for approximately 31.5 and 22 per cent of groceries distributed in Victoria and New South Wales respectively. The Commission therefore concludes that these would be substantial markets for the purposes of section 50 of the Trade Practices Act. The Commission is unable to establish a value for the Tasmanian market, but considers that it too would be likely to constitute a substantial market for the purposes of section 50, since independent retailers account for the supply of approximately 24 per cent of groceries in Tasmania.

5.63. While the immediate impact of the proposed acquisition is in the relevant wholesale markets, it will also affect the retail markets in which Davids' and CBL's customers compete. Davids and CBL also own some retail assets. However, CBL is in the process of disposing of these assets, and only has eight stores remaining at the present time.

5.64. The preceding discussion of functional market canvassed the relevant issues of product and geographic market definition at the retail level. The Commission does not consider it necessary to precisely define these markets for the purposes of evaluating the application. However, the following points are relevant to that evaluation.

5.65. In relation to the *product* dimension of retail markets, the Commission considers that independent supermarkets compete closely with the vertically integrated chains and should be considered part of the same market. As discussed above, these supermarkets account for the majority of Davids' and CBL's sales. Other independent retailers also face increasing competition from the chains in the area of convenience shopping, with the latter now open for extended trading hours. However, the independent convenience and top up stores continue to offer a differentiated product, in terms of access and personal service.

5.66. In relation to the *geographic* dimension of retail markets, each continuous metropolitan area and country town is likely to constitute a distinct retail market; with competitive forces having a ripple effect within those areas, but with a break in that effect at their boundaries. While independent retailers are represented in most, if not all, geographic markets, the vertically integrated chains are not. They are concentrated in metropolitan areas and larger country towns.

## **Liquor**

5.67. The proposed acquisition will involve bringing together the liquor wholesaling operations of Davids and CBL. CBL supplies liquor wholesaling services in NSW, Victoria and Tasmania. Davids supplies liquor directly in the ACT and the Northern Territory, while ALM, in which Davids has a fifty per cent interest, supplies liquor in all states and territories.

## **The applicant's submission**

5.68. The applicant submitted that the relevant market is a market for the distribution and sale of alcoholic beverages throughout Australia, based on the *Penfolds* decision.<sup>36</sup>

5.69. The applicant submitted that liquor wholesalers compete directly with a number of alternative means of supply, e.g. direct supply, buying groups and contract distribution, and retailers mix different methods of distribution and change sources of supply on a day to day basis.

## **Interested parties' submissions**

5.70. Coles submitted (in its November 1993 submission re the FAL application) that there is a liquor wholesaling market, comprising sales from liquor wholesalers to retailers. Market shares were provided on a state basis, implying state based geographic markets.

5.71. The submission also referred to direct supply of liquor from brewers, wineries and spirit merchants. However, there was no argument as to substitutability between direct supply and wholesaling. There was also no discussion of geographic substitution or the relevant functional market definition.

## **Commission evaluation**

5.72. In relation to the relevant *product* market, the parties to the proposed merger supply liquor at wholesale to grocery retailers, hotels, clubs, restaurants and liquor stores. The Commission's market inquiries indicate that direct supply from breweries, wine companies and merchants is a much closer substitute for liquor wholesaling than direct supply of groceries is for grocery wholesaling. Indeed beer is largely directly supplied. The number of liquor orders required by retailers is much smaller than the number of grocery orders that would be required. Independent retailers already use direct supply, switching between this and wholesalers to obtain the best prices. For hotels, clubs and liquor stores, direct supply is even more viable, given their volume of liquor sales. Woolworths (Macs) and Coles (Liquorland) use a mix of direct and contract supply in different states. Liquor wholesaling also does not involve the extensive support services which accompany grocery wholesaling. However, it is questionable whether the distribution of beer should be considered part of the same market as the distribution of wine and spirits. Beer is largely distributed direct from breweries, which do not provide a substitute service for wine and liquor distributors. Hence the Commission considers that the relevant product market is either the distribution of wine and spirits, or alternatively the distribution of liquor.

5.73. In relation to the relevant *geographic* market, distribution is predominantly from state-based warehouses and breweries, due to the same transport cost considerations relevant to grocery wholesaling. However, liquor suppliers do not always follow the grocery industry practice of supplying FIS and the higher value of liquor products, \$50-60 per case compared to \$18 for groceries according to FAL<sup>37</sup>, results in more inter-state supply. Whether this provides a sufficient constraint to expand the relevant geographic

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<sup>36</sup> Davids Ltd Submission, 23 February, Q.9; *Petty v Penfold Wines Pty Ltd*, Australian Trade Practices Reporter 1993, 41-263.

<sup>37</sup> FAL supplementary submission, 15 December 1993, in relation to Authorisation No. A90553.

market is not clear, but the competition analysis of the acquisition in chapter 7 does not hinge on the geographic market definition.

5.74. In relation to the relevant *functional* market, all potential downstream sources of retail competition obtain their liquor supplies from the same sources as independent retailers, switching between liquor wholesaling and direct supply. Hence, downstream competition does not impose any additional competitive constraints on liquor wholesalers than have already been incorporated in the product market definition. Consequently, there is no need to expand the functional market definition beyond the distribution level.

5.75. The total value of wholesale wine and spirit sales in Australia is estimated to be \$2,460 million. If the relevant markets are state markets, the estimated values are \$1,030m (NSW), \$598m (Victoria) and \$59m (Tasmania).<sup>38</sup> If the broader market definition of liquor distribution is adopted, being the market for the distribution and sale of alcoholic beverages, the relevant values are \$5,845m, \$2,240m, \$1,300m and \$150m, respectively. In either case, the Commission considers these would be substantial markets for the purposes of section 50 of the Trade Practices Act.

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<sup>38</sup> Davids Ltd Submissions, 23 February and 9 March 1995; CBL Submission, 9 March 1995.

## **6. Submissions**

6.1. This chapter outlines the submissions received from Davids, CBL and interested parties on the public benefits and the effects on competition likely to result from the proposed acquisition.

6.2. The Commission received approximately 290 submissions from interested parties, of which around 100 claimed, and have been granted, confidentiality. (However, the confidential submissions raised similar issues to those raised in the public submissions.) Of the submissions received, approximately 235 were opposed to the proposed acquisition, and around 55 were in favour of it. Approximately 220 submissions were received from independent grocery retailers, and around 25 from liquor stores. Submissions were also received from Coles Myer, Woolworths, the Jewel supermarket chain, AIW, and QIW (confidential). The balance of submissions were received from suppliers, banner groups, and associations.

### **The applicant's submission**

6.3. Davids' original submission was made on 2 February 1995 and further information was provided on 23 February and 9 March in response to the Commission's requests. On 24 April 1995, Davids made a second submission to detail the 'fourth force' aspect of their public benefit argument. On 13 April 1995, Davids provided confidential proposed draft undertakings to the Commission. The Commission sought submissions from relevant banner committees, CBL and other interested parties in relation to these proposed draft undertakings. Some of these submissions were made available to Davids with the consent of the relevant party. In response to these submissions and comments made by the Commission, Davids then submitted a public final draft of those proposed undertakings to the Commission on 15 May 1995 (see paragraphs 6.29 - 6.35). The Commission accepted final undertakings from Davids on 29 May 1995.

6.4. The thrust of many of Davids' public benefit arguments is perhaps best captured by the following extract from the executive summary of its submission - (the proposed) "acquisition by Davids represents an opportunity for independent retailers being supplied by CBL to obtain cheaper prices, better support, a broader range and a chance to improve significantly their overall offering, all of which are crucial to help satisfy consumers and remain competitive with the Chains."

6.5. Davids' concept of a 'fourth force' is that to provide genuine competition to the chains, the independent wholesalers must effectively become a fourth chain or a 'fourth force' with the independent stores they supply.

6.6. Included in Davids' submission of 24 April, was a report prepared by IBIS Business Information Pty Ltd (IBIS) titled "Review of the Supermarket & Grocery Store Retailing Industry and the Grocery Wholesaling Industry". Davids has used this information in support of its claim that its proposed merger with CBL is necessary to be competitive with the chains. The following extracts from this report were emphasised by Davids in its submission to justify the need for its merger with CBL:

A strong national position is critical across most wholesale and retailing sectors. The (current) fragmented state based structure of the independent wholesalers can only contribute to their continued decline.<sup>39</sup>

The message is clear. Independent retailers can only survive if they are part of a larger group that can deliver the benefits of big business in terms of buying and marketing, merchandising, store design, information technology, signage etc, while retaining the advantages of an owner operator at the store level.<sup>40</sup>

6.7. The IBIS report states that the face of the grocery industry is changing, with the most noticeable trend being the move away from frozen, canned, bottled and other highly process foods to "fresh chilled" products.<sup>41</sup> Davids therefore sees its role as a wholesaler to encourage and support change in the independent retailing sector to meet these changing trends and remain competitive with the chains.

## **Public benefits claimed**

### **Rationalisation benefits**

6.8. Davids estimates that in the order of \$120 to \$135M of savings will be generated from its proposed merger with CBL over the next five years. The proposed merger will result in incremental net pre-tax earnings to Davids of approximately \$13 to \$16M in year one. It advised that the anticipated increase in earnings for Davids from CBL's operations following the merger would result from cost reductions, not increased margin/service fees. Davids provided examples of rationalisation benefits to result from the merger to include:

- improved warehouse efficiency, including rent, labour and other direct costs through the elimination of duplicated facilities;
- improved administrative efficiency in terms of accounting, electronic data processing and other overhead functions;
- reduction in interest expense as a result of working capital and debt reduction (through the rationalisation of surplus inventory and the sale of surplus property, plant and equipment);
- improved and more efficient retailer services, improved skills of retailer services personnel, and improved retailer host support and management services;
- greater financial resources to support independents, and to speed up the development of new stores and new formats.;
- advertising savings and increased co-operative moneys (through additional stores) would enable the merged group to increase its advertising exposure and channel it more effectively thereby ensuring that independent retailers can be more competitive with the chains;

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<sup>39</sup> IBIS Business Information Pty Ltd (April 1995) Review of the Supermarket & Grocery Store Retailing Industry and the Grocery Wholesaling Industry, p 32.

<sup>40</sup> Ibid, p 33.

<sup>41</sup> Ibid, p 12.

- significant reductions in product development and design costs, given the rationalisation of generic and premium private labels and increased volume resulting from the merger;
- scale benefits in respect of IGA and Premium Selection products;
- transport and freight savings would arise due to scale efficiencies. Currently transport companies will only accept country perishable freight runs on a "per run" basis. The additional volume would allow Davids to utilise unused capacity on current runs and consequently achieve significant savings;
- delivery costs per carton could be reduced on the basis of complete utilisation of expensive refrigerated transport vehicles and greater utilisation of existing fleets for optimisation of delivery volumes. It was provided by a transport company in a confidential submission that the basic principle of greater utilisation of transport capital equipment always leads to a lesser cost per items delivered; and
- access to EFTPOS facilities for all stores with a centralised control system.

### **Passing savings on - cheaper prices**

6.9. The applicant submitted that a stronger merged group would enable the independent sector to compete more effectively with the chains and in the process provide better service and more competitive pricing to consumers. It intends to ensure that the merger benefits are passed through to consumers.

6.10. Davids advised that it would undertake to the Commission to transfer approximately \$6 - \$8 million per annum of its incremental earnings following the merger directly to retailers in Victoria, New South Wales and the ACT by increasing rebates (on all products except liquor and cigarettes) in two stages of at least 0.25 per cent each; six and twelve months after the merger and will be maintained at the increased level thereafter. The increased rebates would be provided to all members of the major Davids and CBL banner groups - Rainbow, Festival, Foodtown, Cheapa, Welcome Mart, Clancy's, Maxi, Tuckerbag, Payless, Riteway, Goodfellows, Budget Rite, MFC, Tiger Barn and Tasmanian Island Food Mart. (See paragraphs 6.29 - 6.35 on Davids' proposed undertakings.)

6.11. Davids' pricing fields, that are used by these banner groups, would be adjusted to reflect the rebate being passed on to consumers. Davids submits that this pricing field policy and competitive pressures would ensure that the majority of savings to retailers would be passed on to consumers. However, Davids would support, with the Commission's approval, the imposition of conditions onto independent retailers obliging them to pass the increased rebates through to consumers in the form of lower pricing. In addition, in respect of those independent retailers in country areas that do not face competition (where there may be greater scope for anti-competitive detriment as a result of the merger), Davids propose to undertake to the Commission to continue to provide wholesale prices and services to its customers on a basis which is no less favourable than is provided by Davids or CBL, as the case may be, at the date of the takeover.

6.12. Davids also submits that CBL's financial deterioration has increasingly led that company to inflate its prices, so that CBL's pricing is now a minimum one per cent higher than Davids'. Following the merger, CBL's customers would be moved onto Davids' lower pricing structure and this would translate into savings of approximately



\$4.5 million per annum, the substantial majority of which would be passed through to consumers due to competitive pressures.

6.13. Tuckerbag commissioned the services of Ferrier Hodgson Corporate Advisory (Vic) Pty Ltd (Ferrier Hodgson), to test Davids' claim that their prices are a minimum one per cent cheaper than CBL. Ferrier Hodgson completed a comparative study of banner prices between Tuckerbag, supplied by CBL, and its Davids supplied counterpart, Festival stores.<sup>42</sup>

6.14. The main area of comparison related to the actual invoice costs of the goods supplied by each warehouse. Using product lines common to both warehouses, a comparison was made between the actual price paid and what it would have cost Tuckerbag or Festival to purchase the same products from the opposing warehouse. Ferrier Hodgson took the following items into account in undertaking their comparison: service fees, freight and cartage, hand bills, conference levies, meat levies, IGA levies, host services and scanning support, stretch wrap, ullage, payment terms, directs and charge thru, generics, group rebates, and money into price.

6.15. Ferrier Hodgson summarised their findings as follows:

	Twelve months to 31 December 1994	Three months to 31 March 1995
If Tuckerbag member had purchased its stock from Davids.	Davids was between 1.59% and 2.08% cheaper* than CBL.	Davids was between 1.04% and 1.53% cheaper* than CBL.
If Festival member had purchased its stock from CBL.	CBL was between 2.64% and 3.13% more expensive* than Davids.	CBL was between 2.38% and 2.87% more expensive* than Davids.

\* Depending on the individual retailers' weekly volumes.

6.16. Also, a study of prices for the week commencing 6 March 1995 was completed, which was limited to a comparison of the unpromoted price only. This comparison found that Davids was 0.83% cheaper than CBL.

6.17. Based on these findings, Ferrier Hodgson concluded that the independent retailers being supplied by Davids purchase their goods significantly cheaper than the independent retailers sourcing their goods from CBL.

6.18. In response to the findings of the report, CBL have disputed the extent of the alleged price difference, but not its direction. CBL have stated that they believe the result should have been more of the order of 0.23 to 0.63 per cent in Davids' favour.

#### **Improved purchasing power**

6.19. Davids claimed in its original submission that the merger would result in improved purchasing power. It said that the benefits of increased volume flow back through manufacturers' rebates and deals, and a merged Davids/CBL would be better able to obtain terms similar to those enjoyed by the chains. It claimed that the improvement in CBL's existing terms would be significant.

<sup>42</sup> Ferrier Hodgson Corporate Advisory (Vic) Pty Ltd (May 1995) Banner Price Comparison, report to Tuckerbag Banner Committee.

6.20. In response to Commission questions, Davids later advised that attractive terms do not relate merely to volume, but also relate to certainty of product flow from the manufacturer's point of view. The chains have vertical discipline which permit them to commit to volume. An independent wholesaler is less able to commit to volume unless it supplies well disciplined banner groups. Part of the claimed benefit of the merger is the greater discipline (and ability to commit to volume) expected to flow from rationalisation. Davids' vision for a fourth force involves the establishment of a strong unified wholesaler to provide retail and financial support to a co-ordinated, disciplined and formula driven group of independent and corporately owned retailers to combat the chains.

### **Other benefits**

6.21. Davids also claim that the balance of the estimated incremental net earnings resulting from the merger (ie apart from the \$6 - \$8 million to be transferred to retailers through increased rebates) represents Davids' return on capital invested and would be directed towards strengthening Davids' position so that it can ensure that independent retailers are better able to compete with the chains.

6.22. Davids claim that a formal strategy for competition with the chains is necessary because the national market share held by independents has progressively fallen over the years from 54 per cent in 1975 to approximately 27 per cent today while conversely the chains market share has risen from 46 per cent to 73 per cent.<sup>43</sup> Additionally, the IBIS report forecasts that if the independent wholesaling sector continues on its current course, there will be a further decline in their market share from 27 per cent currently to 22 per cent by 1998 and 18 per cent by the year 2000. However, under a rationalisation scenario, IBIS predicts that the independents will lose only two to three percentage points to the chains over the next five to six years, maintaining a market share of 22-23 per cent.<sup>44</sup> The following paragraphs outline the areas that Davids states will be targeted and would result in public benefits:

- *Banner rationalisation.* Davids said in its original submission that it would enter into discussions with all banner committees with a view to achieving a more efficient banner structure, and it expected that some rationalisation of banners would be effected following these discussions. Davids also provided in their undertakings that banner rationalisation would only proceed if approved by a majority of members of each respective banner. It was claimed that a rationalisation of banners would lead to the following benefits:
  - CBL's customers would be able to avail themselves of a national banner, and would have the potential to access the IGA concept and premium brand of products; and
  - Advertising expense reductions would be achieved by defraying costs over broader bases, volume buying and more efficient geographic use of media.
- *Access to capital.* It is submitted that independent retailers must upgrade existing stores and develop new stores to respond to the chains' extensive store development and refurbishment programs and that the substantial capital investment required

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<sup>43</sup> IBIS, *op.cit.*, p 4.

<sup>44</sup> *Ibid*, p 33.

can only be obtained through a financially healthy and viable wholesaler with access to significant amounts of capital.

It was submitted that the merger would create a strong independent wholesaler which would be able to combat the chains "cheque book" competition (ie. the acquisition of independent retail stores by the chains) and retain stores in independent hands. The merged group would also have the financial strength to assist independents to upgrade their stores. (Davids noted that in the last year alone it had instituted some form of upgrade in over 300 stores. Davids also submitted that each major refurbishment of a supermarket would cost a minimum of \$1M and in many cases upwards of \$3M.<sup>45</sup>) Following the merger Davids would target this area, together with retail development, as an important means of combating the chains.

Davids also submitted that it is outside the resources of all but a few independent retailers to develop new supermarket sites, and independent wholesalers must assume that role on behalf of independent retailers. CBL cannot undertake that role because of its limited equity base and frail financial condition. Davids has shown through its Rainbow concept that independents can improve and out perform chain stores by developing appropriate new generation stores. It was submitted that the merger would enable independents to benefit from a national identity (IGA) to support new store formats, and would provide greater access to capital for the merged group to assist in instituting a development program. The merger would also create a greater pool from which to draw prospective owner/operators of the new businesses to be developed.

As part of their submission of 24 April 1995, Davids included a paper by County NatWest Securities Australia Limited (CNWSAL) to support their claim that the merged entity would be able to provide retailers with greater access to capital. The paper addressed a number of issues relating to access to, and the price of, equity and debt capital. CNWSAL provided that:

bankers are willing to lend to retailers provided they receive comfort from a substantial or viable third party. In the wholesale sector ... FAL and Davids are the only two entities which can offer genuine comfort to bankers. CBL, with negative net tangible assets and a history of substantial losses, is at best in a frail financial position and would not, in the ordinary course, represent a viable third party guarantor.<sup>46</sup>

- *Enhancement of retail support functions.* Davids claim that it has placed emphasis on retail support functions, such as training through IGA, of smaller banners, and field counsellors covering all aspects of retail operations. Davids submit that it intends to emphasise the provision of management support services, technological advice and support, and retail support services to assist independents to adapt to changing trends. It claims that CBL has reduced staff in this area, and that providing CBL's customers with access to Davids' retail support services will assist those retailers become more profitable and competitive.
- *Generic and other products.* Following the merger, Davids propose that CBL's customers would have access to the premier independent generic product, "Black &

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<sup>45</sup> Davids Ltd submission, 24 April 1995, p.15.

<sup>46</sup> County NatWest Securities Australia Limited submission, 24 April 1995, p.1, (attached as Exhibit B to Davids Limited submission of 24 April 1995).

Gold", and also to Davids' wider range of products including cigarettes and general merchandise.

- **IGA.** This is an internationally recognised banner and world-wide standard for independents. Following the merger, Davids propose that CBL customers that meet the requisite standards would be awarded IGA recognition and consequently would benefit from retail support, training (access to the IGA/Coca Cola Retailer Training Institute), advertising and market recognition (national identity). Davids also propose to provide access to the IGA private label (premium) products, such products it claims are an essential part of contemporary grocery retailing mix. It was also submitted that having a larger group of retailers to supply would allow Davids to defray costs over a broader base and direct greater resources towards extending the IGA range. Davids estimated in its 'fourth force' submission that savings as a result of scale benefits in respect of IGA and Premium Selection products could be in the order of \$3.5 to \$4.0M over five years.

## **Anti-competitive detriment**

### **Lack of alternative supplier**

6.23. Davids acknowledge that its proposed merger with CBL would lead to the elimination of an alternative wholesale supplier, so the merger may have an anti-competitive effect on the market for the wholesale supply of grocery products to independent retailers in New South Wales and Victoria. However, it submitted that this effect would be minor because CBL no longer represents a substantial long term competitive force in the market by reason of its damaged financial position and, in any event, any anti-competitive detriment would be substantially outweighed by the public benefits arising from the merger.

6.24. Davids also submitted that each of the chains has the financial strength and expertise to enter the market for the wholesale supply of groceries to independent retailers, but considered that Coles Myer was the most likely to do so. Davids noted that Coles Myer had repeatedly made public statements that it is determined to play a major part in grocery wholesaling to independent retailers. Davids claimed that Coles Myer's establishment in 1993 of its subsidiary Grocery Holdings Pty Limited to service Bi-Lo stores, was a significant step in this process.

6.25. Davids observed that Foodland and/or QIW represent possible alternative suppliers to independent retailers in Victoria and NSW. Such a move on their part would need to be economically viable which would depend upon whether or not the merged group was providing competitive terms to independent retailers.

### **Failing firm argument**

6.26. Davids submitted that although CBL's financial condition may have stabilised under its current administration, it has no realistic prospect of raising capital in the foreseeable future, at a time when the capital needs of the independent sector are increasing. It claimed that CBL remains vulnerable to an extended period of market competition as it simply does not have the financial strength to withstand a sustained period of losses and deteriorating trading.

6.27. Davids claimed that CBL's damaged financial condition has led to the following developments infringing on its competitiveness:

- CBL is not investing in company owned retail stores;
- CBL will no longer commit to head leases in support of independent retailers;
- CBL's pricing is a minimum of one per cent above Davids' pricing;
- CBL's retail support staff has been considerably reduced;
- CBL has closed down its fresh food supply and support system;
- CBL does not have access to a range of competitively priced premium brands; and
- Davids is constantly being approached by CBL's customers.

6.28. In Davids' view CBL no longer represents a substantial long term competitor to Davids. It submitted that CBL no longer has the capacity to protect its customer base from the chains "cheque book" competition, and other CBL customers will continue to shift to Davids as the gap between Davids' and CBL's financial condition and access to capital continues to widen. Accordingly, if the merger were not permitted, CBL is at risk of being removed as a competitor in any event, but as part of that process numerous independent stores would either be acquired by the chains or go out of business.

### **Section 87B Undertakings**

6.29. Davids provided proposed undertakings to the Commission, under s87B of the Act, in confidential draft form on 13 April 1995, in a final draft form on 15 May 1995, and then in a final form on 29 May 1995 which were accepted by the Commission (a copy of the final undertakings are attached at Appendix B). The undertakings intend to address concerns regarding its proposed acquisition of CBL, particularly in relation to:

- any possible anti-competitive detriment to independent retailers as a result of losing an alternative wholesale supplier;
- more specifically, supply to those independent retailers who would not be constrained by competition from chain stores; and
- passing through tangible benefits to the public, in the form of increased rebates.

6.30. The Commission sought submissions on the proposed draft undertakings from relevant banner committees, CBL and other interested parties. Some of these submissions were made available to Davids, with the consent of the relevant party. The Commission then required Davids to provide non-confidential proposed final undertakings by 15 May 1995. Davids consequently lodged non-confidential proposed final undertakings to the Commission after taking into account comments made by the Commission and other interested parties. Further submissions were sought by the Commission from relevant parties, and following receipt of these submissions, Davids provided final binding undertakings to the Commission on 29 May 1995.

6.31. The statutory undertakings given by Davids to the Commission are intended to:

- limit the effects on customers of Davids and CBL and on consumers of any lessening of competition that may arise as a result of the acquisition;
- provide for an improvement in rebates of at least 0.5 per cent to Davids' and CBL's banner groups;
- provide mechanisms to review Davids' compliance with these undertakings;
- establish a system for resolution of complaints;
- ensure that there is no reduction in the nature, quality or level of services currently

provided by Davids and CBL to their customers; and  
- ensure that there is no unreasonable discrimination between members of banner groups.

6.32. Accordingly, Davids has undertaken to the Commission:

1. to maintain existing service levels to all Davids and CBL customers (clauses 1 and 2);
2. to maintain existing pricing levels (subject to point 3) for all Davids and CBL customers (clauses 1 and 2);
3. to increase the wholesale rebate to all Davids and CBL customers by at least 0.5 per cent not more than twelve months after the takeover (clause 3);
4. to offer to all CBL customers the opportunity to be supplied on the same terms as the comparable Davids banner (clause 4);
5. not to rationalise any banner without the agreement of the banner group (clauses 6 and 7);
6. not to favour, or unreasonably discriminate between, members of any particular banner groups, in terms of wholesale prices, services or otherwise (clauses 8 and 9);
7. to ensure that Black and Gold products and terms negotiated through AAW continue to be made available to existing members of AAW on the same, or a more favourable and non-discriminatory basis (clause 10);
8. to ensure continued supply of Payless products to AIW on terms which are no less favourable to AIW than are provided by CBL (clause 11);
9. to enable an independent expert to "audit" Davids' performance under the undertakings and report to the Commission and to the banner groups (clauses 12 and 13)and;
10. to have all disputes regarding the above, put to an independent expert (paid for by Davids) and to be bound by the determination (clauses 14 and 15).

The terms of the undertakings given by Davids are set out at Appendix B.

6.33. Davids' compliance with the undertakings would be enforceable by the Commission in the Federal Court.

6.34. Ferrier Hodgson provided comments on Davids' proposed draft undertakings from the point of view of a potential independent expert. They provided that the final draft form of the undertakings were fair and reasonable and should achieve their stated purpose. It is their belief that an expert would be capable of monitoring Davids' compliance with the undertakings and resolving any disputes that may arise between Davids and its retailers in respect of the undertakings.

6.35. Other comments were made in relation to the draft forms of Davids' proposed undertakings by CBL and the relevant banner committees which are discussed below at paragraphs 6.43-6.44 (CBL) and 6.57 (banner groups).

## **CBL's submissions**

6.36. CBL advised that its Board considers the company to be competitive and now financially viable, although not immune from takeover bids from a number of sources. In the event the Commission authorises Davids to proceed with its intended bid, CBL would seek to maximise that bid such that it represents "fair and reasonable" value to CBL's shareholders. It would also ascertain whether or not other bidders are prepared to come forward.

6.37. In stating CBL's position on its competitiveness, the company considered it appropriate to comment on aspects of Davids' submission which CBL believed are erroneous or overstate the case.

6.38. CBL provided to the Commission, on a confidential basis, a copy of its 1994/95 Business Plan and Budgets, its management accounts for the half year to December 1994, other reports on the company, and a comparison prepared by it of Davids' and CBL's prices (for goods and services) in respect of Festival and Payless stores in Victoria. It also supplied on a confidential basis, customer store size and sales data.

6.39. CBL noted that the takeover of CBL by Davids would, as stated by Davids, lead to an elimination of an alternative wholesale supplier in the grocery, liquor and food service areas. It submitted that the merger would have an anti-competitive effect on the independent retail grocery market.

6.40. CBL said that in a non competitive market place, consumers' choice is limited in many ways - the range available, the same weekly specials, the same products unavailable. It noted that independent retailers purchased their businesses with the knowledge they could source stock from an alternative supplier if their current wholesaler was not able to look after their needs. CBL considered that independents need competition at both wholesale and banner level to ensure they can remain competitive with the chains.

6.41. In response to Davids' claims regarding CBL's financial position and its competitiveness (see paragraphs 6.26 to 6.28 above), CBL made the following submission.

- CBL has effected a turnaround in its operating performance from losses to profits for the six months to December 1994. The company has the capacity in its operations and liquidity reserves to compete effectively and profitably in the future; and a large number of suppliers and customers had expressed the wish that CBL continue as an independently owned and operated company.
- Davids has stated that it believes the emergence of a 'fourth force' in the grocery market is the key to competing with the chains. CBL submit that there is no logical reason why there cannot be a 'fifth force'.
- There is a mistaken belief, promoted by Davids, that overall Davids' prices are one per cent cheaper than CBL's. If full account is taken of the cost of all services provided to customers it would be easy to argue that the advantage lies with CBL, particularly when considering the question of the return of 'case deal' income to retailers from Davids and from CBL. (The company later advised that it had evidence to suggest that CBL customers would in fact be disadvantaged to anything between 1 and 4.5 per cent, even after allowing for the extra 0.5 per cent rebate promised by Davids.)

- In owning retail stores CBL competes with its own customers in this sector. It has therefore embarked on a program of selling its retail stores to independent owners and concentrating on its core business of wholesale grocery and liquor distribution.
- It is true that CBL will no longer commit to head leases of retail stores. It has a substantially different view of how it should compete to that of Davids. Investment in head leases creates large contingent liabilities, a problem which Davids will eventually have to face. CBL has already addressed the issue and does not wish to be the financier to its customers; it believes that the banking industry is better able to provide such services.
- CBL was considerably overstaffed, hence its poor profit performance. It will now concentrate on higher output from fewer people. Evidence from customers suggests that CBL's service has improved.
- CBL concede that in the atmosphere of uncertainty following a financial crisis, customers will, even during the remedial period, look to their options elsewhere. Despite Davids' consistent and dedicated policy of pursuing CBL customers, particularly since its financial troubles of April/May 1994, very few have left. CBL argue that it is not inevitable that CBL will lose more customers. In fact, as its financial and trading position is seen as more secure, there is evidence to suggest that CBL will win customers, particularly from Davids.
- At a time of recovery, CBL has been investing new capital in warehouse systems and expanded warehouse facilities at its head office site. CBL provides that it would not do so if it were in terminal decline as Davids suggests.

6.42. CBL considered that in the main there is no difference between suppliers' base trading terms to chains and independent wholesalers. It also advised that through AAW, independent wholesalers have successfully negotiated 'national rebates' over and above the base trading terms, equivalent to those enjoyed by the chains. However, CBL considered that it was not unreasonable to surmise that the chains can and do command a higher co-operative component of trading terms given their ability to deliver promotional compliance, tie up end-caps across all stores, guarantee stock weights in stores, ensure core ranging etc. Independent wholesalers cannot make such guarantees as they do not own the retail stores. CBL was also of the view that chains may be able to access incremental trading term monies in the form of ranging rebates (given their, on average, larger trading space) and volume incentive rebates given their general market growth. CBL questioned the ability of a merged independent entity to access these incremental trading terms given its ability to deliver the same 'benefits' or volume growth as the chains. However, it would be possible for a merged entity to 'dictate' settlement terms because of its sheer size and market dominance in certain situations.

### **Section 87B Undertakings**

6.43. CBL were invited to make comments in relation to the draft and final forms of Davids' undertakings. No comment was made in relation to the proposed draft undertakings but the following claims were made regarding Davids' proposed final undertakings:

- The stated purpose of the undertakings to "limit any lessening of competition" could not be achieved if CBL is taken over by Davids. The intense competition that currently exists between Davids and CBL will disappear to the detriment of independent retailers, in the event of the proposed merger.



- The terms of the undertakings were not sufficiently precise and certain as would allow them to be enforced in a Court of Law. For example, there is no definition of a 'rebate'.
- Control is identified at a level of 50%. CBL state that the Corporations Law provides a threshold level of 20% for possible control of a public company. The undertakings would not become effective until Davids had a 50% shareholding. Does this mean that Davids could remain at its current 30% level and seek to exercise control?
- The undertakings did not guarantee that Davids would make a takeover bid, should authorisation be granted.
- CBL believe that it is commercially unrealistic to believe that there would not be banner rationalisation after a successful takeover. To suggest otherwise is a misrepresentation.
- The material in relation to 'rebates' is devoid of detail.
- CBL claim that the appointment of an expert for dispute resolution "is a very shallow and superficial attempt at addressing what is a very complex issue of conflict resolution between wholesale supplier and retail seller".
- Use of terminology such as "no less favourable" is imprecise. Davids has indicated that it intends to close the Knoxfield warehouse which will result in a huge loss of knowledge and experience, which must ultimately affect service levels. CBL state that this seems inconsistent with Davids' claim that it will continue to provide "services" on a no less favourable basis.

6.44. CBL asserted that Davids' proposed undertakings were far too vague and would be difficult to interpret and are a poor attempt at offsetting the loss of a competitive source of supply in the grocery wholesaling industry.

## **Interested parties' submissions**

6.45. During its consideration of FAL's 1993 application for authorisation (the proposed merger of FAL, Davids, CBL and IHL), the Commission received substantial submissions (in November 1993) from Coles Myer and QIW, with both companies expressing strong opposition to that proposal. The Commission contacted both Coles Myer and QIW to check whether the Commission should consider the views expressed in their respective submissions in the FAL matter (noting that the issues raised in the current proposal to amalgamate Davids' and CBL's operations were similar to those raised in the earlier FAL proposal). The Commission also asked Coles Myer to comment on its likely approach concerning the future of its \$20 million in CBL convertible notes if Davids were to obtain a majority shareholding in CBL. Coles Myer, QIW, and Woolworths were also invited to comment on Davids' 'fourth force' submission.

6.46. **Coles Myer** advised that it has consistently been concerned that a situation not arise whereby competition in the independent wholesale sector of the grocery industry is reduced. It also advised that it does adopt the comments in its submission of November 1993, in relation to the current proposed acquisition. The company said that it had not taken any decision relating to its \$20 million convertible note in CBL, and any such decision would depend on the commercial circumstances then apparent. It noted that presently the outcomes seemed very unclear.

6.47. Coles Myer made a number of comments in relation to Davids' 'fourth force' submission. It was stated that they believed Davids' submission to be incorrect in three main areas:

- (a) impact on competition - Coles Myer believe that the merger would result in the removal of a strong and viable competitor for Davids;
- (b) alleged public benefits - Coles Myer consider Davids' claims to be 'unsubstantiated and illusory' and are entirely dependent on the goodwill of Davids to deliver them on terms and conditions within Davids' discretion. They also question who will receive the alleged benefits and believe that they will not be secured by any undertakings offered by Davids.
- (c) fourth force - Coles Myer submits that it and the other chains do not in any sense compete with Davids or CBL, nor would they compete with the merged group. Also, they consider it difficult to see why Davids' acquisition of CBL is necessary for the creation of this so-called 'fourth force'.

6.48. **Woolworths** provided a brief response to Davids' fourth force submission to address one point. Davids claimed that a deterioration of the independent retailer system will lead to "reduced competitive restraints on the chains and diminished choice for the public". Woolworths believe that such suggestions are incorrect and insupportable in light of the vigorous competition between the three chains.

6.49. **QIW** advised that it does not believe the conditions ruling in the market in 1993 are relevant now. In QIW's opinion, independents do compete with the chains at both the wholesale and retail levels. The company did not wish the Commission to take any previous submission by the company into account in finalising its determination of Davids' application. QIW lodged two confidential submissions in respect of the current application and Davids' fourth force submission.

6.50. **AIW** advised that it purchases a range of products from CBL that it is unable to satisfactorily source elsewhere (mainly due to manufacturers' minimum purchase requirements). AIW also advised that it purchases a wide range of CBL's "Payless" generic products, and that it previously purchased the "Black & Gold" brand from Davids for some years until Davids terminated that arrangement. AIW stressed the importance (due to customer preference and the fact competitors range similar low cost products) to both its retail and wholesale business of the availability of a generic range of products. AIW has endeavoured to introduce its own generic brand, "Our Brand", but has experienced many practical problems, in particular manufacturers' trading terms and minimum order quantities which favour AIW's larger competitors. AIW submitted that in the event the Commission endorses Davids' proposed acquisition of CBL, there ought to be an absolute pre-condition that access to the merged entity's generic range be generally available to independents at competitive prices and trading terms. AIW lodged a confidential submission in respect of Davids' fourth force submission.

6.51. **The Jewel supermarket chain** supports the proposed acquisition. Jewel advised that Coles Myer has offered to supply independents. The company also referred to the scarcity of commercial land to develop supermarkets, and the advantage the large public companies (Woolworths and Coles Myer) have in obtaining such land due to their access to capital. Jewel supports the proposed acquisition because it would strengthen the independent sector at the wholesale and retail levels, and assist independents to compete with the chains.

## **Independent grocery retailers**

### **In favour of proposed acquisition**

6.52. The Commission received around thirty submissions from independent grocery retailers (including Jewel (discussed at 6.51 above), a number of Festival stores, and some other independent retailers) in favour of Davids' proposed acquisition of CBL. These submissions generally supported Davids' submission, and the benefits that it perceives would result from the merger. The main issues raised are outlined below.

- It was submitted that a united independent sector would be better equipped to compete on a more even footing with the major supermarket chains.
- The merged entity would have increased buying power which would result in an improvement in price structures for retailers, enabling them to offer better prices and service to customers. Retailers passing on the increased rebates promised by Davids would reduce retail prices further.
- The proposed merger was considered to be the best available alternative in light of CBL's apparent poor financial position. If the merger was blocked by the Commission, the chains would be the only ones to benefit.
- It was considered a positive step that all stores would have access to "Black & Gold" generics, and the IGA product range would also be available to more retailers.
- It was submitted that the merger would result, at the wholesale level, in better overhead cost control and savings in operating and indirect costs, more efficient use of existing plant and equipment, more co-ordinated use of computer facilities, and better stock turnover resulting from increased sales.

### **Opposed to the proposed acquisition**

6.53. Around 190 submissions from independent grocery retailers (in Victoria, NSW, the ACT and Tasmania) opposed the proposed acquisition of CBL by Davids. These submissions were primarily concerned about the impact that a monopoly at the wholesale level would have on the grocery market and their individual businesses. They considered that the proposed merger would reduce competition to the detriment of the independent grocery retailing sector and consumers. The main issues raised are outlined below.

- Concern was expressed that a monopoly situation would allow Davids to substantially increase prices to retailers with a flow on effect of increased prices to consumers. The retailers' view was that they would have no choice but to accept any increased prices as they would have no alternative supplier. Most considered that there were no other viable alternatives for supply in the wholesale grocery market. A substantial number were concerned that they would be forced to purchase from Campbell's Cash & Carry at significantly higher prices.
- A significant number of retailers questioned Davids' claim that its prices are one per cent cheaper than CBL's prices. They considered this claim to be unfounded.
- Retailers were concerned at the implications of Davids' proposed 'banner rationalisation'. They considered that such rationalisation would have the effect of destroying the identity that they had worked hard to achieve. There was also concern that if the number of banners were reduced, it would be likely that stores in

the same geographic area would be running the same weekly specials, offering the same product range and running the same advertising . Retailers would have no power to differentiate their stores or products from other supermarkets in their area, and consumers would be left with no choice or differentiation between stores and product lines. It was considered that a number of retailers would be forced out of the market. Retailers were also concerned about the outcome of banner rationalisation where there are two stores in a given area of approximately the same size: Would one store be closed?; Would one store be favoured by Davids over the other? There was a concern that stores currently supplied by Davids would be given priority in this situation.

- Some retailers currently supplied by CBL were concerned that in the event of store upgrading decisions being made for a particular area, there would be a real chance that they would be passed over in favour of stores currently supplied by Davids. There was also some degree of confusion as to how store upgrading decisions would be made and who would pay.
- Many considered that there would be a reduction in the product range available under a one warehouse situation, and this would be significantly detrimental to consumers. This was particularly the case in relation to generic products. It was considered that consumers would be disadvantaged by the "Payless" range being removed from the market in the event of a takeover.
- A significant number of retailers considered that with a lack of competition at the wholesale level Davids would not be compelled to offer quality retail support and delivery services. Retailers would have to accept what was offered by Davids because they would have no other alternative.
- Many retailers expressed concern as to who would get the stated increased rebates. There was concern that smaller independents would be discriminated against and not receive any increase in rebates. Some also questioned whether the increased rebates would extend any further than the initial twelve months after the takeover.
- Stores were also concerned about the suggestion that they may be forced to pass on any increase in rebates to consumers in the form of cheaper prices. Although it would often be in retailers' best interests to do so, it was considered that retailers should not be compelled by their supplier to pass on the rebates.
- Concern was expressed at the effects of any industrial action in Davids' warehouse, which would be severe if there is no alternative source of supply.
- A number of small independent retailers advised that they had been refused supply by Davids in the past due to their small size. They questioned what would happen in the future in the event of a Davids/CBL merger.
- A major concern expressed by many retailers was that they would be ultimately forced out of business. It was submitted that reduced competition in a one warehouse situation would lead to higher prices, diminished retail support and delivery services, loss of identity, reduced product range, the ill effects of banner rationalisation and discrimination, all of which would ultimately result in the failure of their businesses and the gradual collapse of the independent grocery retailing sector (resulting in a significant increase in unemployment).

## **Liquor stores**

6.54. Seven liquor stores provided submissions which supported the proposed merger. They observed that the merged entity would be in a better position to compete with the chains through increased buying power, which would result in an improvement in price structures. A number also commented that a merger would be the best alternative in light of CBL's alleged poor financial position.

6.55. Around twenty liquor stores provided submissions which opposed the proposed merger. The main issues raised were similar to those raised by independent grocery retailers opposed to the proposed merger.

## **Banner groups and retailer associations**

6.56. The Commission was provided with the results of a survey concerning the proposed merger which the following CBL banner groups conducted amongst their members - Goodfellows, Budget-Rite, Payless (Victoria and NSW), Rite-way, MFC, Tiger Superbarn and Island Foodmart. There were around 340 respondents to the survey, with most expressing extreme concern over a number of the issues raised - such as the one independent warehouse situation and the likely detrimental effect on retail prices and product range, banner rationalisation issues, and the effect on consumers of an industrial dispute in a one warehouse situation.

6.57. A number of the CBL banner group committees also provided submissions in relation to Davids' authorisation application and their proposed undertakings. The main issues raised are outlined below.

- The **Tuckerbag** group considered it essential to establish the validity of Davids' claim that its prices are one per cent cheaper than CBL's prices. Tuckerbag, with the agreement of Davids and CBL, commissioned an independent audit, by Ferrier Hodgson, of the two wholesaler's pricing structures. The results of this analysis stated that independent retailers being supplied by Davids purchase their goods significantly cheaper than independent retailers sourcing their good from CBL. Ferrier Hodgson concluded that Davids were 2.08% cheaper than CBL for the twelve month period to 31 December 1994. (See paragraphs 6.13 to 6.18 on the results of this study.)

Tuckerbag submitted that two warehouses means competition for independents' business, while one large warehouse means greater competition against the chains. The group advised that it would have to be absolutely certain that a single operation would pass its efficiencies and economies onto its retailers, and to date the group did not have that assurance. Tuckerbag concluded that with the current information available, it did not believe that a merged operation under the Davids formula would mean economies that would flow through to the Victorian public.

Tuckerbag also provided a number of comments in relation to Davids' proposed draft undertakings. Tuckerbag submitted that there is no effective, practical way of ensuring that Davids deliver a satisfactory level of supply for the goods and services required. Tuckerbag then went on to detail an alternative agreement between Davids and Tuckerbag that would be suitable to the Tuckerbag banner group. The submission spelled out the specific terms of a proposed five year agreement for the provision of goods and services to the Tuckerbag group.

- **Payless NSW** submitted that a lack of competition in a one supplier market would inevitably lead to higher prices to the consumer. Payless considered it important to the market that there be alternative sources of supply to ensure a healthy, vibrant and competitive independent industry for the benefit of the Australian public. The group considered that its members' current trading terms were better than Davids' standard trading terms to its NSW customers.

Payless provided detailed submissions in relation to Davids' proposed draft undertakings. They did not believe that the proposed undertakings would lessen to any extent the fact that there would only be one wholesaler of any substance left in NSW if the merger is allowed to proceed. They reiterated earlier comments that it is important to the market that there be alternate sources of supply to ensure a healthy, vibrant and competitive independent industry. They made the following comments:

- Payless should have its own nominee with access to all the documents necessary to determine if the members are being invoiced at no more than the agreed price. This arrangement currently exists with CBL.
- A register of all suppliers dealing with Davids should be kept and made available to the retailers' nominee, and also detail the rebates and type of rebates given to Davids. This arrangement also currently exists with CBL.
- The definition of 'wholesale prices' was too vague and should be much more specific.
- Payless NSW believe that the true net cost system of the wholesaler putting all rebates, discounts and allowances into price and then charging a service fee to cover costs and profits for the wholesaler would be easier to administer and monitor and would enhance the wholesaler/retailer relationship.
- There should be no loadings and/or margins added to any goods and Davids should undertake to eliminate any existing at the Effective Date.
- Payless members are also concerned about any action that may result from any member's slow payment to the warehouse, including slow or refused delivery which would result in retailers being out of stock, or higher prices.
- The second point in Davids' undertakings combined wholesale prices and services, whereby Davids could offset a price advantage with a drop in service which would be unacceptable to most Payless NSW members. They considered that the wholesale price is the most important issue and should not be combined with any other issue.
- Payless NSW disagreed with the ballot method for banner rationalisation suggested by Davids. They saw this as a dangerous mechanism which may force some stores into banners they do not want to go to. They believed that it was undemocratic to allow one vote per store as 25 per cent of owners could control more than 50 per cent of the stores. Payless NSW stated that if a retailer wants to keep his existing banner, he must be allowed to do so.
- Payless NSW believed that punitive penalties should be imposed if Davids do not comply with their undertakings as the retailer will have no other supply option

available and would have to continue trading with Davids and accept the prevailing conditions.

Payless NSW summarised their position by stating that monitoring of the undertakings would be an extremely difficult and onerous task but if it were to be attempted then it should be done on a day to day basis with a nominee of the retailers located on Davids' premises with access to all the necessary books and records. Payless NSW believed that unless Davids are prepared to put all the above points into their undertakings there can be no way their members will be better off. They provided that anything less than the adoption of the above undertakings would mean that their members would be worse off and would have to considerably increase their retail prices to consumers. Under the present circumstances, Payless NSW sees no benefits for either retailers or consumers if Davids were allowed to take over CBL.

A submission was also received by NSW Supermarkets Pty Limited trading as Payless Bourke, Walgett, Nyngan and Summer Hill, in relation to Davids' draft undertakings. It was stated that the proposed undertakings address satisfactorily all of the various concerns which have been raised by the Payless NSW banner group committee. These include such matters as an increase in wholesale pricing, costs of ancillary services, adequate service levels, and the rationalisation of banners. This submission was provided to the Commission with the aim of showing that the Payless group had a divided view on the proposed merger.

- The **Goodfellows** group provided a submission based on the results of the survey of its members mentioned above, and feedback received by committee members from retailers. The main concerns raised by the group are outlined below.
  - One warehouse will lead to higher costs and higher prices resulting from removal of competition.
  - Small turnover stores will be forced to purchase some or all stock from Cash & Carry wholesalers at higher cost prices, resulting in higher prices for consumers.
  - In many country towns and older suburbs there are many small supermarkets that compete with each other. Banner rationalisation would remove this competition and result in a market place where stores offer the same specials, pricing and range which would eventually force the closure of stores.

The Goodfellows and Budget-Rite banner groups made two joint submissions in relation to Davids' proposed draft undertakings. It was submitted that the objective of limiting any lessening of competition could not be achieved with the removal of CBL from the market. The two banner group committees submitted that the undertakings would leave Davids open to "do as they wish" and that the undertakings would therefore fail to guarantee any security or stability to CBL and its customers. They also provided that the undertakings would not ensure that banner rationalisation would not occur which they state would be confusing and disadvantageous for consumers.

- The **MFC** group consider the proposed acquisition to be anti-competitive and are strongly opposed to it. The group considers that the proposed acquisition would have a deleterious effect on the general public by threatening the survival of independent grocery retailers. Currently such retailers have the ability to change banner groups, compare prices, service and availability of stock. One of the likely

effects of such an acquisition is that smaller independent retailers would be forced into using Campbell's Cash & Carry which is more expensive, has a more limited product range and has the disadvantages of no delivery service.

MFC provided comments in relation to Davids' proposed draft undertakings. MFC made the comment that its members strongly believe in the alternative warehouse distribution system which currently exists, which results in cheaper prices and better product range, allowing the independent retailer to remain competitive with the chains stores as well as provide a point of difference with other independent retailers. MFC submitted that while there may be some advantages to some of the larger banner stores, those stores at the smaller end of the scale would be disadvantaged by higher premiums, either within the list price of goods or by increased service fees. MFC also questioned what will happen at the end of the five year period when Davids propose to be no longer constrained by the undertakings. It was submitted that Davids would then be "at liberty to charge what it likes".

- The **Rite-way** group expressed the following concerns regarding the proposed merger:
  - higher cost of goods due to the one source of supply and no competition, resulting in increased prices to consumers;
  - banner rationalisation would lead to competing stores operating under the same banner resulting in reduced choice for the consumer, down-grading of stores, possible store closures and possible price increases due to lack of competition;
  - concern that small or minor banner groups may not receive sufficient commitment or support from Davids and so be forced to purchase from Campbell's Cash & Carry which again would result in higher prices to consumers;
  - higher prices for generics due to no competition;
  - highly possible that transport costs would rise because all products may not be available from the one location;
  - loss of flexible, multi functional retail price zones which are to be replaced by six rigid price zones;
  - scanning services offered by Davids are considered to be "totally inadequate" when compared to those of CBL;
  - refurbishment of stores could lead to the closure of other independent stores in close proximity resulting in reduced choice and higher prices for the consumer; and
  - industrial action involving the only wholesaler may lead to towns and communities being severely affected.

The Rite-way group made several brief comments in relation to Davids' draft undertakings. The banner committee provided that the proposed undertakings were only a side issue and that they are strongly opposed to the proposed takeover as it would remove the right of choice and thus create a monopoly. However, in relation to the proposed draft undertakings, Rite-way commented "... that in the event of (a takeover), it is comforting to know that we will not be disadvantaged".

6.58. **Foodlink** is a co-operative style retail support company which provides a number of banner groups (and related services) for independent retailers in Queensland



and northern NSW. Foodlink supports the proposed acquisition, as in its view rationalisation in the independent sector of the market is necessary so that wholesalers have the capacity to develop the larger retail outlets (such as Rainbow stores) that can compete with the chains. Foodlink did not consider that the proposed Davids/CBL merger, or the merger of other independent wholesalers, would have an anti-competitive effect on the market to independent retailers because of the interdependence between wholesaler and retailer and the necessity for independent retailers to remain competitive with the chains. Foodlink stated that it is necessary to allow rationalisation of the independents so that a fourth force can at least give the right sort of financial support and discipline that is necessary for the independent sector to maintain their current market share.

6.59. **The Retail Traders' Association of Tasmania** supports the proposed acquisition stating that it would result in store upgrading, increased product range, development of premium brands, better training and support services, and increased buying power to boost competition with the chains. They also provided that the valuable resources of time and effort used in competing at the wholesaling level could be more effectively utilised in providing strong and vibrant competition at the retailing level. They support Davids' claim that without rationalisation, the deterioration of the independent system will continue.

6.60. **The Liquor Stores Association of Victoria and The Retail Confectionery and Mixed Business Association (RCMBA)** oppose the proposed merger on the grounds that it would reduce competition through the creation of a monopoly. The RCMBA was concerned that the merger would result in retailers being forced to purchase from Cash & Carry wholesalers at significantly higher prices.

### **Suppliers, and supplier associations**

6.61. Twelve submissions were received from suppliers in the grocery industry, of which nine have been granted confidentiality. Eight of the twelve submissions were either in favour of the proposed merger or had no objection to it. The main benefits these suppliers saw emerging from the merger were reduced costs for suppliers through servicing one rather than two warehouses, this would also improve efficiency in the transport of goods. It was considered that manufacturers would be able to improve the efficiency of promotional activity, which would result in lower prices for goods to the consumer. A number of suppliers also stated that a merger would be the best alternative in light of CBL's alleged failing position.

6.62. These suppliers also considered that the merger would allow Davids to put forward a more consistent marketing plan that would be to the benefit of the smaller retailer and consumers, and have the effect of allowing stores to compete more favourably with the chains in terms of price, service and product range.

6.63. It was submitted by the **Paper Converting Company** that any potential anti-competitive effects associated with independent supermarkets not having the ability to choose wholesalers, should be offset by the improved buying power that a larger Davids group would have.

6.64. **The Grocery Manufacturers of Australia and Ricegrowers Co-operative Limited** considered that the proposed merger offered significant rationalisation benefits which could strengthen the competitive position of the merged entity and independent retailers relative to the chains. **Cleanaway** submitted that the merger should create

healthier competition to the chains, would be beneficial for CBL's customers and that the merger is the best alternative in light of CBL's uncertain financial future. The **Soft Drink Association** did not oppose the proposed merger.

6.65. Four suppliers' submissions opposed the proposed acquisition, and raised issues similar to those raised by the independent retailers opposed to the acquisition. It was considered that the merger would result in a reduction in competition and a decline in the number of retail stores available to consumers, and therefore reduced choice and higher prices. The **Australian Egg Industry Association** opposed the proposed acquisition on the grounds that it would increase concentration in the grocery industry and be anti-competitive.

## 7. Commission evaluation

7.1. The Commission shall only grant authorisation if it is satisfied in all the circumstances that the acquisition would result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to take place.

7.2. This chapter sets out the Commission's evaluation of the likely effect on competition of the acquisition and the public benefits claimed for it.

### Introduction

7.3. While the concept of competition in the Act is generally well understood and rests on a set of economic principles which have been articulated in the decisions of the Australian courts and the Trade Practices Tribunal, the concept of public benefit in the Act is less clearly understood. The Act itself does not define the term, except to require that significant increases in exports or import replacement be considered as public benefits and that the Commission take account of all relevant matters relating to international competition. (s.90(9A)).

7.4. Professor Maureen Brunt has suggested that the test for authorisation was left deliberately broad and open-ended because in the early days, when restrictive practices were so pervasive in Australia, it was unclear to legislators how many of them might be "justifiable".<sup>47</sup> Hence the statutory test was not couched in terms of efficiency or consumer welfare, but the potentially much broader concept of public benefit<sup>48</sup>.

### Principles

7.5. In reviewing the substantial body of Tribunal and Commission determinations of merger authorisation applications, it is possible to distil the following relevant key principles.

### Procedure

7.6. In assessing the benefit to the public of a proposed acquisition it is appropriate to commence with an assessment of the competitive impact of the proposed acquisition. (See discussion above at paragraphs 5.1 to 5.3).

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<sup>47</sup> Maureen Brunt (1994), "The Australian Antitrust Law After 20 Years - A Stocktake", Review of Industrial Organisation, Vol.9, No.5, p.48.

<sup>48</sup> A strictly economic approach to public benefit would evaluate the likely net gain to the economic welfare of society arising from the proposed acquisition, including the effects on allocative, cost and dynamic efficiency. A merger may improve cost efficiency by tapping economies of scale and scope, or may improve dynamic efficiency through increased levels of investment in new product development etc.. However, if competition is likely to be adversely affected, the merger may reduce allocative efficiency, by raising prices above competitive levels. The reduced competitive pressure may also reduce the pressure on firms to minimise costs and develop new products and new ways of supplying them.

Williamson's trade-off model provides a limited framework for making such an evaluation. (O. E. Williamson (1968), "Economics as an Anti-trust defence: the welfare trade-offs", American Economic Review, 53, pp.1032-57).

7.7. However, it is not necessary or appropriate to express a view as to whether the proposed acquisition would breach section 50 of the Trade Practices Act in the absence of authorisation.

7.8. In this application Davids has conceded that the acquisition may be likely to substantially lessen competition. The relevant public benefit is a net or overall benefit after any detriment to the public resulting or likely to result from the proposed acquisition. The Tribunal stated in QCMA:

We accept that the statute calls upon us to adopt a balance-sheet approach: we must balance the likely benefits and detriments flowing from the acquisition.<sup>49</sup>

and further;

We are to be concerned with probable effects rather than with possible or speculative effects. Yet we accept the view that the probabilities with which we are concerned are commercial or economic likelihoods which may not be susceptible of formal proof. We are required to look into the future but we can be concerned only with the foreseeable future as it appears on the basis of evidence and argument relating to the particular application.<sup>50</sup>

### **Competition Issues**

7.9. A primary public detriment is any reduction in competition which will result or is likely to result from the proposed acquisition. However, the notion of detriment falling for consideration under "all the circumstances" is wider than the notion of anti-competitive effect. The Tribunal stated in QCMA:

We accept that the notion of detriment falling for consideration under "all the circumstances" is wider than the notion of anti-competitive effect. But at the same time, given the policy of the Act and the subject-matter under consideration, the most important of these potential detriments will normally be the anti-competitive effects.<sup>51</sup>

7.10. It is relevant for the Commission to assess how any reduction in competition may affect ultimate consumers. In Wesfarmers<sup>52</sup> (1979), the Tribunal considered it relevant in assessing the public benefit of a proposal for Wesfarmers (a distributor of farm products amongst other businesses) to acquire control of CSBP (a manufacturer of fertiliser) that notwithstanding the impact on competition at the distributor level there was likely to be no detrimental impact on fertiliser prices to farmers.

### **Public Benefit, Efficiency, Private Benefits**

7.11. The concept of a benefit to the public is not limited to a benefit to consumers, a benefit to a private party which is of value to the community generally is a public benefit. The Tribunal stated in QCMA:

One question that arises is whether by the public is meant the consuming public. One submission to us was that, in the context of the objectives of the Act, we should direct our attention to that part of the public concerned with the use or consumption of flour in the

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<sup>49</sup> QCMA, *op.cit.*, 17,243.

<sup>50</sup> QCMA, *op.cit.*, 17,243.

<sup>51</sup> QCMA, *op.cit.*, 17,243.

<sup>52</sup> Rural Traders Co-operative (WA.) Ltd. & Ors. Australian Trade Practices Reporter (1979), 40-110 (re Wesfarmers).

Queensland market. This would be to interpret the phrase as pointing to much the same considerations as those raised by sec. 21(1)(b) of the British *Restrictive Trade Practices Act* 1956, which asks whether withholding approval would "deny to the public as purchasers, consumers or users...specific and substantial benefits or advantages .....". However this is not what the Australian Act says; and we cannot but think that the choice of a wider expression was deliberate, as pointing to some wider conception of the public interest, though no doubt the interests of the public as purchasers, consumers or users must fall within it and bulk large.

Another question raised is whether public benefit must be contrasted with private benefit. Can a benefit to some of the private parties to the merger - for example the shareholders of Barnes - be claimed as a public benefit? Must a benefit which accrues to the private parties be "passed on" to members of the wider community before it can be considered? The Commission has expressed its view in its *First Annual Report* (Year Ended 30 June 1975) that the test requires "benefits to the public and not merely to the applicant or some other limited group". (p. 41). While agreeing with this statement as far as it goes, we would not wish to rule out of consideration any argument coming within the widest possible conception of public benefit. This we see as anything of value to the community generally, any contribution to the aims pursued by the society including as one of its principal elements (in the context of trade practices legislation) the achievement of the economic goals of efficiency and progress. If this conception is adopted, it is clear that it could be possible to argue in some cases that a benefit to the members or employees of the corporations involved served some acknowledged end of public policy even though no immediate or direct benefit to others was demonstrable.<sup>53</sup>

7.12. However the interests of the public as purchasers, consumers or users are of primary importance.

7.13. A proposed acquisition may lead to enhanced competition in some markets which is a substantial public benefit. This is referred to earlier at paragraph 5.2.

7.14. One of the principle aims of the Act and the community generally is the achievement of the economic goals of efficiency and progress.

7.15. Efficiency is itself a prime public benefit. Efficiency gains resulting from a proposed acquisition have been recognised by the Commission and the Tribunal as substantial public benefits in numerous matters, including QCMA referred to above. In Wesfarmers (1979), the Tribunal stated:

the encouragement of competition and competitive behaviour and the achievement of the economic goals of efficiency and progress will commonly be paramount.<sup>54</sup>

In Monier (1983)<sup>55</sup>, the Commission described efficiency as "itself a prime public benefit."

In Henderson Springs (1987)<sup>56</sup>, the Commission authorised an acquisition which resulted in Henderson being the sole Australian manufacturer of automotive suspension

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<sup>53</sup> QCMA, *op.cit.*, p 17,242.

<sup>54</sup> *Re Wesfarmers* *op.cit.*, p 18,123.

<sup>55</sup> *Monier Limited* (1983) Australian Trade Practices Reporter (Com), 50-062.

<sup>56</sup> *Henderson's Federal Spring Works Pty Ltd* (1987) Australian Trade Practices Reporter (Com), 50-054.

components and sealing components, on the basis of the public benefit in rationalisation which would generate cost savings.

In the TRW Determinations (1989, 1992 (No.1)<sup>57</sup> and 1992 (No.2)<sup>58</sup>), the Commission recognised production efficiencies resulting from the acquisition as a public benefit.

7.16. Fostering business efficiency and rationalisation of industry resulting in more efficient allocation of resources, in lower or contained unit costs of production and in lower capital costs are of benefit to the community generally and, accordingly, are public benefits. In ACI (1991) the Commission stated:

The Commission accepts, therefore, that there is likely to be a capital saving in purchasing the Smorgons plant, although difficult to quantify. ACI will achieve the same net result (that is, a new efficient plant) at a lower capital cost, and this should be viewed as a saving of resources from the point of view of the community at large.<sup>59</sup>

7.17. Rationalisation savings which are not passed through to the wider community are still public benefits, although they might be given less weight than if such savings or a portion of such savings were passed through to purchasers, consumers and users in lower costs of supply. While efficiencies which result from a proposed acquisition are public benefits, it is a relevant consideration for the Commission to assess whether such saving, either in whole or in part, will be passed through to purchasers, consumers or users. In Howard Smith (1977), the Tribunal stated:

If a merger is likely to result in the achievement of economies and a considerable saving in the cost of supplying a good or service this might well constitute a substantial benefit to the public, even though the cost saving is not passed on to the consumers in the form of lower prices. Nevertheless, if such a merger benefited only a small number of shareholders of the applicant corporations through higher profits and dividends, this might be given less weight by the Tribunal, because the benefits are not being spread widely among members of the community generally.<sup>60</sup>

Professor Brunt has suggested that it is not so much the immediate distribution of benefits that is important but their durability. If the benefits will not be passed through to consumers due to an absence of competitive pressures, this may in turn lead to their dissipation through slackness or rent seeking<sup>61</sup>.

### **Conditional Authorisation**

7.18. The Commission can grant authorisation subject to conditions. Sub section 91(3) of the Act provides that:

An authorisation may be expressed to be subject to such conditions as are specified in the authorisation.

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<sup>57</sup> *TRW Australia Holdings (1992)* Australian Trade Practices Reporter (Com), 50-122.

<sup>58</sup> *TRW Australia Holdings (1992)* Australian Trade Practices Reporter (Com), 50-127.

<sup>59</sup> *ACI Operations Pty Ltd (1991)* Australian Trade Practices Reporter (Com) 50-108, p 56,085.

<sup>60</sup> *Howard Smith Industries and Adelaide Steamship Industries (1977)* Australian Trade Practices Reporter, 40-023, p 17,334. Emphasis added.

<sup>61</sup> Maureen Brunt (1994), op.cit., p.508.

7.19. It may be appropriate in particular cases for the Commission to grant an authorisation subject to conditions which may lessen any detriment that might result from the acquisition, including a reduction in competition, and which may result in the passing through of rationalisation savings to purchasers, consumers and users in lower costs of supply. Such conditions may include a requirement that the applicant provide relevant undertakings. The Commission and the Tribunal have accepted undertakings in relation to numerous applications for authorisation of a proposed acquisition. Aspects of these undertakings have involved undertakings:

(a) to maintain existing distribution networks;

Wesfarmers: undertakings were given to maintain existing distributors and to offer fertiliser to competing distributors on non-discriminatory.

(b) to limit price increases and to pass on price reductions

ACI: ACI undertook to pass through price reductions to green bottle purchasers and future price rises were capped.

Qantas<sup>62</sup>: Undertakings were given which limit any future prices by Qantas in respect of certain classes of air travel.

(c) referral of disputes between the applicant and its customers to an independent body for resolution and determination

TRW (1989): undertakings were given to submit to an independent arbitrator any disputes involving the criteria to which repairers and reconditioners were required to conform; and to any dispute involving the rejection of a person refused accreditation under such criteria.

(d) ongoing monitoring of the performance of the applicant pursuant to the undertakings.

ACI: undertakings were provided for the ongoing auditing of ACI's prices by an independent auditor.

Wesfarmers: undertakings were provided to enable an independent auditor to investigate complaints from distributors of non-compliance.

Monier: undertakings were given to the Court (the Commission had commenced related proceedings for an injunction under s.86 in respect of a threatened breach of s.50) which included an undertaking that Monier's compliance would be audited by an independent auditor.<sup>63</sup>

See also Qantas.

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<sup>62</sup> Trade Practices Commission Determination A90565, 12 May 1995, in respect of an application for authorisation lodged under s.88(1) of the Trade Practices Act by Qantas Airways Limited and British Airways Plc.

<sup>63</sup> Monier, op.cit.

7.20. The Commission may accept written undertakings in connection with a matter in relation to which the Commission has a power or function under the Act (section 87B of the Act).

7.21. Such undertakings are enforceable by the Commission in the Federal Court. The Federal Court has wide powers in relation to a person who has breached an enforceable undertaking, including the power:

- to direct compliance with the undertaking;
- to order that the person pay compensation to any person who has suffered loss or damage as a result of the breach;
- any other order the Court considers appropriate. (Section 87B of the Act).

## **Effects on competition**

7.22. In terms of evaluation, the Commission has considered the proposed acquisition of CBL by Davids in light of the undertakings (copy at Appendix B), accepted by the Commission on 29 May 1995. For the purposes of determining an application for authorisation, the Commission is not required to determine the threshold issue of whether the proposed acquisition would substantially lessen competition in breach of section 50 of the Trade Practices Act. However, in considering the likely effect of the acquisition on competition, the framework provided by section 50 is a useful one. Section 50(3) sets out a number of factors which must be taken into account when assessing the likely effect of an acquisition on competition. The Commission has incorporated these into an evaluation process outlined in its *Draft Merger Guidelines*.

7.23. The first stage of that process is market definition. This was dealt with in chapter 5, which determined that the relevant markets were markets for the distribution of groceries by independent wholesalers to independent retailers in each of Victoria, NSW and Tasmania; multiple retail grocery markets in these states; and either a national or state markets for the wholesale distribution of wine and spirits, or alternatively the distribution of liquor. The following analysis utilises the statutory factors as incorporated in the *Guidelines* to evaluate the likely effect of the merger on competition in those markets.

## **Grocery wholesaling**

### **Concentration**

7.24. In Victoria there are currently two independent grocery wholesalers, Davids and CBL. Their market shares at December 1994 were approximately 53 and 47 per cent



respectively.<sup>64</sup> The Commission's market inquiries indicate that competition between the two evenly matched wholesalers is strong. Independent retailers switch between the two suppliers or use the better deal offered by one to extract a deal from the other. Following the proposed acquisition, the merged entity will have a monopoly in Victoria and competition between Davids and CBL will cease.

7.25. As discussed in chapter 5, New South Wales and the ACT are considered to constitute a single market. There are currently three independent wholesalers supplying this market; Davids, CBL and AIW. Davids is the largest supplier, with a market share of 77 per cent at December 1994; CBL had a share of seventeen per cent; and AIW had a share of six per cent.<sup>65</sup> Both CBL and AIW are relatively new entrants to the market. The Commission's market inquiries indicate that CBL in particular has been attempting to win market share from Davids. AIW was established specifically to supply Cannons food barns in the ACT, but has been expanding to supply other independent retailers, particularly in country areas around Canberra and the south coast. This growth has been more passive than active, picking up disaffected customers from other wholesalers, particularly Davids. However, it now supplies two banner groups, Shop-Ezy and Ace. Following the proposed acquisition, the merged entity will have close to a monopoly in New South Wales and the ACT, with AIW as its only remaining competitor.

7.26. In Tasmania, independent retailers are predominantly supplied by Statewide Independent Wholesalers (SIW), (a joint venture owned sixty per cent by Woolworths and forty per cent by Tasmanian Independent Wholesalers (TIW)); and Purity Supermarkets, also owned by Woolworths. Davids has recently licensed the Festival banner and IGA to TIW in Tasmania. The 1989 Tasmanian Prices Inquiry was critical of the low level of wholesale competition in the grocery industry in that state.<sup>66</sup> Davids had begun supplying the Tasmanian market, but later withdrew, selling their operations to Woolworths. CBL has recently commenced inter-state supplies and several submissions from Tasmanian customers spoke positively about the competitive prices and service levels provided. The applicant has said that they will continue to supply these retailers if it is commercially viable. The undertakings extend to Tasmanian retailers of CBL. This being the case, the merger will have no effect on the level of concentration in Tasmania.

### **Import competition**

7.27. There is no effective import competition for the supply of grocery wholesaling services. Costs of transportation and the need for reliable and rapid delivery of orders would make such a venture unviable, even for non-perishable groceries.

7.28. Furthermore, most of the groceries required by the independent retailers are locally manufactured. Imported foods tend to be either cheaper (including generic) foods, e.g. canned fruit and vegetables, or high value added foods, e.g. cheese and pate. The 1986 PSA inquiry into retail prices of food and groceries reported that Davids imported less than five per cent of their total turnover.<sup>67</sup> FAL indicated in 1993 that

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<sup>64</sup> Derived from Retail World (1994), Australian Grocery Industry Marketing Guide 1995, p.19.

<sup>65</sup> Ibid., p.13.

<sup>66</sup> The Prices Inquiry Board (1989), Report to the Tasmanian Government on Retail Prices in Tasmania in relation to other Australian states, 31 March.

<sup>67</sup> Prices Surveillance Authority, Inquiry in Relation to Retail Prices of Food and Groceries, Report No.9, 5 September 1986, p.28.

the combined imports of the then proposed Amalgamated Group would be around \$100 million, which was around two per cent of the combined sales revenue of the four companies (FAL, Davids, IHL and CBL), and that Black & Gold products are their major imports.<sup>68</sup>

### **Barriers to entry**

7.29. The Commission considers that barriers to entry into grocery wholesaling, while not overwhelming are nevertheless significant. The major barriers consist of economies of scale and scope; sunk costs; access to generics; and the threat of predation. Of these, economies of scale and scope constitute the major barrier.

7.30. In relation to economies of scale and scope, a minimum efficient scale (MES) of \$150m turnover was suggested in the *QIW* decision.<sup>69</sup> FAL suggested a figure of \$200m.<sup>70</sup> A figure of \$150-200m is confirmed by the Commission's market inquiries. This scale would be required both to minimise operating costs, to gain access to quantity discounts, rebates and promotions and to enable the warehouse to carry a full product range.

7.31. According to the *QIW* decision, a potential entrant would need to acquire a substantial market share in order to attain such a turnover, but there is no indication of what proportion of the market would be required. This will vary considerably according to the size of the different state markets. The NSW and Victorian markets are valued at over \$1.2 billion each. Hence MES is less than fifteen per cent of the market. While still substantial, economies of scale pose less of a barrier to entry than in smaller states. In Tasmania the size of the market is considerably smaller and a new entrant would have to secure a much larger share to be viable.

7.32. The need to achieve this level of sales may permit the incumbent to maintain prices above their competitive levels without attracting entry. Investment in capacity of this scale and the need to achieve turnover will be likely to drive post-entry prices down and reduce the expected return on investment, deterring such entry. Consideration of the post-entry scenario means that pre-entry prices will need to be significantly higher than competitive levels, providing an above normal rate of return before entrants will be attracted.

7.33. The importance of volume for entry into grocery wholesaling is indicated by the history of the sector, with new groups largely formed as co-operatives to supply a group of retailers or by vertical integration backwards to supply a large independent chain. Jewel supermarkets previously operated their own warehouse and in the event of the merged parties increasing prices, the sales volume from its own stores would be sufficient to achieve MES. AIW was established specifically to service Cannons food barns, which provided a significant sales base for subsequent growth to supply independent retailers.

7.34. Entry into grocery wholesaling would involve some sunk costs, but these alone would not constitute an insurmountable barrier. FAL's new warehouse at Canning

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<sup>68</sup> FAL submission 3 November 1993 and supplementary submission 15 December 1993, in relation to Authorisation Application No. A90553.

<sup>69</sup> *QIW*, *op. cit.*, 41,118 and 41,144.

<sup>70</sup> FAL supplementary submission, 15 December 1993, in relation to Authorisation Application No. A90553.

Vale, which has a floor space of 49,000 sq.m., cost \$21m including fitout.<sup>71</sup> However, warehousing can be rented and often is, with building requirements not being grocery specific, reducing sunk cost requirements. Warehouse fixtures and fittings, fork lift trucks, computer systems etc. may involve sunk costs, although some rental is available.<sup>72</sup> Transportation is generally arranged through trucking companies, either directly by the retailer or through the wholesaler; hence there is no requirement to sink costs in transport equipment.

7.35. The main sunk cost is unrecoverable stock holding costs. Although payment terms for acquisition of stock are generally more generous than those provided to retailers, if sales were not achieved, the bills would still have to be paid. Information in the annual reports of various grocery wholesalers suggests they have working capital in the range \$50-70m tied up in "inventories".<sup>73</sup> Mr Bullock's affidavit in *QIW* refers to a figure of \$19.4m tied up in stock.<sup>74</sup> However, both of these figures would exceed the investment required to stock a warehouse of MES. Mr Window's affidavit in *QIW*, which examines the requirements for market entry, suggests a figure of \$15m inventories in a warehouse of 220-265,000 sq.ft. (approx 20-25,000 sq.m.).<sup>75</sup> Although some stocks would be able to be sold, their shelf life is limited and there would also be a loss of foregone interest on working capital tied up in the stocks. Hence there could be significant sunk costs lost on exit.

7.36. Generics comprise a significant proportion of sales by independent wholesalers. Black & Gold products account for 5.6 per cent of Davids' sales and IGA products account for 2.3 per cent of sales to Festival and Rainbow stores.<sup>76</sup> The *QIW* decision suggests that access to these products is an essential input to grocery wholesaling. Members of AAW other than CBL currently have access to the Black & Gold product range, while CBL has its own Payless brand (negotiated through AAW), which it also supplies to AIW. Although a new entrant could negotiate supply of its own range of generic products, this would take time and increase the level of sunk costs. The applicant is committed to maintaining AAW, which would guarantee continued supply of the Black & Gold brand to existing members. However, the Payless brand will be merged with Black & Gold. AIW has expressed concern about its ability to compete effectively without access to the Payless brand and its demise would seem to create further problems for potential entrants. The undertakings which Davids has given to the Commission provide for continued access to Black & Gold products for FAL and *QIW* and also continued supply of Payless generic products to AIW.

7.37. Having already sunk their entry costs, it may be in the interests of incumbents to price at marginal cost (or even lower, given barriers to entry) and drive out any new entrants. With economies of scale and scope and relatively low marginal cost, the likelihood of a price war being instigated by incumbents may be a deterrence to entry. The threat of such retaliation by a combined Davids/*QIW* was regarded as a significant

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<sup>71</sup> FAL, *Annual Report 1991-92*.

<sup>72</sup> CBL had \$8.4m and \$4.2m invested in warehouse fixtures and equipment in Victoria and NSW respectively in 1993 (FAL supplementary submission, 15 December 1993, in relation to Authorisation Application No. A90553).

<sup>73</sup> CBL's balance sheet at 25 December 1994 gives a figure of \$55.2m (Victoria and NSW) and Davids balance sheet at 31 December 1994 gives a figure of \$273.8m (Queensland, NSW, Victoria and South Australia).

<sup>74</sup> Affidavit of Mr Bullock, p.10.

<sup>75</sup> Affidavit of Mr Window, p.11.

<sup>76</sup> Davids Submission, 23 February 1995, p.7.

barrier to entry in the *QIW* case. Davids admitted that "the combined financial strength of Davids and *QIW* would give rise 'to an ability to supply groceries to independent retailers in Queensland and northern New South Wales below cost for a sustained period' "<sup>77</sup> Given that the most likely entrants post-merger would be *FAL* or *QIW* entering into states where they do not currently operate or a group of independent retailers setting up a warehouse, their pockets would be shallower and their ability to sustain a price war consequently lower than Davids'.

7.38. Hence, there appear to be not insignificant barriers to entry to grocery wholesaling. In these circumstances, the threat of potential competition would not be sufficient to prevent the exercise of a degree of market power by a merged Davids/CBL.

7.39. However, these barriers are least significant in Victoria and New South Wales because of the size of the markets compared to the *MES*. There has been actual entry in recent years, e.g. *VGD* in Victoria, *G&L* and *AIW* in the *ACT* and New South Wales. However, the first two of these were taken over by Davids and the Commission understands that inability to maintain a sufficient retail customer base contributed to their sale. *AIW* is only a recent entrant and has not established its full competitive force, but the Cannons food barns provide it with a stable core customer base. The threat of further entry on this basis would provide some constraint on the conduct of incumbents.

7.40. The most likely entrants would seem to be independent wholesalers operating in other state markets. They have the industry knowledge, access to *AAW* (providing nationally negotiated rebates from manufacturers and access to Black & Gold generics) and access to capital. This was also suggested by Justice Spender in *QIW*. The proposed merger would deliver control of *AAW* to Davids. The Commission considers it important that *QIW* and *FAL* maintain equal access to the national rebates and Black & Gold products negotiated by *AAW* if they are to offer a viable alternative as potential entrants. Such access is also important to enable *QIW* to continue as a viable competitor to Davids in Queensland and northern NSW. The undertakings given by the applicant make provision for continued access to both rebates and generics for the other members of *AAW*, on non-discriminatory terms.

7.41. Another potential source of entry is an independent supermarket chain or joint venture of independent retailers setting up their own warehousing facilities. These retail stores would provide a guaranteed customer base to overcome the major barrier to entry. Hence, *AIW* was established to service the Cannons food barns and *VGD* was set up by a group of independent retailers in Victoria. The Foodlink group of retailers in Queensland and northern NSW have combined warehouse withdrawals of \$150m<sup>78</sup>, which would provide the necessary volume to support a contract warehouse and distribution system. Jewel has previously indicated that it would establish its own warehouse if a merged Davids-CBL attempted to extract monopoly rents.<sup>79</sup> It does not rely on Davids for any of the associated wholesaling services and would be able to establish their own warehousing facility; their own (69 in NSW and 24 in Victoria) retail outlets would guarantee sufficient turnover to make the warehouse cost efficient and minimise the risk of sunk cost investment discussed above.

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<sup>77</sup> *QIW*, *op. cit.*, 41,106.

<sup>78</sup> Foodlink Submission, 16 February 1995, p.1.

<sup>79</sup> Jewel Submission, 17 September 1993, in relation to Authorisation Application No. A90553.