

Trade Practices Commission

Determination

Application for Authorisation

by

Dauids Limited

**in relation to its proposed acquisition of
Composite Buyers Limited**

Application No:

A30165

Commissioners:

Broome (Deputy
Chairman)

Asher

Lieberman

File No:

CA95/3

Date: 29 May 1995

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Summary

Dauids Limited (Dauids) has sought authorisation for its proposed acquisition of all the issued shares and other securities of Composite Buyers Limited (CBL).

The principal activities of Dauids and CBL are the wholesale distribution of groceries, refrigerated foods, general merchandise and liquor. The independent grocery wholesalers supply independent retailers, but not the national retail chains (Woolworths, Coles and Franklins) which operate their own vertically integrated grocery distribution businesses. Dauids is the largest independent grocery wholesaler in Australia. It operates in New South Wales, the ACT, Victoria, Queensland, South Australia and the Northern Territory. CBL wholesales groceries in Victoria and to a lesser extent in New South Wales and Tasmania. The other distributors of groceries to independent retailers in Australia are FAL which supplies Western Australia, QIW which distributes in Queensland, and AIW which operates in the ACT and some areas of New South Wales. The parties to the proposed acquisition also have direct interests in grocery retailing. However, CBL is in the process of disposing of these assets, and only has eight retail stores remaining at the present time.

Following the *QIW* decision, the applicant submitted that the relevant markets are for the supply of grocery products by independent wholesalers to independent retailers in Victoria and to independent retailers in NSW. The Commission considers that a number of factors bring independent retailers into closer competition with the vertically integrated chains in Victoria and NSW, thereby increasing the constraint imposed by the chains on independent wholesalers. A larger proportion of independent retailers are supermarkets, offering a service in close competition with the chains; the chains are open for extended trading hours, offering an alternative form of convenience shopping; and a larger proportion of independent retailers are located in close geographic proximity to chain stores. Nevertheless, there still exists a degree of product differentiation between independent retailers and the chains. Furthermore, following *QIW*, even if independent retailers and the chains compete in the same retail markets, there is still room for a monopoly supplier of wholesale services to independent retailers to impose a significant increase in its price (the wholesale margin) and profits, which the independent retailers would absorb. Hence the Commission agrees with the applicant's submission on market definition, with the addition of the Tasmanian market for the wholesale supply of groceries from independent wholesalers to independent retailers, in which CBL competes. Geographic market boundaries are determined by transportation costs rather than political boundaries and hence do not coincide exactly with states. The Commission also considers that these markets would be substantial markets for the purposes of section 50 of the Act.

While the immediate impact of the proposed acquisition is at the wholesale level, it will also impact on retail markets. Indeed, an increase in retail competition is one of the major public benefits claimed by the applicant. The Commission considers that a large proportion of Dauids' and CBL's customers compete in the same product and geographic retail markets as the chains.

The parties also have interests in liquor wholesaling. Dauids owns fifty per cent of Australian Liquor Marketers Pty Ltd, which is the largest distributor of wines and spirits in Australia. The applicant submitted that the relevant market is a market for the distribution and sale of alcoholic beverages throughout Australia. The Commission considers that direct supply of liquor is a close substitute for wholesale supply and should be considered part of the same market. However, there is a question as to

whether the relevant market is best considered a market for the distribution of liquor generally or more narrowly for the distribution of wine and spirits, since beer is almost entirely directly distributed. There is a higher degree of inter-state supply of liquor than is the case for grocery distribution. However the competition analysis does not hinge on the geographic market definition.

In assessing the anti-competitive detriment and public benefit likely to arise from the proposed acquisition, the Commission has considered the applicant's claims, submissions received from interested parties, the Commission's own market inquiries and other relevant research material.

Dauids acknowledges 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.

Dauids claim that its acquisition of CBL represents an opportunity for independent retailers being supplied by CBL to obtain cheaper prices, better support, a broader range of products and a chance to improve significantly their overall offering, all of which are crucial to help satisfy consumers and remain competitive with the chains.

In their 'fourth force' submission, Dauids claimed that in order to provide effective competition to the chains, the independent system must respond to the dynamic changes in the grocery industry. The level of capital expenditure and expertise required to permit such a response from the independent system is substantial. Individual retailers do not have the resources to fund new developments, upgrades and refurbishments. Dauids has advised 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. Dauids' 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.

The Commission received around 290 submissions from interested parties including independent grocery retailers, liquor stores, AIW, QIW, Coles Myer, Woolworths, Jewel, suppliers, associations and banner groups.

Those in support of the acquisition primarily support Dauids' public benefit claims of cheaper prices for retailers and consumers from rationalisation, greater access to capital, enhanced retail support, access to Black & Gold and IGA products, and the resulting increased ability to compete on a more level footing with the chains.

Those submissions in opposition to the proposed acquisition raised the concern that the merger will result in increased prices due to a monopoly warehouse situation, loss of identity, reduced product range, reduced retail support and delivery services, negative effects of industrial action, discrimination in terms of increased rebates and store upgrades. Many independent retailers are concerned that they may be forced out of business and that the merger may result in the gradual collapse of the independent grocery retailing sector.

Dauids has given statutory undertakings to the Commission which 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.

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. In making this evaluation, the Commission adopts the approach set out by the Trade Practices Tribunal of comparing the position that would apply in the future were the proposed acquisition not given effect, with the position in the future which would arise if the proposed acquisition were given effect. This in turn requires an assessment of the claimed public benefits, the likely effects on competition of the proposed merger and any other public detriments that may arise.

The Commission considers that the proposed acquisition would reduce competition in the NSW, Victorian and possibly the Tasmanian markets for the wholesale supply of groceries from independent wholesalers to independent retailers. Davids and CBL currently compete vigorously in NSW and Victoria and the Commission does not consider CBL to be a failing force. The merger will deliver a monopoly to Davids in Victoria, a near monopoly in NSW and may reduce the long term competitive impact of CBL's recent entry into Tasmania. These markets are protected by significant barriers to entry and there is no import competition for distribution services. Davids would be able to increase prices and/or profits following the merger. However, the impact of these price rises would not be evenly felt. Prices charged to independent supermarkets in close competition with the vertically integrated chains would be significantly constrained by that downstream competition. Prices charged to smaller convenience stores and country supermarkets would be less constrained. However, Davids has provided statutory undertakings to the Commission which will reduce the anti-competitive effect of the merger, by maintaining existing prices and levels of service. The undertakings provide for an Independent Industry Ombudsman to monitor compliance with the undertakings and to undertake dispute resolution.

The Commission accepts that significant public benefits will arise from the proposed acquisition. In particular, there will be cost savings from rationalisation of warehousing, banner groups, generics, transportation and overheads. These cost savings are likely to be passed on to independent supermarkets who are in direct competition with the chains, enabling them to compete more effectively, increasing retail, and consequently wholesale, sales. The extent to which savings would be passed through to other independent retailers would depend on the degree to which their own prices were constrained by the chains. However, Davids has provided statutory undertakings to pass through at least \$6-8 million of rationalisation benefits to all Davids and CBL banner groups, in the form of an increased rebate of at least 0.5 per cent. This can be expected to be passed through to retail consumers through competition between retailers, both between independent retailers themselves and between independents and the chains. Secondly, the improved profitability which can be

expected to arise from the rationalisation of Davids and CBL's operations is also likely to increase Davids' access to capital. This in turn will permit an acceleration of new independent retail developments, offering an improved shopping environment, product range and value added services to customers. Such a development will provide additional competition in retail grocery markets to that currently provided by the chain stores. Hence, while competition in wholesale markets will be reduced or eliminated, competition in retail markets will be enhanced through lower prices and better services.

Accordingly, the Commission has determined to grant authorisation for Davids to acquire CBL. Authorisation is granted for a period of fifteen months, commencing on the day on which the authorisation granted by this determination comes into force, and is subject to conditions that:

- (a) Davids shall acquire any additional shares, convertible notes, debentures or other securities in CBL only by way of, in conjunction with or immediately followed by a takeover scheme, provided that this condition will not prevent the conversion in accordance with their terms of any convertible securities in CBL to which Davids is presently entitled; and
- (b) Davids will not acquire a share or shares issued by CBL which is not an ordinary share or ordinary shares unless by the acquisition Davids controls CBL within the meaning of that expression in the undertakings given by Davids to the Commission pursuant to s.87B of the Trade Practices Act, dated 29 May 1995; and
- (c) any takeover scheme announced by Davids is to contain a minimum acceptance condition to ensure that Davids will become entitled at the conclusion of the takeover scheme, or of any period of compulsory acquisition, to such number of shares in CBL as will entitle it to cast more than 50 per cent of the votes which may be cast at any general meeting of CBL. In calculating the number of votes which may be so cast, Davids shall treat all convertible notes and other convertible securities as if they had already been converted and Davids shall not waive its minimum acceptance condition unless it is or will become entitled to more than 50 per cent of the votes which may be cast at any general meeting of CBL.

Contents

	Page
1. Introduction	1
The Application	1
History of the Application	2
2. Relevant provisions of the Act	4
Prohibition against anti-competitive acquisitions	4
Authorisation of anti-competitive acquisitions	5
Conditional Authorisation and Enforceable Undertakings	5
3. The parties	6
Davids	6
CBL	7
4. Other participants in grocery distribution	9
Independent wholesaling	9
FAL	9
QIW	9
AIW	10
AAW	10
The retail chains	12
Coles Myer Ltd	12
Woolworths Limited	13
Franklins Limited	14
Jewel Food Stores	14
5. The relevant markets	16
Groceries	17
The QIW decision	17
The applicant's submission	19
Interested parties' submissions	20
Commission evaluation	20
Liquor	27
The applicant's submission	28
Interested parties' submissions	28

Commission evaluation	28
6. Submissions	30
The applicant's submission	30
Public benefits claimed	31
Rationalisation benefits	31
Passing savings on - cheaper prices	32
Improved purchasing power	33
Other benefits	34
Anti-competitive detriment	36
Lack or alternative supplier	36
Failing firm argument	36
Section 87B Undertakings	37
CBL's submissions	39
Section 87B Undertakings	40
Interested parties' submissions	41
Independent grocery retailers	43
In favour of proposed acquisition	43
Opposed to proposed acquisition	43
Liquor stores	45
Banner groups and retailer associations	45
Suppliers, and supplier associations	49
7. Commission evaluation	51
Introduction	51
Principles	51
Procedure	51
Competition Issues	52
Public Benefit, Efficiency, Private Benefits	52
Conditional Authorisation	54
Effects on competition	56
Grocery wholesaling	56
Concentration	56
Import competition	57

Barriers to entry	58
Availability of substitutes	61
Countervailing Power	61
Dynamic Characteristics	62
Vigorous and effective competitor	64
Vertical integration	64
Effect on prices and profit margins	65
Grocery Retailing	67
The wholesale distribution of liquor	67
Public benefit assessment	69
Rationalisation	69
Purchasing Power	71
Banner Rationalisation	72
The Fourth Force	73
Other Issues	74
Corporate Control	74
Timing and Manner of Takeover	77
Review of Undertakings	78
Review of Authorisation	78
Conclusion	78
8. Determination	81
Appendix A - Abbreviations	82
Appendix B - Section 87B Undertakings	83

1. Introduction

The Application

1.1. On 2 February 1995 Davids Limited (Davids) lodged with the Commission an application for authorisation pursuant to sub-section 88(9) of the *Trade Practices Act* (the Act), of its proposed acquisition of Composite Buyers Limited (CBL). In effect, Davids seeks a statutory exemption for the proposed acquisition from the prohibition in s.50 of the Act against anti-competitive acquisitions.

1.2. The principal activities of Davids and CBL are the wholesale distribution of groceries, refrigerated foods, general merchandise and liquor. The independent grocery wholesalers supply independent retailers, but not the national retail chains (Woolworths, Coles and Franklins) which operate their own vertically integrated grocery distribution businesses.

1.3. Davids is the largest independent grocery wholesaler in Australia. It operates in New South Wales, the ACT, Victoria, Queensland, South Australia and the Northern Territory. CBL wholesales groceries in Victoria and to a lesser extent in New South Wales and Tasmania. The parties to the proposed acquisition also have direct interests in grocery retailing. However, CBL is in the process of disposing of these assets, and only has eight retail stores remaining at the present time.

1.4. A merger between Davids and CBL would lead to the elimination of an alternative wholesale supplier, so Davids concede that the merger may have an anti-competitive effect on the market for the wholesale supply of grocery products to independent retailers in NSW and Victoria. However, Davids has also submitted that any anti-competitive detriment will be substantially outweighed by the public benefits arising from the merger; and that the competitive impact will be minor because CBL no longer represents a substantial long term competitive force in the market by reason of its damaged financial position.

1.5. Davids claim that its acquisition of CBL represents an opportunity for independent retailers being supplied by CBL to obtain cheaper prices, better support, a broader range of products and a chance to improve significantly their overall offering, all of which are crucial to help satisfy consumers and remain competitive with the chains. In addition, Davids claim that the following public benefits would also flow from the proposed merger:

- improved efficiency, cost savings, and economies of scale through the rationalisation of operations;
- greater access to capital for store development, upgrade and refurbishment;
- improved purchasing power and resulting cheaper prices for retailers and consumers;
- increased rebates to retailers of at least 0.5 per cent in the first year;
- cheaper prices and improved marketing coverage as a result of critical mass and banner rationalisation;
- enhancement of retail support functions;

- rationalisation of generic products; and
- expansion of the IGA product range.

1.6. In their 'fourth force' submission, Davids claimed that in order to provide effective competition to the chains, the independent system must respond to the dynamic changes in the grocery industry. The level of capital expenditure and expertise required to permit such a response from the independent system is substantial. Individual retailers do not have the resources to fund new developments, upgrades and refurbishments. Davids has advised 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. 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. Davids' submissions are discussed in detail in chapter 6.

1.7. Davids has given statutory undertakings to the Commission which 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.

1.8. Davids' undertakings are discussed in detail in chapter 6, together with comments made by CBL and other interested parties in relation to the proposed undertakings; and are then evaluated in chapter 7. A copy of the undertakings given by Davids are attached at Appendix B.

1.9. Around 290 submissions were received from interested parties of which approximately 235 were opposed to the proposed acquisition. Approximately 220 submissions were received from independent grocery retailers, and around 25 from liquor stores. Submissions were also received from Coles Myer, Woolworths, Jewel Food Store, AIW, QIW, suppliers, banner groups, and associations. These submissions are discussed in detail in chapter 6 of the determination.

History of the Application

1.10. Application A30165, lodged on 2 February 1995, was made in relation to the proposed acquisition by Davids of all the issued shares and other securities in CBL to which Davids has no entitlement - currently 16 045 998 ordinary shares, 692 000 converting preference shares and \$20M of convertible notes.

1.11. On 17 February the Commission issued a notice to Davids under sub-section 90(11) of the Act requesting additional information relevant to the Commission's

determination of the application. Such a notice has the effect of extending the thirty day period (from when an application is received) during which the Commission must make a determination in respect of an application under sub-section 88(9), by the number of days the applicant takes to provide the information requested. Davids provided a written response to that request for information on 23 February. However, in the Commission's view, some of the answers provided by Davids were incomplete.

1.12. On 1 March the Commission notified Davids, pursuant to sub-section 90(11A) of the Act, that due to the complexity of the issues involved the Commission was extending the thirty day period for determination of the application to 45 days.

1.13. On 3 March, the Commission wrote to Davids outlining those areas where the information provided by it in response to the Commission's notice requesting additional information appeared incomplete, and requesting Davids to provide full answers. Davids response was received on 9 March.

1.14. On 16 March Davids advised the Commission, pursuant to sub-section 90(12) of the Act, that it agreed to the Commission taking an additional three weeks for determination of the application.

1.15. On 29 March, pursuant to sub-section 90(12) of the Act, Davids advised the Commission that it agreed that the time for determination of the application be extended by a further seven weeks. This further extension was requested to enable Davids to prepare undertakings under section 87B of the Act, and a further submission expanding on Davids' "fourth force" public benefit argument.

1.16. On 6 April, the Commission responded to this request stating that it proposed to issue its determination on 8 May and requested Davids to prepare and lodge any further submissions by 24 April. Consequently, Davids submitted its "fourth force" submission on Monday 24 April.

1.17. On Thursday 13 April, Davids provided proposed draft undertakings to the Commission and then resubmitted these undertakings in a final draft form on Monday 15 May 1995. The Commission accepted final undertakings, pursuant to section 87B of the Act, on 29 May 1995.

1.18. In order to consider and receive feedback from interested parties on these new documents the Commission, on 28 April, advised that they would require the full period of time for determination of the application. Accordingly, the Commission issued its determination on 29 May 1995.

2. Relevant provisions of the Act

Prohibition against anti-competitive acquisitions

2.1. Davids lodged its application in order to seek a statutory exemption from the operation of section 50 of the Trade Practices Act 1974, which otherwise may prohibit the proposed acquisition of CBL.

2.2. Relevantly, subsection 50(1) of the Act provides:

A corporation must not directly or indirectly:

(a) acquire shares in the capital of a body corporate; or

(b) acquire any assets of a person;

if the acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a market.

2.3. Section 50(3) sets out the factors which must be taken into account when assessing whether an acquisition is likely to have the effect of substantially lessening competition. Section 50(3) provides that the following non-exhaustive list of factors must be taken into account in the evaluation of the effect or likely effect of particular acquisitions:

(a) the actual and potential level of import competition in the market;

(b) the height of barriers to entry to the market;

(c) the level of concentration in the market;

(d) the degree of countervailing power in the market;

(e) the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins;

(f) the extent to which substitutes are available in the market or are likely to be available in the market;

(g) the dynamic characteristics of the market, including growth, innovation and product differentiation;

(h) the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor; and

(i) the nature and extent of vertical integration in the market.

2.4. Sections 50(4) and (5) (which provide a mechanism for application for authorisation of existing contracts for the acquisition of shares or assets provided the contract is conditional on authorisation being granted) are not relevant to this application.

2.5. Where an acquisition is found to breach section 50, the Federal Court can order divestiture of shares or assets (section 81(1)) or set aside the transaction (section 81(1A)) and, in addition, impose pecuniary penalties on the acquirer of up to \$10M. If an acquisition has not proceeded and the Federal Court is satisfied that it breaches the Act, it can restrain the parties from proceeding with that acquisition (section 80(1)).

Authorisation of Anti-Competitive Acquisitions

2.6. The Trade Practices Act contains a process whereby certain conduct, including acquisitions, which may breach the restrictive trade practices provisions in Part IV of the Act, can be authorised if there is sufficient public benefit in allowing the conduct.

2.7. Relevantly, this application is made under sub-section 88(9) of the Act which provides that:

the Commission may, upon application by a person, grant an authorisation to the person to acquire shares in the capital of a body corporate or to acquire assets of a person.

The Commission shall only grant authorisation if the applicant satisfies the relevant test in sub-section 90(9) of the Act.

2.8. Sub-section 90(9) provides that the Commission shall not grant authorisation unless it is satisfied in all the circumstances that the proposed acquisition would result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to take place. In making its determination the Commission gives consideration to both the claimed public benefits and any public detriment, particularly any negative effect on competition, that the proposed acquisition is likely to have.

2.9. Should the Commission be satisfied as to the requisite degree of public benefit attributable to the proposed acquisition in all the circumstances, including in particular, the effect of the proposed acquisition on competition, the Commission may grant authorisation or grant authorisation subject to conditions. If this is not the case, the Commission may refuse authorisation or alternatively, in refusing authorisation, indicate to the applicant how the application could be constructed to change the balance of detriment and public benefit so that authorisation may be granted.

Conditional Authorisation and Enforceable Undertakings

2.10. It is open to the Commission, in granting an authorisation, to do so on condition that certain relevant undertakings are provided. Previously such undertakings were of questionable enforceability however, pursuant to section 87B of the Act, the Commission is now able to accept undertakings which can be enforced by the Federal Court.

2.11. Section 87B of the Act provides for enforcement in the Federal Court of written undertakings accepted by the Commission in the exercise of its powers. Where the Commission believes that a term of such an undertaking has been breached it may apply to the Court for:

- an order directing compliance; and/or
- an order to pay the Commonwealth up to the amount of any financial benefit that can be reasonably attributed, directly or indirectly, to the breach; and/or
- any order the Court considers appropriate to compensate a third party for loss or damage resulting from the breach; and/or
- any other order the Court considers appropriate.

3. The parties

DAVIDS

3.1. Davids is a publicly listed company incorporated in New South Wales. Davids changed its status from a proprietary to a public company in March 1994 and was listed on the stock exchange in June 1994. The principal activities of Davids are the wholesale distribution of groceries, refrigerated foods, liquor and general merchandise. Davids is the largest independent grocery wholesaler in Australia. It operates in New South Wales, the ACT, Victoria, Queensland, South Australia and the Northern Territory.

3.2. In the six months to 31 December 1994, Davids' operating profit before tax was \$40.8 million, and its sales revenue (including \$0.7 billion sales of Australian Liquor Marketers which is 50 per cent owned by Davids) was \$2.3 billion.

3.3. The operations of the Davids Group are outlined below:

- **Grocery wholesaling:** Davids supplies eighteen per cent¹ of the branded packaged groceries (ie excluding generics, house brands and fresh foods) sold in New South Wales. It supplies around 720 stores under various groups including - Jewel, Rainbow, Festival IGA, Foodtown, Clancy's, Welcome Mart, Food Plus, 7 Eleven, Shell Select, Quick Stop, Quix, and Road Pantry. It also supplies 24 Big W stores.

Davids supplies 16.7 per cent of the branded packaged groceries sold in Victoria. It supplies around 600 stores under various groups including - Jewel, Rainbow, Festival IGA, Foodtown/SSW, Welcome Mart, 7 Eleven, Food Plus, Shell Select, Quix, Road Pantry, and Cheapa Food Barns. It also supplies 7 Big W stores.

Davids supplies 8.3 per cent of the branded packaged groceries sold in Queensland. It supplies around 370 stores under various groups including - Jewel, Festival IGA, Foodtown, 7 Eleven, 7-2-7, Cut Price, Thrifty T, CPS 7 Days, and Quix. It also supplies the Pick 'n Pay Hypermarket and fourteen Big W stores.

In September 1994 Davids acquired Independent Holdings Limited (IHL), the only independent grocery wholesaler operating in South Australia. As a consequence of this acquisition Davids now supplies 38.5 per cent of the branded packaged groceries sold in South Australia. It supplies around 390 stores under various groups including - Foodland, ServWel/Four Square, Supa Valu, Triple Seven, United Supermarkets, and Drake Foodmarkets. Davids, through its acquisition of IHL, also supplies groceries to retailers in the Northern Territory through warehouses in Darwin and Alice Springs.

- **Cash-and-Carry:** Davids operates 41 Campbell's Cash & Carry warehouses which supply thousands of small retailers in NSW, Victoria, Queensland and South Australia. Through its takeover of IHL, Davids acquired four cash & carry outlets in South Australia. In 1994 Davids also acquired eight such outlets in Victoria from CBL. (Cash-and-carry warehouses generally supply small businesses that are

¹ Unless otherwise stated, the market share figures quoted in this determination are from "Retail World", 12 - 16 December 1994.

unable to meet the minimum order requirements of a grocery wholesaler's main warehouse.)

- **Liquor wholesaling:** Australian Liquor Marketers Pty Ltd (ALM), the fifty per cent joint venture between Davids and Foodland Associated Limited (FAL), wholesales wine and spirits throughout Australia. ALM is Australia's largest distributor of wines and spirits. Including IHL's liquor operations in South Australia, the group is the major wine and spirits distributor in all states of Australia.

3.4. Davids currently holds around thirty per cent of the ordinary shares (but a 24 per cent voting interest due to the voting rights of Coles Myer Limited - see paragraph 3.8 below), and around 31 per cent of the converting preference shares in CBL. Davids also holds approximately nineteen per cent of the shares in QIW Limited (QIW), an independent grocery wholesaler operating in Queensland, northern New South Wales and the Northern Territory.

CBL

3.5. CBL is a public company incorporated in Victoria. The authorisation application describes CBL as an independent grocery wholesaler which supplies groceries, dairy/frozen, variety, food services and liquor in Victoria and to a lesser extent, in New South Wales and Tasmania.

3.6. On 15 February 1995 CBL announced an operating profit of \$5.4 million for the six months to December 1994, and revenue of \$0.5 billion for this period. It advised that its core business, the distribution of grocery and liquor goods, produced an operating profit of \$2.2 million, and there was an abnormal profit of \$3.2 million. CBL reported substantial losses in the previous two financial years, a \$32.2 million loss in 1993/94 and a \$12.2 million loss in 1992/93.

3.7. Davids acquired its current shareholding in CBL (see paragraph 3.4) when it acquired IHL, the then owner of these shares, in September 1994. The Commission was concerned at the possible anti-competitive effects of Davids having such a significant shareholding in its competitor in the Victorian and NSW wholesale grocery markets. The Commission therefore obtained an undertaking from Davids that it would divest its shareholding in CBL if the Commission formed the view that such a shareholding would be likely to breach the Trade Practices Act. The Commission had not reached its final view on the competitive implications of Davids' substantial shareholding in CBL when Davids lodged its application for authorisation to acquire all the shares and other securities in CBL.

3.8. Coles Myer Limited holds \$20 million of convertible notes in CBL, and a special share which provides it with voting rights equivalent to 19.99 per cent. The notes mature in June 1997, but may be converted to shares at any time. Such a conversion would give Coles Myer an approximate twenty to thirty per cent shareholding in CBL, depending on the conversion price.

3.9. The main activities of CBL are outlined below.

- **Grocery wholesaling:** In Victoria, CBL has a warehouse at Knoxfield from which it supplies stores throughout Victoria and the Riverina district of New South Wales.

The company supplies 14.8 per cent of the branded packaged groceries (ie excluding generics, house brands and fresh foods) sold in Victoria. It supplies around 450 independent retailers under the following banner groups - Tuckerbag, Goodfellows, Payless, Rite-way and Budget-Rite.

In New South Wales, CBL has a warehouse at Moorebank from which it supplies four per cent of the branded packaged groceries sold in that State. It supplies around 160 stores including the Tuckerbag, Payless, Rite-way and MFC groups.

CBL supplies, from its Victorian warehouse, 3.4 per cent of the branded packaged groceries sold in Tasmania. It supplies 21 Tiger Superbarns and 11 Island Foodmarts.

- **Liquor wholesaling:** CBL distributes liquor in Victoria, New South Wales and Tasmania.
- **Food services:** The company supplies restaurants, hotels and food outlets mainly in Victoria, but also in New South Wales and South Australia.
- **Knoxfield Transport Services:** Provides external cartage service to customers.

4. Other participants in grocery distribution

Independent wholesaling

4.1. Apart from Davids and CBL, the other independent grocery wholesalers currently operating in Australia are Foodland Associated Limited (FAL), QIW Limited (QIW), and Australian Independent Wholesalers Pty Ltd (AIW).

FAL

4.2. FAL is a publicly listed company incorporated in Western Australia. It operates in both Australia and New Zealand.

4.3. The FAL group is the sole independent grocery wholesaler in Western Australia. It distributes 53.5 per cent of the branded packaged groceries (ie excluding generics, house brands and fresh foods) sold in that State, and supplies approximately 290 stores under various banner groups including - Supa Value, Foodland, Four Square, Cheap Foods, Bi-Lo (not connected with Coles) and Quick Stop. The company also supplies a large range of general merchandise to stores in Western Australia such as Action and Bi-Lo, and distributes a wide range of groceries and general merchandise through three cash-and-carry outlets in Western Australia. FAL, through its wholly owned subsidiary, Action Holding Limited, owns and operates the Action Food Barn chain of around thirty discount supermarkets in Western Australia, which supply a full range of dry groceries as well as fresh meat, fruit and vegetables. Since 1 March 1993, FAL and Davids have distributed wine and spirits through their fifty per cent joint venture company, ALM (see paragraph 3.3 above).

4.4. In New Zealand, FAL's wholly owned subsidiary, Farmer Deka Limited, operates department stores, home centres, and toy warehouse speciality stores. FAL also holds a majority shareholding in Progressive Enterprises Limited, which operates grocery wholesale distribution, supermarket retailing and family restaurant businesses.

4.5. In 1993, FAL lodged an application for authorisation with the Commission in respect of a proposed amalgamation of four of the five major independent grocery wholesalers then operating in Australia. It was proposed that FAL, Davids, CBL and IHL would amalgamate to form one large grocery wholesaling company which would operate throughout Australia. However, FAL withdrew its application for authorisation before the Commission had reached a determination in respect of the application.

QIW

4.6. QIW is a publicly listed company incorporated in Queensland. The company supplies 14.6 per cent of the branded packaged groceries (ie excluding generics, house brands and fresh foods) sold in Queensland. It supplies around 650 stores in Queensland, northern New South Wales and the Northern Territory under various banner groups including - Foodstore, Four-Square, 7-2-7, Nightowl Convenience Stores and Cut Price. QIW through its wholly owned subsidiary, Denham Bros Limited, operates fourteen supermarkets throughout central Queensland. The company also owns two large warehouse style supermarkets located at Woodridge (south of Brisbane)

and on the Gold Coast. It operates twelve cash-and-carry warehouses extending from northern New South Wales to northern Queensland. The company's variety division supplies giftware, homeware, manchester and hardware to independent retailers; and its food services division supplies the catering trade, canteens, hotels, restaurants, and food outlets.

4.7. As noted above, Davids currently owns approximately nineteen per cent of QIW's issued capital. In 1992 Davids made a takeover bid for QIW. This bid was opposed by QIW which sought a declaration from the Federal Court that the takeover would constitute a contravention of section 50 of the Trade Practices Act. In addition, the Commonwealth Attorney-General, the Minister then responsible for the administration of the Trade Practices Act, sought a Federal Court injunction restraining Davids from acquiring QIW. On 30 April 1993, Justice Spender held that Davids' proposed takeover of QIW would breach section 50 of the Act.² His Honour concluded that the relevant market was the market for the supply of grocery products by independent wholesalers to independent retailers in Queensland and northern New South Wales, and that a merged Davids/QIW would be likely to dominate that market.³ Davids appealed against this decision, but the appeal was dismissed by the Full Federal Court on 22 April 1994⁴.

AIW

4.8. Australian Independent Wholesalers Pty Ltd (AIW) is a small independent wholesaler that distributes groceries in the ACT and in some (mainly the southern) areas of New South Wales from its warehouse at Hume in the ACT. AIW was established in 1992 by the Cannons Food Barns retail group and supplies 1.3 per cent of the branded packaged groceries (ie excluding generics, house brands and fresh foods) sold in New South Wales and the ACT. AIW supplies thirteen Cannons Food Barns and around thirty independent retailers under the Shop-Ezy and Ace banners.

4.9. AIW supplies dry groceries, general merchandise and chilled foods. It also supplies the "Payless" brand of generic products which it obtains from CBL, and is developing its own generic products under the "Our Brand" label.

AAW

4.10. Australian /Asia Pacific Wholesalers Pty Ltd (AAW) is a national purchasing body on behalf of the major independent grocery wholesalers. Its principal function is to negotiate rebates on a national basis from suppliers, using the collective purchasing power of its independent wholesaler members. AAW's members account for about thirty per cent of the sales of suppliers. AAW also represents its members in relation to matters of common concern, such as sales tax issues, and negotiates arrangements for the supply of generic products under the "Black and Gold" label.

² *QIW Retailers Limited v Davids Holdings Pty Limited & Ors; Attorney-General of the Commonwealth v Davids Holdings Pty Limited & Anor*, Australian Trade Practices Reporter 1993, 41-226.

³ Prior to January 1993, mergers were prohibited under section 50 of the Trade Practices Act where, as a result of the merger, the acquiring corporation would be in a position to dominate a market. Following amendments to section 50 which came into effect on 21 January 1993, mergers are now prohibited where they would have the effect, or likely effect, of substantially lessening competition in a market.

⁴ *Davids Holdings Pty Limited & Ors v Attorney-General of the Commonwealth & Anor*, Australian Trade Practices Reporter 1994, 41-304.

4.11. The shareholders in AAW are - Davids Limited (200 shares), and Davids (SA) Limited, CBL, QIW, and FAL (100 shares each). Davids' current shareholding allows it to appoint three directors; and CBL, QIW and FAL can each appoint one director.

4.12. The following information regarding the operation of AAW is taken from QIW's November 1993 submission lodged in respect of FAL's application for authorisation (in respect of the proposed amalgamation of FAL, Davids, CBL and IHL). QIW has advised that it does not rely upon that earlier submission in respect of the current application for authorisation, however, the Commission considers that the following extract still accurately reflects the operations of AAW.

AAW negotiates national rebates with most manufacturers. National rebates obtained by AAW are paid by suppliers to AAW, which then distributes the rebate to its members after deduction of operating costs. Each member bears one-sixth of AAW's operating costs. Rebates however, do not flow to members in the same proportion, but are calculated on the basis of volume of sales each wholesaler/AAW member produces in respect of products to which the national rebate applies.

Regularly throughout the year, AAW engages in national promotions, negotiating "case deals" with suppliers. Essentially, AAW negotiates more favourable rebate or discounts on product lines, usually 12 - 15 lines, than would otherwise normally be granted by the manufacturer. Those product lines are then promoted nationally by each independent wholesaler.

In addition to the national rebates and promotional arrangements which are referred to above, each independent wholesaler negotiates rebates on a state by state basis, and also negotiates specific discounts and incentives with individual manufacturers. ...

AAW negotiates arrangements for the supply of generic products under the "Black & Gold" label. AAW is the holder of the trademark for Black & Gold. Generic brands are intended to provide value for money for reasonable quality, which are packaged in less expensive packaging and sold at lower prices. ...

One of the functions of AAW is product selection and negotiating with manufacturers for the supply of Black & Gold product to its members. The process of developing the bulk of the range of Black & Gold products took several years. ...

For the manufacturer, the production of generic products increases his economies of scale. From the point of view of the independent wholesaler, generic brands are an important marketing tool to ensure independent retailers are able to satisfy consumer demands. Generic products are, generally speaking, as profitable as proprietary brand products from the retailers perspective. They are generally high volume, low margin lines, for wholesalers. ...

As a result of the level of consumer demand and marketing acceptance for Black & Gold products, a wholesaler, being an existing wholesaler or a new wholesaler, needs to have an established range of generic products similar to the range of Black & Gold products in order to achieve and retain the custom and support of independent retailers. To develop a new range of generic products equivalent to the Black & Gold range, and to achieve similar consumer acceptance of such products, would be a very expensive process that could take several years.⁵

⁵ QIW submission re application for authorisation A90553, 19 November 1993, pages 14 and 15.

The retail chains

4.13. The other major distributors of groceries in Australia are the retail chains, Coles, Woolworths and Franklins. Justice Spender considered the distribution activities of the retail chains in the QIW case.

There are significant differences in the purchasing, warehousing and pricing practices between independent wholesalers and the major retail chains, Coles, Woolworths and Franklins. The chains have a restricted product range, determined by the head or state office. The product range of independent wholesalers is much wider, being dictated by the much more diverse customer base. The chains supply company owned stores only and the chains can derive their profitability from retail operations. Independent wholesalers service a diverse customer base, and both warehouse and retail stores make separate profits. The area serviced by the chains is limited to larger population centres, while the wholesalers are much more diversified. The average store order for retail chains involves larger warehouse picking runs resulting in economies. The average store order from a wholesaler is mainly small to medium and, as a consequence, is more expensive in terms of picking and processing. Because the range is more tightly controlled and demand can be more accurately forecast, stock levels can be minimised in the operations of a retail chain and stock turns maximised. Independent wholesalers need to carry a wider range and more low volume lines and therefore more buffer stock to ensure adequate service levels and, as a consequence, average stock levels tend to be higher and stock turns are lower compared with the chains. The fluctuations in demand for wholesalers is much more variable than for the chains.

So far as credit and cash flow is concerned, deliveries to retail stores in a chain are an internal transfer. The retail stores sell for cash, resulting in the chain having access to daily cash flows and the chains are not subjected to bad debts. Independent wholesalers, on the other hand, provide a minimum of seven days' credit to retail customers, and carry the debt risk of many hundreds of retailers they supply, with a considerable amount of bad debts annually. ...

So far as promotional funds are concerned, the discount chains, particularly Franklins, spend little or no moneys on advertising, the savings being put into discount prices. The independent wholesalers require funds for the marketing of promotional groups and, as a consequence, there is less available for price subsidy to permit lower prices. Settlement terms on acquisitions generally are the same for both independent wholesalers and chains; there is, therefore, no recognition of the credit risks the independent wholesalers are obliged to carry and the higher stock levels needed to service the wholesale business.

Sales tax has a differential effect. The retail chains buy sales tax paid and the supplier pays the sales tax. The wholesalers buy pre-tax and pay tax on the value which includes the value added warehousing component. As a consequence the wholesaler pays tax on a higher value than the retail chains, and also a wholesaler forwarding stock to a Cash-and-Carry outlet pays sales tax on the value which includes freight, affecting the price and profit from a Cash-and-Carry outlet compared with a retail chain. Sales tax also has a greater effect on the trading terms between the retail chains and the independent wholesalers, in that rebates and other allowances are paid by suppliers on a pre-tax value.⁶

4.14. The main activities of the major retail chains are briefly outlined below.

Coles Myer Ltd

4.15. Coles Myer is Australia's largest retail company operating a range of businesses including premium and discount supermarkets, department stores, discount department

⁶ QIW, *op. cit.*, at 41,111.

stores and speciality operations. The company operates more than 1500 stores in Australia, over 500 of which are supermarkets, with sales of around seventeen per cent of total Australian retail sales. This represents a large concentration of total retail sales by international standards, for example, in the United States the largest retailer, Walmart, has sales of around 2.4 per cent of total retail sales.

4.16. The main activities of Coles Myer are outlined below.

- **Groceries:** The company is Australia's second largest grocery retailer with around 500 supermarkets in all states of Australia. It supplies, through its Coles and Bi-Lo stores, around 24 per cent of the branded packaged groceries (ie excluding generics, house brands and fresh foods) sold in Australia. On a state basis, the company's share of branded packaged grocery sales are - New South Wales 19.3 per cent, Victoria 25.9 per cent, Queensland 27 per cent, Western Australia 22.5 per cent, South Australia 31 per cent and Tasmania 23.3 per cent.
- **Department stores:** The company's department stores, Myer and Grace Bros. in the traditional sector and Coles-Fosseys, K-Mart and Target in the discount sector, dominate the Australian market with almost 500 stores.
- **Liquor:** Liquorland is the largest retail liquor chain in Australia with over 300 stores.
- **Fast food:** The company operates around 200 Red Rooster outlets.
- **Ladies' fashion:** Katies is one of Australia's largest ladies' fashion chains with around 200 stores. The Target brand is the biggest selling apparel brand in Australia.

4.17. In August 1993, Coles Myer announced a \$4 billion, five year, expansion and refurbishment program including the creation of 420 new stores, 1100 store refurbishments, and \$900M expenditure in distribution centres, new technology and other retail investments. Included in these plans was the creation of around eighty new supermarkets over the subsequent five years.

Woolworths Limited

4.18. Woolworths operations fall into three main retail groups: supermarkets, general merchandise and speciality retail. The company has approximately 980 stores throughout Australia.

4.19. In 1989 Industrial Equity Limited (IEL) made a successful takeover offer for Woolworths, and in 1989 the company's shares ceased to be listed on the Australian Stock Exchange. In 1993, as part of a strategy to raise funds to apply, in part, towards the retirement of borrowings, IEL and the vendor resolved to dispose of their interest in the company by way of a public flotation. Woolworths raised \$2.45 billion from the public issue and the company was listed on the Australian Stock Exchange in July 1993.

4.20. The main activities of Woolworths are outlined below:

- **Groceries:** Woolworths is Australia's largest grocery retailer with around 420 supermarkets and seventy food stores in all states of Australia. It supplies 31.5 per cent of the branded packaged groceries (ie excluding generics, house brands and fresh foods) sold in Australia. On a state basis, the company's share of branded packaged grocery sales are - New South Wales 30.5 per cent, Victoria 34.2 per cent,

Queensland 34.1 per cent, Western Australia 24 per cent, South Australia 25.3 per cent and Tasmania 53 per cent.

- **General merchandise:** The company has around sixty BIG W discount department stores in all mainland states. It also operates eighty Woolworths Variety and Crazy Prices stores in New South Wales, Victoria, Queensland and South Australia.
- **Liquor:** The company operates around 180 Mac's Liquor and Safeway Liquor Stores. Around eighty per cent of these outlets are located within Woolworths' supermarkets.
- **Chisholm Manufacturing:** Produces manufactured and processed food products, approximately ninety per cent of which are sold through Woolworths' supermarkets.
- **Ladies' fashion:** Woolworths operates the Rockmans chain of around 200 women's apparel stores.
- **Electronics:** The company operates around 110 Dick Smith Electronics stores in Australia and New Zealand.

4.21. Woolworths' Chairman announced at the company's annual general meeting in November 1994, that it intended to open fifteen supermarkets, six Big Ws and fifteen Rockmans stores, on average, each year for the next five years.

Franklins Limited

4.22. Franklins Limited is the third largest supermarket chain in Australia. The company operates around 240 outlets in New South Wales, Victoria, Queensland and South Australia.

4.23. Franklins is owned by Dairy Farm International Holdings Ltd, a company incorporated in Bermuda and listed on the Hong Kong Stock Exchange. Dairy Farm is involved in the retailing of food and general household goods in Asia, Australasia and Europe. In 1979 Dairy Farm purchased Franklins which then operated 78 stores in the Sydney metropolitan area. Franklins immediately began a program of closing smaller stores and opening newer and larger supermarkets in Sydney. The company also expanded its operations, first into the provincial towns of New South Wales and then into Queensland in 1984, Victoria in 1987 and into South Australia in 1989.

4.24. Franklins supplies 14.2 per cent of the branded packaged groceries (ie excluding generics, house brands and fresh foods) sold in Australia. On a state basis, the company's share of branded packaged grocery sales are - New South Wales 27 per cent, Victoria 8.5 per cent, Queensland 16 per cent and South Australia 5.2 per cent.

4.25. In 1992 Franklins opened its first Big Fresh farmer's market style supermarket in Sydney. It has since opened other Big Fresh supermarkets, and has introduced fresh food departments to a number of its existing stores (Franklins Fresh supermarkets).

Jewel Food Stores

4.26. Jewel is the fourth largest supermarket chain in Australia with over 96 stores in NSW, the ACT, Victoria and Queensland. Jewel also operates a total of sixteen liquor stores in NSW, Victoria and the ACT. Jewel's philosophy is to be the cheapest grocery

and liquor retailer in every market in which it competes. Jewel currently has its operations for sale.

4.27. Jewel is currently conducting a three year refurbishment program. Jewel recognise the need to continually improve customer service and have introduced or will introduce: EFTPOS in all stores; more timely check-outs; staff friendliness; a wider range of health foods; nutrition labelling on all products; access to convenience foods; and longer trading hours.

4.28. From 1971 to 1976, Jewel operated its own warehousing facilities. Following industrial problems, these operations were transferred to Davids. Jewel performs its own buying functions, that is, it negotiates prices, terms and promotional activity for all of its stock. Davids then physically purchase the stock and distribute it to Jewel stores for a fee.

4.29. Jewel's own warehouse facilities are used for:

- storage of investment stock that is purchased on promotion or in anticipation of price rises;
- storage of stocks held in reserve in the event of strike action by Davids;
- liquor distribution; and
- head office, printing room, training room, fixtures storage and maintenance department facilities.

4.30. Jewel launched its "No Name" generic product range in the late 1970's which presently covers over 700 products and represents approximately 10% of Jewel's sales.

5. The relevant markets

5.1. While it is conceded by the applicants that the proposed acquisition may have an anti-competitive effect on the market for the wholesale supply of grocery products in NSW and Victoria, the Commission is not required to express an opinion as to whether the proposed acquisition would breach s.50 of the Act.⁷ However, in order to assess the claimed public benefits, the likely effects on competition of the proposed merger and any other public detriment must also be considered.

5.2. The Trade Practices Tribunal concluded in *QCMA*, that it is appropriate to commence the assessment of public benefit with an assessment of the competitive implications of the proposed acquisition, for the following reasons:

- (1) A merger may positively enhance the competitive process and thus give rise to a substantial benefit. ...
- (2) ... the benefits claimed may not mention competition. ... Nevertheless, our appraisal of all the listed claims must depend upon our appreciation of the competitive functioning of the industry, with and without merger. ...
- (3) A claimed benefit may in fact be judged to be a detriment when viewed in terms of its contribution to a socially useful competitive process. ...
- (4) ... the substantiality of benefits needs to be measured against likely anti-competitive effects (and other detriments).
- (5) Quite generally, the Tribunal's role is seen as forming one of the means of achieving the policy objective of the Act, namely the preservation and promotion of useful competition.⁸

5.3. In any competition assessment, the first place to start is an assessment of the appropriate market for the issue under consideration. Section 50 of the Trade Practices Act refers to substantial lessening of competition *in a market*. (Section 50(6) limits the application of section 50 to a substantial market.)

5.4. Section 4E of the Act determines that a market for goods or services includes other goods or services that are substitutable for, or otherwise competitive with, the first goods or services. The courts have established that both demand and supply side substitution must be taken into account in determining the relevant market. Substitution possibilities must be considered in three dimensions: product; geographic and functional. The relevant market can be identified by determining the smallest area over which a profit maximising monopolist would impose a small but significant and non-transitory increase in price (SSNIP), or equivalent exercise of market power. By including all substitution possibilities, the process of market definition identifies all those sources of close competition to the merged entity. However, market definition should be considered an integral part of the analysis of competition. It is only necessary to precisely define the relevant market to the extent that it is necessary to determine the effect of the acquisition or other conduct on competition.

⁷ *QCMA and Defiance Holdings*, Australian Trade Practices Reporter 1976, 40-012.

⁸ *QCMA*, op.cit., at 17,244-17,245.

5.5. The proposed acquisition of CBL by Davids will involve the merging of grocery wholesaling and retailing and liquor wholesaling operations. Accordingly, it is necessary to consider the relevant markets in which these activities are located.

Groceries

5.6. The proposed acquisition will involve bringing together the grocery wholesaling and retailing activities of Davids, which cover NSW, Victoria, the ACT, Queensland, South Australia and the Northern Territory; and the wholesaling and retailing operations of CBL in Victoria, NSW and Tasmania.

The QIW decision

5.7. Of great significance in determining the relevant market(s) for this determination is the judgement of Justice Spender in *QIW*.⁹ That case concerned the proposed acquisition of QIW by Davids and Justice Spender determined that the relevant market was the market for the supply of grocery products by independent wholesalers to independent retailers in Queensland and northern New South Wales:

Only within the market so defined is there an area of close competition between firms and significant cross-elasticity of demand and supply. Collectively, Davids and QIW possess a relatively small but nevertheless significant margin within which they may exercise monopoly power to substantially increase profits. (*QIW*, at 41,142)

5.8. Justice Spender's decision was appealed by Davids. The appeal court, comprising Justices Von Doussa, O'Loughlin and Drummond, upheld Justice Spender's decision, including his determination of the relevant market.¹⁰

5.9. The product dimension of the market was not in contention; but both the functional and geographic dimensions were.

5.10. In relation to the *functional dimension*, Justice Spender recognised that the vertically integrated chains placed a constraint on the pricing of independent retailers, but did not accept that that constraint was sufficient to expand the functional dimensions of the market from independent wholesaling to incorporate the activities of the vertically integrated chains:

It is true that some restraints exist on the ability of Davids and QIW to exercise their market power.Indirectly, the retail pricing and product policies of the major chain stores, because they act as an ultimate constraint on the pricing policy of independent retailers, also act as an ultimate constraint on the prices Davids and QIW can charge independent retailers without threatening their continued viability. However, the relevant inquiry is whether the existence of these restraints acts as such a significant check on the power of Davids and QIW that it is correct to say they are in close competition with the independent retailers and the chain stores' retail outlets. In my view that is not the case. The restraints operating here are of an ultimate nature only, and in this sense restraints exist on the power of all monopolies. (*QIW*, at 41,142)

5.11. This view was supported by evidence from market participants regarding competition between QIW and Davids; differences between the operations of the independent wholesalers and the vertically integrated chains; that the majority of

⁹ *QIW*, *op. cit.*

¹⁰ *Davids*, *op. cit.*, at 42,066-42,069.

independent retailers operated in "pricing zones" which were not competitive with the chains; and that prices fell by 2-3 per cent when Davids entered Queensland in 1986.

5.12. Justice Spender considered that the use of pricing zones which were not competitive with the chains reflected differences in the size, product range, trading hours and location of those retailers compared to chain supermarkets. He found there was a linear relationship between the size of stores and the average dollar value of purchases. He accepted a classification of grocery retailers into convenience stores (<400 sq m), top up stores (<800 sq m) and supermarkets (>1,000 sq m).¹¹ An analysis of QIW's Foodstore banner group, which accounts for 65 per cent of all QIW sales, showed that only 4 per cent of stores, accounting for 17 per cent of sales, were over 800 sq m. Since Foodstores have significantly larger average purchases than other QIW banners, supermarkets are likely to represent an even smaller percentage of QIW's total customer base.¹²

5.13. Independent retailers were found not to compete with the chains primarily on price, but rather to offer a differentiated service: more personalised services, greater convenience, longer trading hours and a commitment to local community involvement.¹³ Justice Spender recognised that price and product differentiation does not by itself place the products in different markets, and quoted *AMH* that the relevant test is what happens (or would happen) on either the demand or supply side in response to a change in relative price.¹⁴ The fact that when QIW was a wholesale monopolist, prices had been maintained at levels 2-3 per cent higher, and that FAL as a monopolist in Western Australia, was able to maintain similarly high margins, was seen as instructive.¹⁵

5.14. Moreover, in many cases the independent retailers were not located in close geographic proximity to a chain store and the geographic remoteness lessened price sensitivity.¹⁶

5.15. Furthermore, even if independent retailers competed directly with the chains in retail markets, this would not entirely constrain the activity of independent wholesalers. Since wholesale margins are a relatively small percentage of the total cost of wholesale goods and services to retailers, a merged Davids-QIW would be able to impose a significant proportional increase in those margins and its profits, with a much smaller proportionate effect on the total cost of wholesale goods and services, which could be absorbed by independent retailers and/or their customers.¹⁷

5.16. In relation to the relevant *geographic dimension*, Justice Spender determined that the relevant market was confined to Queensland and northern New South Wales on the grounds that transport costs precluded effective inter-state competition. In order to compete in Queensland and northern New South Wales, wholesalers would have to establish warehouse facilities, which would be in the nature of market entry rather than supply side substitution.

5.17. The QIW decision is only strictly relevant to the situation in Queensland and northern New South Wales. However, it does suggest that if the underlying conditions

¹¹ *QIW, op. cit.*, at 41,114-41,115.

¹² *QIW, op. cit.*, at 41,114.

¹³ *QIW, op. cit.*, at 41,120.

¹⁴ *QIW, op. cit.*, at 41,127.

¹⁵ *QIW, op. cit.*, at 41,144.

¹⁶ *Davids, op. cit.*, at 42, 085.

¹⁷ *QIW, op. cit.*, at 41, 142.; and *Davids, op. cit.*, at 42, 088-42, 089.

of supply and demand, which determine substitution possibilities, are reproduced in Victoria and New South Wales, the relevant markets would be for the supply of grocery products by independent wholesalers to independent retailers in each of those approximately state-based geographic areas.

The applicant's submission

5.18. Consistent with the *QIW* decision, the applicant submits that the relevant markets are for the supply of grocery products by independent wholesalers to independent retailers in Victoria and NSW.¹⁸

5.19. However, the applicant submits that "an important feature of this market is the fact that independent retailers compete with and are constrained by Chain Supermarkets."¹⁹ In particular, it is submitted that there are significant differences between the markets in Victoria and NSW compared to the Queensland market delineated by Justice Spender. These differences bring the vertically integrated chains into closer competition with independent retailers, providing a stronger constraint on the pricing of independent wholesalers.

5.20. First, it is submitted that the deregulation of trading hours in NSW, the ACT and Victoria has brought the chain stores and independent retailers into closer competition. Larger stores are permitted to trade 24 hours per day Monday to Friday, all day Saturday and Sunday in NSW and the ACT, and all day Saturday plus specified Sunday trading days in Victoria. Extended trading hours were previously a major point of differentiation between the chains and smaller independent retailers, but chain stores are now open for extended periods; with Coles stores generally open 24 hours and Woolworths/Safeway stores open until midnight during the week. For many consumers, this means that the chains now offer convenience shopping in the evenings and at weekends in competition with independent retailers. There had been no deregulation of trading hours in Queensland at the time of Justice Spender's decision.

5.21. Second, the applicant submits that while many independent retailers in Queensland are geographically isolated from competition with the chain stores, this is less so in Victoria and NSW. In the order of 55-65 per cent of Davids' Victorian sales are to metropolitan retailers, compared to 25 per cent quoted by Justice Spender for Queensland.²⁰ In non-metropolitan areas it is submitted by Davids that the catchment areas of the chain stores extend up to 150km, depending on the nature of the shopping centre in which they are located. On this basis it is claimed that less than one per cent of sales in Victoria and two per cent of sales in NSW are unconstrained by the chain stores.²¹

5.22. Third, the applicant submits that the development of the Global Electronic Marketing and Merchandising Network (GEMMnet), largely driven by Woolworths, will bring the chains into direct competition with independent retailers in isolated geographic areas.²² GEMMnet provides communities not directly serviced by the chains with the capacity to order groceries for delivery.

¹⁸ Davids Ltd submission, 2 February 1995. (The Executive Summary refers to both Victoria and NSW, while the main body of the report refers only to Victoria.)

¹⁹ Davids Ltd submission, 2 February 1995, p.4.

²⁰ Davids Ltd submission, 3 March 1995, p.2.

²¹ Davids Ltd submission, 3 March 1995, p.1.

²² Davids Ltd submission, 2 February 1995, pp.7-8.

5.23. Fourth, the applicant disputes the appropriateness of Justice Spender's categorisation of retail stores into convenience, top-up and supermarket stores according to size. It is submitted that many grocery stores, including Flemings and Food for Less stores owned by Woolworths, some Bi-Lo stores owned by Coles and some Franklins stores, as well as a number of Davids supplied Festival stores, are supermarkets under 800 square metres and are in full competition with the chain stores. It is submitted that a more appropriate categorisation of convenience and top-up stores are those stores under 5,000 square feet.²³

Interested parties' submissions

5.24. Few submissions from interested parties put forward arguments as to the relevant market.

5.25. CBL submitted that the relevant market is the "independent retail grocery market".²⁴

5.26. Coles, in a submission originally made in relation to the 1993 application by FAL in respect of the proposed amalgamation of FAL, Davids, IHL and CBL²⁵, argued that the Commission cannot ignore Justice Spender's decision; that independent wholesalers compete in a separate market of wholesaling groceries to independent retailers; and that geographic limitations of that market are broadly state based. It argues that the facts relating to the proposed merger are identical to the facts before Justice Spender and hence the latter's decision sets a precedent which is binding on the Commission; and FAL had failed to put forward any evidence that Victoria is significantly different from Queensland.

Commission evaluation

5.27. In relation to the *product dimension* of the market, the main product supplied by CBL and Davids is the supply of groceries (dry, frozen and fresh) from multiple manufacturers in a single delivery and the provision of support services, such as promotions, advice with store layout, pricing guides, ticketing and/or scanning support systems, etc..

5.28. The price of this service is the gross margin or service fee (after all rebates) charged by the wholesalers to the retailers. The Commission has considered whether there are other products which provide a sufficiently close substitute, either in demand or supply, to prevent a monopolist of this service exercising a significant degree of market power, e.g. by imposing a significant price increase, by reducing credit terms or service levels. Independent grocers need access to groceries to sell in their shops. Hence, any substitute product would at least have to provide this access.

5.29. The main alternative means of access is direct supply. This currently occurs for some products; bread, milk, chips and Arnotts biscuits. However, such supply is much more expensive than wholesale supply (both in transport costs and in time and disruption to the retailer), requiring multiple small deliveries. Products where it currently occurs are mainly characterised by perishability (bread, milk, meat, fruit and vegetables) or transport and storage problems (chips) or where the supplier effectively

²³ Davids Ltd submission, 3 March 1995, p.2-3.

²⁴ CBL submission, 21 February 1995, p.1.

²⁵ Application No. A90553, 6 August 1993, withdrawn 21 December 1993. Coles confirmed to the Commission that this submission continued to reflect its view of the current application.

views direct delivery as an investment in promotion (Arnotts). The product range of milk bars is such that they tend to obtain a relatively large proportion of their supplies from the route trade (confectionery, tobacco, milk, bread). However, for most independent retailers, direct supply is not viable for the bulk of their product range.

5.30. A second possibility is acquiring grocery supplies from the warehouses of the vertically integrated chains. However, they currently stock a smaller range of products and are not set up to supply small non-standard deliveries requiring billing and collection of sales tax. According to evidence in *QIW*, the average delivery to independent retailers is 3-4 pallets, compared to an average delivery of 70 pallets to a chain store, the product mix differs and often contains lines not carried by the chains.²⁶ The Commission's market inquiries have indicated a wide range of requirements by independent retailers, in terms of size, frequency and content of deliveries. Only the large independent supermarkets would have orders compatible with the operations of the chains and since they are in direct competition with them the chains may be reluctant to supply them with wholesaling services. The applicant has submitted that the creation of Grocery Holdings Pty Ltd by Coles, to service its Bi-Lo stores, makes it much more likely that Coles will offer wholesaling services to independents, and Jewel claims that such offers have been made.²⁷ However, the Commission is not otherwise aware of such offers or of any independent retailer accepting such services. More likely is the possibility of the chains providing cash-and-carry services from their retail outlets. Market inquiries indicate that this is already being done by Safeway (Woolworths) in Victoria and Franklins in NSW.

5.31. Problems would also occur in accessing promotional deals from manufacturers, organising associated publicity etc. and contracting for the supply of generic products. While some independent retailers are sufficiently large to negotiate such deals and organise their own promotions, e.g. Jewel, most are too small. The costs of organising hundreds of individual promotions for manufacturers and the costs of organising advertising material etc. for individual retailers would be prohibitive.

5.32. Labelling of goods could be done by the retailers themselves, although probably less efficiently, and advice on store layout could be obtained from independent consultants, but these services alone would not provide an adequate substitute for the package of grocery wholesaling services.

5.33. In relation to the *geographic dimension* of the market, the Commission observes that grocery wholesaling is supplied from state based warehouses, located close to the major population centres. Groceries are supplied to retailers across regions approximated by state boundaries, with some variations reflecting transport costs, such as northern New South Wales being supplied from Queensland.

5.34. The Commission considers that this reflects the underlying conditions of supply, trading off economies of scale and scope against increasing costs of transportation as the geographic coverage of warehouses increase. A further contributing factor is the practice of manufacturers to supply groceries free into store (FIS) in each capital city, absorbing transport costs and making inter-state supply by wholesalers uncompetitive. Davids supplies grocery wholesaling from separate warehouses in Victoria, New South Wales and Queensland and CBL has separate warehouses in Victoria and NSW. The same conditions of supply are reflected in the state-based warehousing of groceries by

²⁶ *QIW*, *op. cit.*, at 41,114.

²⁷ Jewel Submission, 2 March 1995, p.1.

the vertically integrated chain stores (Coles, Woolworths and Franklins). Inter-state supply of grocery wholesaling would not be cost effective and hence does not provide a close substitute for intra-state supply. For an inter-state wholesaler to supply would require new investment in warehousing etc. which would be in the nature of market entry rather than supply substitution.

5.35. The Commission considers that the ACT and New South Wales constitute a single market. Davids has a separate warehouse in the ACT and AIW also operates in the ACT. However, AIW will supply throughout New South Wales. Davids' ACT warehouse was an acquisition in 1992, rather than being built as a reflection of the underlying cost trade-offs.

5.36 In relation to the *functional dimension* of the market, the Commission accepts that if substitution possibilities in the downstream retailing market are sufficient to constrain the competitive conduct of the upstream grocery wholesalers, then the market boundary should be expanded to incorporate this source of substitution.

5.37. In relation to Queensland and northern New South Wales, Justice Spender found that such downstream competition from the vertically integrated chains did not provide a sufficiently close source of substitution to warrant expanding the relevant market.

5.38. Grocery retailing involves the supply of a range of grocery products in particular circumstances which may vary considerably between retailers in a number of dimensions: service; store layout and comfort; opening hours; location; product range; etc.. The price of these retail services is the gross margin charged by the retailer to customers. At one extreme is the milk bar, which is conveniently located close to residential areas, with long opening hours and personal service, but a limited product range. At the other extreme is the large supermarket located in a shopping centre or stand alone site, but less convenient to residential areas, with impersonal service but a wide range of products and variable trading hours. Justice Spender found there was a linear relationship between the size of stores and the average dollar value of purchases. He accepted a classification of grocery retailers into convenience stores (<400 sq m), top up stores (<800 sq m) and supermarkets (>1,000 sq m).²⁸

5.39. However, differences in price and quality do not necessarily mean that two products are not in the same market, as has been acknowledged by the courts. What is relevant is whether substitution possibilities, in either demand or supply, place a sufficient constraint on the conduct of independent retailers to prevent the exercise of market power by a potential monopolist of independent wholesaling services.

5.40. On the demand side, while all grocery retailing services are substitutes to some extent, they are not perfect substitutes. As indicated above, they offer a different combination of price, quality and service.

5.41. Whether there is supply side substitution between different types of grocery retailing will depend on factors such as the need for investment in new premises (providing a different size and location). Such supply side substitution is more likely to be possible between supermarkets and discount supermarkets; or between different types of small local grocery retailers, such as convenience stores and milk bars, although the need to invest in new shop fittings and stock may still limit substitution possibilities. However, supply side substitution possibilities between supermarkets and

²⁸ *QIW, op. cit.*, at 41,114-41,115.

smaller convenience and service oriented grocery retailing are much more limited. Supermarkets require the provision of significantly larger floor space and car parking, which cannot usually be supplied from the premises of a convenience store. On the other hand, the location and fit out of supermarkets limits their ability to provide convenience and personal service.

5.42. In addition to price and service (product) differentiation between retailers, they are also differentiated by location. Retail markets are generally narrower in geographic dimensions than wholesale markets, with demand side substitution limited by the cost and ability of consumers to travel and there is no supply side substitution. In Queensland, independent retailers were disproportionately located in country areas and often not in close geographic proximity to chain stores.

5.43. Whether downstream competition from the vertically integrated chains is sufficient to constrain the exercise of market power by the independent wholesalers, will depend on whether the latter's customer retailers are operating in the same product and geographic retail markets as the chains. Justice Spender placed considerable weight on the fact that most of the customers of Davids and QIW were smaller retailers, operating in price zones which were not competitive with the chains, reflecting differences in size, location, product range, trading hours etc..²⁹

5.44. If the price zone information reflects the participation of chains and independents in different product and geographic retail markets, while there would be some loss of sales to the chains, it would still be profit maximising for a monopolist of independent grocery wholesaling services to raise prices significantly above their competitive level.

5.45. For Queensland, this contention was supported by evidence that the wholesale price of groceries fell by two to three per cent after the entry of Davids into the market. As a percentage of the price of the wholesaling service, this would be highly significant. While post-entry prices may have been driven below their competitive equilibrium level, it still seems likely that the pre-entry prices charged by the monopolist QIW were significantly above their competitive level.

5.46. Furthermore, even if independent retailers and the chains were in direct competition at the retail level, a wholesale monopolist may still be able to impose a SSNIP, where price is defined as the gross wholesale margin, because this price is a relatively small proportion of total retail costs. Retailers may be able to absorb such an increase, despite being constrained from passing it through to their customers in higher retail prices.

5.47. While the Commission accepts Justice Spender's decision in relation to the relevant market in Queensland and northern New South Wales, the proposed merger affects Victoria and New South Wales, where CBL competes with Davids. It is possible that the conditions of supply and demand, and hence underlying substitution possibilities, are different in Victoria and New South Wales, requiring an expansion of the relevant market in terms of the functional dimension of market definition.

5.48. Market inquiries undertaken by the Commission confirm that the retailers supplied by Davids and CBL in Victoria and New South Wales range from smaller stores offering convenience and service, who do not compete directly with the chains; medium sized stores who try to match the chains prices on the top selling lines, ranging

²⁹ QIW, *op.cit.*, at 41,115 and 41,119.

from 200 to 1,000 lines, but do not match their prices on the full product range; and larger supermarkets, offering a full range of departments and competing directly with the vertically integrated chains on price. Hence the degree of competitive restraint imposed by the chains decreases with the size of independent retailers.

5.49 The table below provides information on the size distribution of stores supplied by Davids, CBL and AIW in Victoria and NSW:³⁰

Table 1: Size Distribution of Independent Retailers in Victoria and NSW*

	VICTORIA	NSW**
Supermarkets > 7,000 sq ft, with full range and departments and sales > \$60,000 per week	224 (21%)	189 (20%)
Supermarkets 3-5,000 sq ft, with core range, limited departments and sales \$20-60,000 per week	216 (20%)	171 (18%)
Supermarkets <3,000 sq ft, with limited range, no departments and sales <\$20,000 per week	134 (12%)	0 (0%)
Convenience Stores (oil company franchise), 1-2,000 sq ft and sales <\$20,000 per week	245 (23%)	309 (33%)
Convenience Stores, 1-2,000 sq ft, with sales <\$5,000 per week	268 (25%)	258 (28%)

* Percentages may not sum to 100 due to rounding.

** Includes the ACT

Note: Davids also supplies sixteen cash-and-carry outlets in NSW and seventeen in Victoria, which in turn supply a large number of milk bars etc..

5.50. Justice Spender defined supermarkets to approximately encompass stores over 1,000m² (10,764 sq ft), but the size range 800-1,000m² was not defined as either supermarkets or top up stores, presumably recognising that this will vary according to individual circumstances. Further information provided by the applicant reveals that supermarkets >7,000 sq ft (650m²) supplied by Davids in Victoria predominantly fall into the size range 10 to 15,000 sq ft and are either Jewel, Rainbow, Festival or Big W stores. This information, and further information provided by CBL, suggests that approximately one fifth of independent grocery stores in each state are supermarkets which would compete directly with the chains.

5.51. The majority of stores supplied by the wholesalers are smaller convenience and grocery stores, with limited departments and product range. These stores are less likely to be in close competition with the vertically integrated chains.

5.52. However, while independent supermarkets in direct competition with the vertically integrated chains may represent a relatively small number of the stores supplied by the wholesalers, they represent a much higher proportion of sales. Confidential information provided by the applicant and CBL indicates that the one fifth

³⁰ Davids Limited Submission, 23 February 1995, Appendix A.