The Australian retail duopoly as contrary to the public interest

Report for the Fair Trading Coalition

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1 Competition, the takeover/merger imperative and its regulation

The merits of the market system are rooted in competition. Traditionally, competition has been understood as that process that inhibits the acquisition of market power by business firms. The intended effect is that market prices will reflect 'economic' values – other than in the short term, prices will reflect the cost of production.

The economics textbooks house the purist version of this story, 'perfect competition', in which market power is obliterated. Myriad independent firms and freedom of entry drive down prices mercilessly. The market rules over any individual firm.

In the 'real world', there is a perennial tendency for business consolidation as a seemingly natural product of market dynamics, and an absence of any comparable countervailing force. The financial press writes approvingly of this tendency, defending the need for industry 'rationalisation' or 'consolidation' in sectors that are deemed 'over-crowded'. Investment houses foster the tendency, gaining substantial fee revenue from the nurturing of 'mergers and acquisitions'.

The tendency is compounded by long-standing business lobbying against effective trade practices legislation. The emasculated 1965 Trade Practices Act lacked a merger provision. The Whitlam Government's 1974 Act finally broke through the impasse.

One of the first actions of the Fraser Coalition Government was the establishment of the Swanson Committee to review Labor's 1974 Act. The 1978 Swanson amendments included the watering down of section 50, the merger provision, to a test that prohibited acquisitions

> which result in, or substantially strengthen, a position of control or dominance in a substantial market.

That weaker provision was to prevail until the section was amended in 1993 to its present form.

There has been a continuing tension between idealism of the textbook model, which still commands a powerful attraction in economic theory, and market and political pressures. Policy-makers have been forced to pragmatically forge a workable substitute. William Shepherd, a long-time American industrial organisation practitioner, has outlined defensible parameters:[1]

For competition to be effective, there must be parity and strong mutual pressure among many firms. The structural conditions are three:

1. Many firms, so that they are not able to collude. Usually five comparable firms is the bare-bones minimum number.

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[1] Shepherd, *The Economics of Industrial Organization*, 1997, p.8

2. No dominance by one or several firms.
3. Reasonably easy entry by new competitors.

Shepherd's proscription of minimum numbers is evidently influenced by his focus on the sizeable American economy. In Australia, the functional model is that implied in the post-1993 wording of s 50 of the Trade Practices Act:

> A corporation shall not acquire, directly or indirectly, any shares in the capital, or any assets, of a body corporate where the acquisition is likely to have the effect of substantially lessening competition in a market for goods or services.

A 'market' (for s 50 purposes) is to be variously delimited as:

> 'a substantial market for goods or services in: (a) Australia; or (b) a State; or (c) a Territory; or (d) a region of Australia

The substantive phrase 'substantially lessening competition' is made operational by the current 'threshold' test, the triggering of which would warrant an investigation by ACCC staff into a proposed takeover/merger:

- that the market share of the [potential] merged entity is below 40 per cent
- that if the market share of the [potential] merged entity is above 15 per cent, the combined share of the four largest market participants after the proposed merger is below 75 per cent.

The working rules in Australia are not insubstantial but are more accommodating to market power than is the textbook ideal.

The aversion of corporate business to an effective merger statute was given a powerful fillip with the emergence during the 1970s and 1980s of two dissident schools of thought towards American antitrust regulation – the [University of] Chicago school and the Contestability school. The two schools developed separately but have exerted a mutually reinforcing influence.

The Chicago school has one simple theme – efficiency should be the overwhelming criterion in the determination of consumer welfare. Possible wealth transfers from consumers (or small business) to producers/retailers is of minor significance compared to the need for efficiency. If the thrust for efficiency means the dominance of industry sectors by a handful of large corporations, then so be it.

Contestability theory denies the correlation between firm numbers and the degree of competition. One or two firms might deliver 'competitive' outcomes, but the dominant pressure on business entities is via the threat of new entry. Traditionally, competition was to be facilitated by inhibiting industry concentration and appropriation of market share by a small number of large players. Under the 'contestability' version, competition was now to be facilitated by its opposite. The notion of what constitutes effective competition had been turned on its head.

The new ideas were readily imported into Australia and have emboldened corporate interest groups and influenced academic and legal culture. They were influential in extending the life of the weaker merger provision, and in the vision of two of the most important inquiries into competition in Australian history – the 1981 Campbell Report and the 1993 Hilmer Report.[2]

The Campbell Report recommended comprehensive deregulation of the financial system. The Hilmer Report recommended comprehensive extension of the competition statute to all domains of economic activity. In both Reports, 'competition' is found to be the universal salve for our then economic maladies, but in neither Report do the respective Committees outline their understanding of this fundamental concept that is to dictate our livelihoods.

The Chicago/Contestability visions have contributed to an extraordinary transformation. From being the enemy of competition, large corporate business has emerged as the hero of competition. The transformation involved a sleight of hand because the bulk of the audience for such a revolutionary recommendation was unaware that such a powerful term as 'competition' could have been radically re-defined.

Undoubtedly a case can be made for regulatory tolerance of structurally concentrated market segments. There might be merits in the scale economies emanating from large-scale production, especially with greater potential for threats to domestic corporates from imports as tariffs barriers have been eliminated. However the rush to praise the potentially positive byproducts of a large corporate presence has lead to the neglect of its negative byproducts – potential inefficiencies of cumbersome administration and the accumulation of market power which facilitates distortions in market outcomes.

The weakness of the merger provision of the Trade Practices Act between 1978 and 1993 provides an object lesson in the rush to uncritically embrace business consolidation and the growth in business size.

From a large number of regrettable consolidations under the weaker s 50, several raised immediate public concern regarding the enhancement of market power. Foremost amongst these was the 1985 merger of Coles, Myer and Grace Bros which dramatically enhanced concentration in the retail sector. Coles also soon acquired the regional grocery retailers Bi-Lo and Shoeys, and New Zealand's largest food retailer, Progressive Enterprises.

The merged entity used its market power to generate profits while obscuring weaknesses in a management culture that continue to this day. By 1989, Coles' buying muscle was described as 'awesome', and its potential clout in shopping centre development worrying.[3]

At the time, Coles' buying power was seen by suppliers as generally being exercised responsibly in apparel (save for its first claim on receipt of goods), but its charges for promotional activities in food retailing were widely perceived as exploitative.

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2. *Australian Financial System: Final Report of the Committee of Inquiry*, Canberra, 1981 ('the Campbell Report"); *National Competition Policy*, Canberra, 1993 ("the Hilmer Report").

3 Colleen Ryan, 'A bigger Coles Myer may sell itself short', *Sydney Morning Herald*, 25 February 1989.

Graeme Bowler, managing director of Franklins, was then quoted as lamenting the tolerance of Coles' expansion:

> I am simply staggered that the Trade Practices Commission has allowed takeovers in the one industry on such a scale. If Coles Myer keeps on eliminating the competition, it cannot be good for suppliers, wholesalers, retailers, but most of all the general public ... yet it seems as though it is going to be allowed to continue along the same track.

Nevertheless, a 1989 Parliamentary Inquiry recommended the maintenance of the weakened s 50 because of the presumed efficiency advantages of business consolidation.[4]

Coles' untrammeled expansion received an unexpected check in 1994. A joint proposed takeover of Foodland's wholesaling and retailing assets was launched by Coles and the New Zealand entrepreneur Graeme Hart's Rank Commercial. Coles and Rank would take the Australian and New Zealand assets respectively. The Trade Practices Commission pre-empted the bid and killed the takeover with an ex-parte injunction.

There had been two (related) changes to the regulatory environment since 1989. Alan Fels had replaced Bob Baxt as Chairman of the TPC in 1991, and the merger provision had been strengthened in 1993. The TPC's legal advice claimed that the takeover would have breached the amended s 50 in four areas – effective control of 75% of grocery retail sales in Western Australia, a dramatic expansion in the market share of liquor wholesaling and retailing, enhanced market power over suppliers at State and national levels, and anti-competitive implications for independent wholesalers.

Of substantial current relevance is the reportage accompanying the TPC's successful intervention. The *Australian Financial Review*'s Ivor Ries is representative.[5]

> The move for an injunction was taken after receiving strong legal advice. But the move may also have been taken in part to expunge one of the competition watchdog's greatest shames.
>
> The retailing sector is a great source of embarrassment to the TPC. One of the TPC's two greatest blunders to date was in that sector - in approving the merger of G.J. Coles & Coy Ltd and The Myer Emporium Ltd that created Coles Myer Ltd in 1985. The other was allowing News Corp to acquire 70 per cent of the national newspaper industry through the Herald and Weekly Times takeover.
>
> With that albatross around its neck, the TPC's move yesterday may be seen as a sign that the TPC will never again allow itself to be hoodwinked by the retail industry. Thanks to the Coles Myer merger, Australia already has the world's highest level of retail concentration.

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[4] *Mergers, Takeovers and Monopolies: Profiting from Competition?*, 1989 ("the Griffiths Report")
[5] Ivor Ries, 'Foodland: TPC lashes out at Coles', *Australian Financial Review*, 29 June 1994.

> The TPC is now saying: no more. The national competition watchdog is suggesting that any growth for the two biggest players – Coles Myer and Woolworths – will have to come organically or by overseas expansion.

Over a decade later, however, a more favourable environment has developed for the self-interested claims of large Australian corporates. Concern for the accumulation of market power has been marginalised, and abuses of market power have received attention only in certain areas (cartels in particular) rather than being addressed systematically.

The retail sector is reflective of the transformation. The recent breakup of Franklins and Foodland indicates a more tolerant regulatory environment than was in evidence in 1994. The breakup of these companies has furthered undesirable concentration in grocery retailing. Woolworths acquired one third of Franklins' 200 stores in 2001 and 21 prime stores and sites in Western Australia (as well as suite of New Zealand outlets) from Foodland in 2005.

The original breakup of Foodland was instigated following a reverse takeover bid by Metcash. Woolworths was able to bid for the New Zealand assets without the bid having anti-competitive implications. However, Woolworths made the New Zealand offer conditional on it also getting Foodland's Action retail stores (Woolworths had previously made a comparable 'all or nothing' threat regarding acquisition of the Franklins' stores). Opposition from Metcash, independent retailers and local suppliers did not detract from the ACCC's condoning of the Western Australian takeover.

The ACCC's evaluation of some of the Action stores and sites highlights the ACCC's absorption of the 'contestability' concept. The ACCC tolerated the Woolworths takeover of two Queensland Action stores (Mudgeeraba and Q Super Centre) and particularly a Kalgoorlie development site not because of existing competition but because of the existence of other sites that offered potential for competition against Woolworths.

The ACCC's reportage of its blessing to the Woolworths takeover includes the claim that: 'Evidence was sought from market participants to support the proposition that there is likely to be a substantial lessening of competition in any supply or procurement markets, but it was not forthcoming'. This claim is a misrepresentation of events. A Western Australian meeting arranged by the ACCC, which anxious suppliers attended, disclosed supplier concerns and estimates of lost business consequent on the Action stores being acquired by Woolworths. ACCC representatives insisted that information was not to be considered legitimate unless the suppliers were prepared to give public evidence. Given the known fear of suppliers, who face a total loss of business to the retailers, the ACCC demands for public disclosure constituted an extreme abrogation of its charter and its responsibilities in this case.

The disposal of Franklins and Foodland assets provided a rare and possibly the last opportunity to inhibit retail sector consolidation. The Franklins sell-off desirably brought the South African company Pick n' Pay into the Australian market, but shareholder concerns took priority over a more strategic approach by which this vital industry was structured to ensure that the public interest was secured in the long term.

The ACCC is now faced with perennial deliberations on potentially anti-competitive *conduct* as a natural byproduct of past takeovers and mergers, and the subsequent possession of market power by a handful of firms in concentrated industries.

2 Concentrated industries and the tendency to anti-competitive conduct

Market power provides the ready capacity for anti-competitive conduct. Some instances of allegations, litigation and corporate pressure in the last decade illustrate the tendency.

2.1. Horizontal cartels

The most notable current instance of anti-competitive conduct is the alleged cartel between the duopoly cardboard box manufacturers Amcor and Visy. In the late 1980s, Visy engaged in aggressive price-cutting (albeit in conjunction with desirable investment) to build market share against the sluggish dominant manufacturer, Amcor. Visy also acquired Smorgon Fibre Containers, a casualty of the price-cutting, in 1990. This takeover was facilitated by the then weakened s 50 of the Trade Practices Act.

The next decade saw the cementing of a duopoly, with the pair roughly dividing 90-95% of the market. The combined share would have been closer to 100% if the ACCC had not prevented Visy from taking over US-owned Stone Containers in 1999 (subsequently acquired by New Zealand-based Carter Holt Harvey).

The customers comprise a number of large processors, and the loss of any one customer to the rival implies a substantial effect on profits. After 2000, customers engaged in renegotiating their service found a marked imbalance in quotes tendered by the two parties, an imbalance consistent with a tacit market-sharing arrangement amongst the producers. An industry analyst noted that prices had risen consistently since 2000. Documentation discovered in an ancillary dispute regarding departed Amcor executives, supplemented by sworn testimony by a retrenched Visy executive, disclose that indeed a market-sharing and price-fixing cartel was established in the course of many illicit meetings from 2000 onwards.

The relationship between industry structure and conduct, a link long emphasised by traditional American antitrust economists, is admirably conveyed by John Durie, the respected financial columnist of the *Australian Financial Review* (7th and 8th December 2004):

> Above all, this case highlights the tragedy that, perhaps, too much of Australian industry has been allowed to fall into too few hands. … It is far easier to prevent market rigging by denying companies the chance to engage in such conduct than attempting to prove wrong-doing after it has occurred. …
>
> Suppliers to the duopoly have long complained it is impossible to get any pricing tension between the two, which end up buying everything from print to

> starch on remarkably similar terms. That is a problem that besets many in an Australian market dominated by oligopolies and highlights the problem when laws don't give regulators the power to stop mergers, allowing anti-competitive behaviour to flourish, which is harder to stop.

The complaint is relevant to other recent cases. In 2004, Weston Foods was found guilty of attempted price-fixing in wheaten flour, the 'fundamental building block for much of the food industry'. In late 1999, the time of the attempts, Weston had an estimated 31% of the flour milling market, Goodman Fielder 46%, and a smaller third player Manildra had 8%. A Weston executive had heard that Goodman Fielder was intending to raise its price. He then approached Manildra concerned (in the words of a newspaper report) 'that if the two big players moved, the increase might not be sustainable unless Manildra followed suit'.

Weston defended assertively the litigation brought by the ACCC until an 'eleventh hour' admission from the agent. The presiding Federal Court Justice Roger Gyles noted that:

> I am not satisfied that this was simply an isolated act of madness by [Paul] Loneragan … An alternative hypothesis, of course, is that this kind of activity was common-place in a tightly organised oligopoly and that this incident only came to light because of [Manildra Chairman] Dick Honan's desire to play it as a card in a collateral commercial dispute.

Gyles also considered it relevant that George Weston Foods had previously engaged in price fixing or attempted price fixing in 1976, 1995 and 1997.

Both the 1995 and 1997 cases were a product of Weston succumbing to pressure from Woolworth subsidiaries as major Weston customers. In the 1995 case involving Weston's attempt to enforce bread prices on retailers to placate Safeway, Justice Goldberg noted that the company:

> … was subject to extreme commercial pressure from a major customer to which its relevant officers succumbed. … it was a concern about Safeway reprisals that motivated the GWF officers to commit the contraventions.

The market power of one of the major retailing duopolies thus trickles down to suppliers, and becomes manifest in the abuse of market power by a supplier against small third parties.

2.2. Vertical price-fixing and misuse of market power

In December 1996, the ACCC initiated proceedings against Woolworths' Victorian subsidiary Safeway. The ACCC alleged that Safeway, as a bulk bread purchaser, had attempted (successfully) to prevent bread manufacturers from supplying bread to independent retailers who were discounting bread prices, and to fix prices at a store owned by a manufacturer. In 2001, the Federal Court dismissed the ACCC's allegations. Yet in June 2003, the Full Federal Court, in response to an ACCC appeal, overturned the primary court decision and ruled that Safeway had misused its market power in some of the incidents.[6] Safeway and the ACCC both sought leave to appeal but were denied by the High Court.

Belatedly in January 2006, on the strength of the Full Court judgment, the primary court judge Alan Goldberg ordered a fine of $8.9 million for Woolworths, a record court-ordered penalty for the misuse of market power. The fine total represented an aggregate of separate fines for misuse of market power at four supermarkets and for price fixing at one supermarket. The ACCC had sought penalties of $15.5 million.

According to a newspaper report of Goldberg's decision (*Australian Financial Review*, 1 February 2006):

> Justice Goldberg found the repetition of the company's conduct over a period of 12 months warranted a significant penalty despite company assurances that the incidents were unlikely to occur again. Safeway's conduct was 'deliberately calculated to restrict competitive conduct' …

The incidents took place in 1994 and 1995. The dominant bread manufacturer, George Weston Foods, admitted liability and was fined in May 1997. Woolworths defended the case assertively, and eleven years have passed between the events and a resolution. The primary court process involved a hearing of 92 days and produced a 370 page judgement. Following the partial judgment against Safeway in 2003, Woolworth's Chief Executive, Roger Corbett, accused the ACCC of wasting taxpayers' money. The *Australian Financial Review*'s financial columnist, John Durie, noted (1 February 2006) that 'Retail doyen Roger Corbett obviously struggles to accept reality when it comes to trade practices breaches'.

2.3. Third line forcing

In January 2005, Coles Myer lodged a notification for authorisation of a scheme to dictate to suppliers of Coles and Bi-Lo supermarkets that they employ CPM Australia Pty Ltd if they wish to conduct in-store demonstrations. This demand, in the name of a 'request', is a form of third line forcing, and transparently anti-competitive.

Trade practices consultant Hank Spier noted in a submission for supplier clients:

> What Coles is proposing to do is to take competitive pressures out of a vital element of marketing and to add a non-competitive cost to its suppliers. …
>
> In store demonstrations are essential to many suppliers to promote their products. Coles already has obstacles through listing fees and limits on the number of suppliers for any one line. This is another control tool. …
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> Coles is not some small chain but one of the two majors. Any third line forcing conduct by someone in that market position must be inherently detrimental to competition and the relevant industry generally. … once Coles does it it is likely that Woolworth's will follow.

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[6] ACCC, 'Australian Safeway Stores Ltd', no date.

As companies seeking authorisation of an anti-competitive arrangement must provide estimates of the expected public benefit, Coles Myer claimed that the arrangement would benefit the Coles Myer supermarkets (not a public benefit), the customers and the suppliers. After a considerable number of opposed submissions from suppliers speaking on their own behalf, Coles Myer withdrew its notification.

To repeat, market power provides the ready capacity for anti-competitive conduct. Many firms with market power grow accustomed to enjoy the exercise of that power, and that mentality becomes entrenched in their corporate culture. The line between legitimate and illegitimate use of market power becomes blurred, facilitated by the weakness of relevant sections of the Trade Practices Act. It is arguable that the two retail giants, among other large corporates, are in this category. The competition regulator will pursue some alleged contraventions of the Act, as above. However, the regulator has neglected to confront the implications of a commercial culture that takes advantage of weak provisions regarding anti-competitive conduct as standard business practice.

3 Lower prices: their benefits, sources and costs

The dominant theme in the defense of and by the large corporates has been that they are good for consumers. The dominant retailers, Woolworths and Coles Supermarkets, have demonstrably delivered lower grocery prices to consumers; so also Bunnings with hardware. The large retailers have received sympathy from consumer organisations for this outcome.

More significant, the large retailers have received tolerance, even tacit admiration, from the ACCC. Behind the ACCC's tolerance has been the development of an unspoken duality in ACCC culture of a fundamental conflict between generic business and consumers. The large retailer appears to have resolved that long-standing conflict in delivering profits and lower prices simultaneously.

Clearly, large retailers have delivered lower prices to ultimate consumers. An important vehicle for this outcome has been not merely the benefits of large scale operation *per se*, but also the strategic attention to logistical improvements (Woolworths in particular through Project Refresh) in goods transport, storage and stock control, and in financial administration. Nevertheless, the story on prices is not clear-cut.

3.1. Duopoly prices are not always the lowest

The claim that the large retailers deliver universally lower prices is a myth. Lower prices are more common in the grocery segment, but there is no guarantee of lower prices in fruit and vegetables, meat or in hardware. The large retailers rely upon the customer's attraction to convenience – once in the supermarket for groceries, the expectation is that the customer will purchase their needs in these other segments at the same time.

The ideal situation for the large retailers is when reasonable alternative sources for customers no longer exist. Lower prices are not guaranteed purely by the purported rivalry between the two domestic giants Woolworths and Coles Myers but by the continued existence of smaller rivals and the threatened entry of other giants (Aldi).

A June 2003 survey of food prices by Choice magazine found that the price of a standard basket of goods had increased by 23% at Woolworths Leichhardt (suburban Sydney) since the previous survey in December 2000. The consumer price index for food had risen by 13% over the period. The closure of Franklins in the Leichhardt Marketown mall provided the opportunity for the price rise. Woolworths denied the scale, claiming that the rise was 'only' 18%, and obfuscated the enhanced market power as 'in line with the change in localised competition in the area'.

A July 2004 survey by the industry watcher FoodX noted a difference in pricing by Coles and Safeway (Woolworths) in two Melbourne suburbs – a basket of comparable products was being sold for significantly higher prices in suburban Malvern compared to their prices in Prahran where the big two faced competition from ALDI.[7]

The implications of the FoodX survey are confirmed by a more general study by Network Economics on grocery retail prices in Victoria.[8] The study correlated prices with competitive conditions in local markets. The study found that: 'An independent store charged the lowest median price in the case of 39.5 per cent of products; a chain store charged the lowest median price for 48.5 per cent of products …'

Other important findings were that a market of two independents and one chain has lower prices than does a market of two chains and one independent; and that Aldi exerts a large negative influence on prices for a narrow range of groceries. The study concluded that:

> … in the case of duopolies, the average chain prices is likely to be lowest for a greater number of product lines when the chain store competes alongside an independent in the same location compared to where the chain competes with another chain.

Two conclusions follow: prices of the two chains are not consistently below those of independents; moreover, the vitality of independent retailing (as well as the presence of Aldi) is of crucial significance in the maintenance of lower grocery prices.

3.2 Low prices come at expense of suppliers

The lower prices of the retail giants come at the expense of their suppliers. Woolworths and Coles Myer have a dominant relationship with their suppliers.

This assymetric relationship was most transparent in the aftermath of the deregulation of the dairy industry. The handful of dairy processors found themselves competing to deliver the lowest quote for the bulk contract to the two giant retailers. Farmgate prices have plummeted as a consequence. Since this initial downward pressure on

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[7] 'Retailing: How various supermarket pricing structures stack up against their oppositions', *FoodX*, Issue No.4, October, 28-29, 2004.

[8] Jill Walker & Tony Webber, 'Retail Grocery Prices in Victoria: The Relevance of Local Market Conditions', *Australian Economic Review*, 37, 3, 2004. Results were generated from work originally undertaken on behalf of Metcash, but the study is the most rigorous on price competition to date.

suppliers, the retailers' own brand milk has remained cheap (typically $2.49 for two litres), but branded fresh milk products are little different in price compared to other outlets and the chains' retail margin on milk has expanded.

A little acknowledged consequence of dairy deregulation and centralised sourcing by the retailers has been the subsequent inefficiency in cross-country goods transport. The scale of inefficiency has been growing, and will escalate with petrol price rises. But given that transport costs are borne by distributors, processors and growers, there is no internal mechanism that registers this dysfunctional dimension of centralised sourcing.

The major retailers have been extracting significant discounts from grocery suppliers for decades. An inquiry was held in the mid-1970s soon after the Trade Practices Commission was established, but to no effect.

The retailers obtain discounts for bulk purposes, a phenomenon recognised by economists, but a range of undocumented additional extractions are involved. An accurate account of the extractions is difficult because of the pervasive secrecy surroundings the relationships. Suppliers are loath to publicise details because of fear of victimisation.

Discounts and allowances are demanded for such factors as national exposure, product range coverage, access to priority shelf space, marketing promotions, and debt settlement in the conventional period. Additional rebates may be demanded after sale. Conventional estimates have discounts and rebates totalling 11-12% of invoice price, but 15% has also been mentioned as a reasonable estimate.

Retail consultant Geoff Cutler was reported in July 2005 as claiming (reporter paraphrase):

> By the turn of 2000, floor space for promotions was so expensive – for example, Woolworths was charging its usppliers $100,000 for one week's use of gondola ends in NSW – and trading terms in general so complicated, that suppliers were discouraged andconfused. In response, the supermarkets came up with 'rolled-up' trading terms, under which all the previous small charges were replaced by a single sum.

Because of the paucity of formal information on discounts and rebates, and on the 'negotiating' process by which prices and conditions are determined for supply to the two giants, some insight is gained indirectly from financial reportage.

For example, an August 2002 report noted that Officeworks (a Coles subsidiary) had contacted some of its suppliers demanding four months to pay. Suppliers wanting ready payment were expected to give a 5.25 per cent discount on supplies.

When Woolworths was bidding for the Australian Leisure and Hospitality Group in July 2004, it was reported that 'Woolworths has cited enhanced scale and leverage with suppliers as a benefit of the bid'. Similarly, Woolworth's mooted entry into the New Zealand grocery sector via the purchase of Foodland's New Zealand assets was openly touted in terms of the potential greater subjugation of suppliers: In October

2005 Deutsche Bank analysts estimated that Woolworths could extract upwards of $130 million in synergies from the New Zealand Foodland takeover, yet over 80% of these ‘savings’ were to be obtained through demanded price reductions from suppliers.

Woolworths duly acquired Foodland New Zealand in late 2005. The New Zealand press reported suppliers’ accounts of Woolworths’ first meeting with them in January 2006 as being conducted on terms of demands for price reductions on a ‘take it or leave it’ basis.

A July 2005 article on the continued roll-out of Aldi stores on the East seaboard quoted the respected retail analyst ACNeilsen as claiming that suppliers ranked Aldi above Coles and Woolworths for fairness and conditions.

Another vehicle for the chain retailers’ enhancement of leverage over suppliers is house brand merchandise. Traditionally restricted to generic products such as sugar and flour, Coles is planning to more than double its house brand share of turnover to 30% by late 2007. Coles is attempting to ape the British retail giant Tesco, and has brought out an ex-Tesco executive to implement the strategy. Yet house brands are extremely unpopular amongst many suppliers, who face either loss of brand status and reduced profit margins or reduced shelf space for their branded products. ACNeilsen claims that there is no evidence that Australian consumers want house brands extended to non-generic products.

An important dimension of the grocery trade is the significant role of Metcash as wholesaler to independent retailers. Metcash also extracts discounts and allowances from suppliers. After its takeover of the bulk of Foodland’s Australian assets in 2005 Metcash chose to emphasise that it would be approaching suppliers for better terms, ‘reflecting the 40% boost to its national buying power’. Metcash’s leverage has traditionally been less than for the two retailers, and the discounts and rebates obtained by Metcash from the suppliers subsequently less. Metcash in turn passes on only a portion of the discount and rebate gains to its independent customers. Some independents complain that the trickle down from Metcash from the supplier extractions is minimal.

The scale of the rebates and discounts extracted by Woolworths and Coles is remarkable. Woolworths reported a $791.6 million net profit for 2004-05, but also the receipt of $601 million in rebates and discounts. Coles reported a $624.5 million net profit, but has ceased to publicise the rebate/discounts figure; on previous reporting, the rebate is running at well over $500 million. Comparative figures from previous years are reproduced in the table, extracted from the retailers’ annual reports.

Woolworths Ltd / Coles Myer Ltd. Profits & Rebates/Discounts ($m.)

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Woolworths Ltd						
Net Operating Profit	295.5	428.0	523.2	609.5	687.8	791.6
Rebates & Discounts	372.4	473.6	511.8	493.2	547.3	600.9
Coles Myer Ltd						
Net Operating Profit	278.3	140.2	345.0	429.5	616.5	624.5
Rebates & Discounts	462.2	575.0	650.6	n.a.	n.a.	n.a.

At first sight, the net profits of the two retail giants are dominated by monopoly extractions. It is not insignificant that stockmarket analysts take it as given that corporate retail giants (including the durable goods retailers) derive their profits from supplier extractions. For market analysts, this peculiar form of profit derivation is a defining characteristic of the corporate retail sector. It is thus surprising that the commercial regulator, legislators and the economics and legal professions have not become apprised of market analyst intelligence.

3.3 Official recognition of retailer extractions from suppliers

Following concerns raised in the 1999 Baird retail sector inquiry, the Senate instructed the ACCC in 2001 to investigate supplier-retailer relations. The 2002 ACCC report surveyed supplier prices in 1999-2000 and 2000-01 (excluding fresh fruit and vegetables) with the view to gauging the extent and possible disparity of 'funding support' by suppliers to their customers. The ACCC concluded that 'Buyer power is present in the Australian grocery market but, on the data received, the suppliers do not favour any single buyer'. The major chains received better wholesale prices more often than did other wholesale buyers, but other wholesalers also received better prices than the chains on a minority of occasions.

The Senate also instructed the ACCC to examine the magnitude of price differences. The ACCC reported on different prices received by six key buyers from suppliers for a sample of product lines. Substantial price differentials were observed, with the bulk of the differentials being within 4% of the 'least favourable price' obtained by a buyer; but there was a significant range of differentials above 10%. The average size of the price differentials increased between the two years studied. The ACCC found that the two major chains (and Franklins in the earlier year) did not monopolise more favourable terms but shared more favourable prices from suppliers with other wholesalers.

The ACCC admitted that its examination was limited by the survey responses – 'At best, the data can only be regarded as indicative'. Neither key buyers nor key suppliers responded appropriately. Only three of seven major buyers provided 'significant financial data', and one major buyer declined to provide any figures at all. More significantly, the Commission did not query the character and reasons for the scale of 'funding support' and its dramatic variation across buyers.

The Commission inferred, without examination and without evidence, that that there was no discernible anti-competitive dimensions to grocery price determination, and that there has been no breach of the law. The regulator saw fit to reiterate its belief that 'price discrimination can also produce a positive outcome and simply reflect competition at work'.

Also of relevance is the 2004 consultancy report by Whitehall Associates for the Department of Agriculture, Fisheries and Forestry.[9] The report desirably places farmgate prices within a broader context of global supply chains of key agricultural commodities. The general thrust of the report is that 'it is a tough world out there',

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[9] S. Spencer, *Price Determination in the Australian Food Industry*, Whitehall Associates, 2004.

and that the rising gap between retail prices and farmgate prices are a natural product of the evolving complexity of the supply chain. There is the presumption of inevitability about evolving structures and prices, with the qualification that some suppliers suffer an information deficit that might deserve remedying. The report notes in passing:

> Industry must weigh up the pros and cons of investments in better information systems and transaction tracking to overcome [dysfunctional market] concerns, as there is little role for external intervention beyond mechanisms such as the Retail Grocery Code of Contact (sic) and Ombudsman.

The report's mode of analysis is schematic rather than forensic. It mentions the phenomenon of market power, but deals with it analytically rather than empirically. Even the abstract analysis is questionable. The report claims (p.122)

> One of the major determinants as to whether there is abuse of market power is whether super-normal profits can be sustained over time. The competitive nature of retail markets and the level of returns being earned in the Australian food sector … do not indicate that there is major abuse of market power to the detriment of food product suppliers.

The report has not confronted the substantial and ongoing quantum of 'discounts and rebates' extracted by Woolworths and Coles from suppliers, running at over $1 billion for the two retailers per annum. Moreover, the author has confused the retailers' net margins on turnover, traditionally low, with returns on capital employed, which is substantial.

The large retailers have a relatively low asset base, because they lease their properties and their working capital is funded by their suppliers. Financial analysts treat the two large retailers as monoliths among major listed companies. Their profits, as noted above, are understood by analysts as being derived from their market power over suppliers. The profitability of Woolworths and Coles, the sources of their profitability and their status have been misunderstood by Whitehall.

There is evidence that the Whitehall consultancy downplayed the evaluation of market power in the report due to the perceived demands of key stakeholders, not least the sponsoring federal Department. The report is a politicised and hence political document, and its nugatory treatment of market power does not merit attention.

The report referenced the 2000 ACCC report as denying large retailer market power ('this indicates the market at work with suppliers varying their deals where they achieved best performance for the terms paid'). In turn, in a major speech on big business - small business relations, Graeme Samuel referenced the Whitehall report as denying retailer market power:[10]

[10] Samuel. 'Big Business V Small Business – vigorous or vicious competition?', Australian Graduate School of Management dinner, 4 November 2004, p.6.

> The Report notes that a 'highly competitive retail sector combined with the strong presence of national and international brands has resulted in a low margin, by world standards, grocery sector' – hardly the sign of a rampant duopoly extracting monopoly profits.

We are thus witness to a peculiar phenomenon in which reports blessed with official status are interpreted as denying the existence of large retailer market power although the reports avoided an examination of the issue. The reputed absence of retailer market power has thus acquired definitive status, although the grounds of its declaration are hollow. Wishful thinking has been converted into tangible reality.

By contrast, official investigation in the UK of supplier-buyer relations has been more systematic, and there has been greater official concern with those relations as a consequence.

A massive 2000 grocery retail report highlighted a major asymmetry of power between suppliers and buyers, and supplier dissatisfaction.[11] The Commission found 'a general climate of apprehension' regarding the possibility of supplier identification, with many suppliers refusing to submit any evidence to the inquiry. The report noted:

> But subsidiaries of large multinational companies, too, argued that it was extremely difficult to attempt to leverage negotiating power in product-by-product price negotiations, and said that there was little they could do against practices of main parties such as unilaterally deducting amounts in dispute from invoices.
>
> Many suppliers commented on the purchasing power of the main parties, their ability to drive down suppliers' prices to uneconomic levels and what they saw as their general high-handedness. A consultant to the packaging industry noted that 'the degree and variety of pressure upon the suppliers was extremely alarming – all complied with the retailers' demands because of the dread of de-listing.

One supplier even complained about a demand from a major retailer for 'a contribution towards profits' that amounted to simple extortion.

Suppliers commented on the peculiarity of suppliers having to face belligerent buyer personnel, often young, inexperienced, and ego-driven, and then having to face a new set of comparable individuals because of retailer staff turnover, making it 'extremely difficult to maintain stability within the industry'.

Data generated by the report expose a close correlation between market shares and buyer power. Evidence generated in the takeover battle for Safeway, Britain's fourth largest supermarket chain, in 2003, highlighted that the correlation had become more pronounced since 2000, with Tesco and Asda acquiring greater market share and greater supplier price differentials.

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[11] Competition Commission, *Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom*, October 2000, esp. Ch.11

The Competition Commission report also concluded that buyer power and not operating cost differences was the source of lower retail prices.

> Like for like, we believe that the major buyers, and indeed many of the other main parties, are large enough to achieve most of the cost savings associated with large orders … so we conclude that operating cost differences will not have played a material part in the price differences achieved by them in our analyses.

A recent report by a UK Parliamentary ginger group reinforced the evidence in the 2000 report.[12] The report confirmed evidence of naked predatory pricing in, for example, groceries and petrol by the chains to drive out independent competitors.

Suppliers refer, for example, to discretionary cancellation of large orders at short notice. Behind such practice is the absence of 'written contracts concerned with price, level of business or specific arrangements', producing a lack of transparency and vulnerability of suppliers.

Wal-Mart-owned Asda came in for particularly trenchant criticism. Suppliers subsidise Asda's staff costs. Marketing allowances are demanded above costs, and without accountability for use. Sales promotions and brand discounting are instituted against supplier preferences, or even against the terms of an agreement.

The High Street report notes that the substantial concessions demanded by the chains of suppliers has to be compensated for in the prices charged to other wholesalers, as occurs in Australia.

The High Street report also considers the adverse environmental implications of chain retailer dominance. One in ten UK car journeys are for food shopping, generating greater carbon dioxide emissions than that by commercial transportation of food. Supermarkets, because more particular regarding fresh produce appearance, lead to greater pesticide use and food wastage. Supermarkets also make greater demands regarding packaging.

Finally, the Parliamentary report highlights a pervasive current concern in Britain – the threat of 'Clone Town Britain' and the elimination of cultural diversity.

3.4 Academic recognition of retailer extractions from suppliers

Traditionally, economists conceived of market power in terms of producing firms dictating conditions to consumers. The prohibition of resale price maintenance was gradually introduced into statutes to prevent powerful producers from undermining the discretion of wholesalers and retailers in the marketing of the producer's products. The conceptualisation of competition policy being essentially about the control of powerful producers in the interests of weaker consumers has come to dominate the culture of the Australian competition regulator.

[12] House of Commons All-Party Parliamentary Small Shops Group, *High Street Britain: 2015*, February 2006.

Between the two World Wars, the American economy, often a leader in commercial trends, experienced the rise of the giant retailers. The early manifestations of power over small retail competitors and over suppliers led to the passage of the Robinson-Patman Act in 1936 as a legal vehicle to protect small business interests.

The rise of the large retailers at least offered the prospect of a powerful force 'countervailing' the powerful force of large-scale producers. But the large retailers have now moved beyond the countervailing stage to be the dominant forces in the market.

For half a century, economic theory has neglected this transformation. Regulators have thus been deprived of expertise in understanding a supply chain centred on giant retailers against which insufficient countervailing power exists from any quarter.

Belatedly, a supportive economic analysis, generally by European academics, has been developed under the title 'retailer buyer power'. This analysis combines the categories of traditional industrial organisation studies with close empirical examination of developments in retail sector structures and practices and the underlying national legal and cultural backdrop.

There is now a productive interaction in Europe between this academic analysis and official investigations. The British academic Paul Dobson is a representative figure.[13] Dobson notes that chain retailers synthesise a number of roles into a powerful platform for the exercise of market power – roles as one of a handful of major customers, as competitors via the sale of house brands, and as suppliers who channel producers' products through essential retail space. Retailers have passed from being passive mediums between producers and ultimate consumers to being 'gatekeepers'.

The significant feature of 'retailer buyer power' analysis is that is that the chain retailer has become a legitimate object of systematic examination, that the chain retailer is a locus of economic power and not merely a beneficiary of inevitable technological transformation, and that this power can be abused and have anti-social implications. This intellectual development has made no impact in Australia, either in academic or regulatory circles.

Dobson notes the official acknowledgment of the close relationship in the UK between the market power of the chain retailers and the extent of their extractions from suppliers. His judgment of British retailing is critical:

> At the supplier level, competition may be distorted when small suppliers, in particular, are forced to cut prices to the point that it endangers their continued existence. The longer-term effect of such strong buyer power could be to threaten the viability of even the most efficient suppliers over the long term if suppliers are forced to price at marginal cost and are unable to cover their fixed costs. Accordingly, even large suppliers may be deterred from making product and process investments if buyer power prevents them making an

[13] C/f Paul Dobson, 'Exploiting Buyer Power: Lessons From the British Grocery Trade', *Antitrust Law Journal*, 2, 2005.

> adequate return to cover costs. As a consequence, product quality, variety, and innovation may suffer – all to the detriment of the consumer.

Dobson notes that both British reports point to a 'vicious circle' in which the quantum of independent retailers falls below a sustainable level to ensure viability of independent wholesalers, and the subsequent appropriation of the entire UK retail market by a handful of retail giants on their own terms.

Given that Woolworths and Coles draw their strategies from those of Wal-Mart and the British majors, the British experience provides a salutary lesson for the future of the retail sector in Australia.

3.5 The possible high cost of low prices

Lower prices to consumers come at a price. Lower prices come at the expense of suppliers. There is the presumption that this must be undeniably socially advantageous. Whether it is socially (or even economically) advantageous depends on the terms.

All affluent Western consumers now accept that it is unethical to purchase goods produced by indentured labour. There is a recognition that low prices may involve unacceptable exploitation of others. It is a small step to confront that low prices may be a product of exploitation of suppliers producing within Western economies. Why should not this latter process equally be deemed unacceptable?

From an ideal perspective, downward pressure on prices through the supply chain forces producers to adopt superior cost-saving techniques. But it may be that prices extracted from suppliers involve exploitation of suppliers on terms that are socially unacceptable. Fruit and vegetable supply, because of the blackmail by purchasers associated with product perishability, is already in this category.

Such supply terms may be sustainable in the medium term only by supply being effected by a succession of loss-making enterprises. In fruit and vegetable production, it is known that the children of the current generation of exploited producers are declining to follow their parents into the business. Food supply in Australia must then be facilitated by access to production by lower-cost countries, not necessarily a product of technically superior production facilities. Lower-cost imports may emanate from countries with lower material standards of living (and environmentally unsustainable practices) but also from first world countries with third world agricultural labour practices.

The threat to livelihoods of small business suppliers is complemented by the threat to livelihoods of the retail workforce. To date, the workforce in Australia has been relatively protected by the century-old award system. The Howard Government's December 2005 Workplace Relations Amendment (WorkChoices) Act has abolished that protection. The retailing sector will be an important testing ground for the implementation of more restrictive wages and conditions. Woolworths and Coles Myer have traditionally organised workplace relations within the conventional award structure.

Aldi, the new grocery retailing arrival, has proved to be aggressively anti-union in its overseas operations, and has been an assertive proponent of Australian Workplace Agreements. Aldi apparently pays higher wages initially upon appointment, but demands maximum flexibility on part-time contracts, with the prospects of lower rises thereafter. There appears to be no doubt that Aldi will employ the new Act to its full force, putting competing retailers under pressure to do likewise in their workplace relations.

Wal-Mart's success has been built partly on the systematic exploitation of its workforce, to the extent that the American taxpayer now underwrites the meagre living standards of Wal-Mart's employees. Wal-Mart's global reach invites other large retailers to copy the aggressive Wal-Mart approach to workforce practices.

4 Industry Case Studies

4.1 Fruit and vegetable growers

All suppliers to the major retailers face a tough environment for the negotiation of trading terms. The fruit and vegetable growers face the most difficult environment of all suppliers to retail outlets.

Fruit and vegetable produce is distinguished by its perishability. Marketing has traditionally been through central markets where informal non-contractual relationships have been the convention. There is a wholesaling layer which has institutionalised practices that exploit the structural weaknesses of the marketplace. Some growers lack sophistication in the skills that should complement their growing expertise. Moreover, the push for economy-wide deregulation has led to the dismantling of longstanding State-based regulatory structures of this sector.

The conditions are all conducive to extreme grower vulnerability, and a culture of insecurity pervades the sector – the belief that complaints will result in growers being 'sent on a holiday'. The NSW Farmers Association has claimed that: '[our members' experience] has demonstrated beyond doubt that the balance of commercial power and advantage is unfairly and unreasonably weighted against the growing community'.

A succession of Parliamentary inquiries and government reports have highlighted the unsatisfactory, even primitive, state of fruit and vegetable trading conditions – notably, the 1996 Reid small business inquiry and the 1999 Baird retail sector inquiry.[14]

The Reid Committee heard evidence of predatory pricing. A salutary instance was produced of Queensland green grocer Joseph Natoli, whose family had been in the business for seventy years. Natoli's Maroochydore business supported four families and 30 employees. The nearby Franklins' supermarket decided to enter fruit and vegetable retailing and embarked on ruthless below-cost price-cutting until the Natoli

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[14] House of Representatives Standing Committee on Industry, Science & Technology, Parliament of Australia, *Finding a balance – towards fair trading in Australia*, May 1997 ("the Reid Report"); Joint Select Committee on the Retailing Sector, *Fair market or Market Failure?*, August 1999 ("the Baird Report").

families were driven out of business. The Baird Committee heard more extensive evidence of demanding or oppressive conditions imposed on fresh food suppliers.

What practices are involved? Grower representative organisations list such as practices as:

- returning or downgrading of product on grounds of inferior quality determined at discretion of retailer
- mis-ordering of inappropriate quantity attributed to grower account
- claims against the product all attributed to grower account
- wholesalers can avoid declaring whether they are an agent or a merchant when produce is received, with ambiguity of ownership facilitating the transfer of risk to the borrower
- lack of transparency in transactions, with no documentation or information that allows comparison of sums received by wholesaler and sums conveyed to grower for a particular consignment. Prices are advised to the grower after the sale. The growers' approval is not sought beforehand. The price is given as a net figure without details of the sale price, the amount retained by the trader, or the identity of the purchaser of the produce.
- wide belief amongst growers of profiteering by wholesalers
- no minimum or default standard terms of trade
- retailer specific packaging and labeling demanded at grower expense

The Baird Committee noted that many small independents across the retail sector offered to give evidence only in confidence. The Committee was moved by this experience, in combination with the public evidence, to envisage an environment in which small and independent retailers could 'seek immediate and timely redress to unfair practices from big business, without fear of retribution …'. Thus the Committee recommended the establishment of a Retail Industry Ombudsman and a mandatory code of conduct 'to deal with the recurring problem'.

The Coalition Government agreed to the establishment of an Ombudsman scheme. The Government rejected the recommendation for a mandatory code as contrary to its philosophy of preferment for self-regulation. Under 1999 guidelines, a mandatory code would only be considered if there has been 'significant and irremediable deficiencies in any existing self-regulatory regime'.

There was no existing voluntary retail code to be tested on its experience. Yet the Baird Committee, as had the Reid Committee three years previously, exposed a longstanding structural fault line in the industry; the recommendation for a mandatory code was considered necessary for the seriousness of the prevailing conditions. A close reading of the Baird report indicates that the Committee inferred that recommendations for the strengthening of the Trade Practices Act were outside its mandate and its competence. The mandatory code recommendation was a default recommendation for the Committee but was still considered as too strong by the Government.

The Retail Code of Conduct was established in September 2000. However, the NSW Farmers' Association has noted that:

> Since its inception, the Code has failed to address farmers supply chain problems. Code participation and mediation are only voluntary, it lacks enforcement power, has poor exposure among market participants and has not changed the practices of unscrupulous operators along the supply chain.

According to the NSWFA, the Code has 'failed completely' to 'promote fair and equitable trading practices among participants in the retail grocery industry'. The Queensland Fruit & Vegetable Growers concurs, claiming that 'the balance of commercial power and advantage [continues to be] unfairly and unreasonably weighted against the growing community'.

Two important matters identified by the Government for consideration for the Code – lack of transparency in vulnerable supply markets and contractual uncertainty regarding ownership – have been ignored by the Code of Conduct Committee. The NSWFA notes: 'It's incredible to us that such important matters were not addressed.' In short, 'This was a contemptuous dismissal of [growers'] needs and concerns.'

No wholesalers from the fresh fruit and vegetable sector had signed on to the Code. Some wholesalers refuse to countenance written contracts. The militant support of the wholesalers for the unequal status quo is reflected in mid-2002 statements by Colin Gray, head of the NSW Chamber of Fruit and Vegetable Industries:

> If they don't like it [the wholesaling system], there is a simple thing they can do. Go somewhere else. … [Information on who an agent has sold produce to and for what price should not concern growers.] If the grower wants to own the product from the time he puts it in the ground until the time it ends up as sewage out the back of Bondi, let him come here and do it.

The foreshadowed three-year review of the Code, in late 2003, was performed by Neill Buck and Associates. The Buck Review was uncomplimentary.

> The Review found that the Code had had an impact on the market, but it would have had a greater impact beyond the major retailers if it had been mandatory. This would have necessitated more specific compliance standards, increased levels of compliance, a requirement for individual participant signatories, excluding growers, but involving the rest of the supply chain above the grower level and more effective promotion.
>
> The Review found a continuing stream of anecdotal evidence and allegations that sections of this industry do not trade in a fair and equitable manner. Some of these raise threshold trade practices issues, notably in the areas of misleading and deceptive conduct; unconscionability; harassment; and restrictive trade practices, such as boycotts and pricing matters

The NSWFA submission to the Buck Review provided a rare extended treatment of the distortions and entrenched ambiguity of the wholesaling system. The variance of this system from the esteemed market principles formally underlying Australia's competition framework is extraordinary.

The NSWFA has provided several cases that exemplify the gap between the functioning markets and the fruit and vegetable market.

- one farmer is both grazier and horticulturalist. He sells his cattle via an agent involving full transparency; he sells his fruit and vegetables on conditions without transparency. The farmers' joint activities provide a running and powerful indicator of the divergence of horticulture trading from the conventional norm.
- a fruit grower was told by his wholesaler that the former's produce has been sold for between $12 and $16 a case. The grower accidentally discovered that the wholesaler was selling his produced for a minimum of $18 a case.
- a vegetable producer queried his wholesaler because dissatisfied with the 'very low' prices received for his produce. As a result of the dissent, the grower received another payment for the produce, effectively doubling the price.

The NSWFA characterises the system summarily: 'The grower is simply given whatever price the trader elects to give.' The Chamber's Colin Gray has admitted to a Horticulture committee Chamber members use 'discretion' when determining what is paid to growers.

The Buck Review was not released for comment for six months. In July 2004 The Government again declined to support a mandatory Code on the peculiar grounds that 'the majority of industry stakeholders' was opposed to such. Growers would remain outnumbered on the Code Administration Committee.

Widespread hostility to this decision by the grower constituency in the context of an impending election led to the Government agreeing to a mandatory Code for Horticulture. The Horticulture Code was finalised in late 2005 and is due to be in force from July 2006. However, the large retailers have been allowed to exclude themselves from the Code, so the supply chain coverage will not be inclusive. There is a flaw embedded in the Horticulture Code from its inception.

Over the last several decades, the grocery retail chains have entered the fresh fruit and vegetable retail business and have built a commanding presence in the market. Woolworths boasts a 25% share, with Coles' estimated share at least 20%, of an annual $6 billion national turnover. Woolworths and Coles Supermarkets are increasingly sourcing their supplies through direct grower relationships, with at least 50% of their supplies sourced through this route.

The supermarket retailers have brought a greater formality to their relationship with suppliers compared to the wholesaling culture. Their purchasing power has enhanced an existing tendency to greater concentration of market share amongst both wholesalers and growers. Some suppliers and wholesalers have grown and profited from their relation with a chain. Select wholesalers have even become contracted category managers for selected produce.

But the retailers' influence is not purely benign. The retail giants are major participants in the practice of exercising discretionary power over product quality and quantum decisions. 'Quality' incorporates not merely genuine quality considerations but appearance. Produce packaging and labeling expenses are allocated to suppliers at retailers' behest. Contract cancellation apparently occurs at their discretion. A NSWFA survey of growers in mid 2003 disclosed that over 60% of respondents feared that the raising of a grower concern would invite commercial retaliation by a supermarket purchaser.

Close association with a major for the bulk of a grower's harvest is a mixed blessing. The relationship with the major may bring atypical rewards, but it may also involve heavy investment in infrastructure which brings a perilous dependence as the associated debt has greater longevity than the relationship itself. There are no formal contracts, only 'supply programs' with no stipulation of terms.

Supplier relationships now involve a new form of grower insecurity via a more assertive 'category management' that narrows product variety. For example, apple varieties appear to be currently subject to category management that displays a fickle quality. Thus red delicious apples have been designated as an undesirable variety, and an orchardist heavy with red delicious will face a serious demand fall-off with no evident links to consumer preferences.

Queensland independent wholesalers have complained that the majors have distorted the traditional market-clearing role of the central markets. They claim that the majors exploit gluts for profiteering purposes and shortages to enhance market share. These processes inhibit the ready movement of prices to offset gluts and shortages, to the detriment of both growers and independent retailers.[15]

The retailer giants may also distort the operations of the central markets themsleves. Evidence was produced at the Reid inquiry relating to a non-level playing field regarding market access to supplies and to customers. Mr Natoli highlighted the then corruption of the Brisbane Rocklea markets whereby the major chains were gaining preferential access before normal opening hours, and locking in prior supply arrangements that leave residual supply subject to even greater price volatility. Small retailers were also excluded from access to shopping centres or 'kicked out' if their offerings competed with the offerings of the anchor retailer.

There are also claims that the majors' buying practices imply a reduction in the general quality of the central markets, whose lower prices are then used as leverage for the contracted prices of the superior produce.

The retail giants thus impose a giant footprint on the fresh fruit and vegetable industry, and are its major beneficiaries. The retail giants are beneficiaries of the continuing dysfunctionality of the sector regarding grower equity and sustainability, yet have side-stepped responsibility for its overall governance and improvement.

4.2 Independent liquor stores

Woolworths and Coles Myer have become significant players in the packaged liquor business in a short period of time. Coles purchased the Liquorland group in the mid-1980s, but Woolworth's purchase of Dan Murphy in 1999 signaled the beginning of the push for market dominance. Because of liquor license restrictions in some States, the expansion of Woolworths and Coles has been fuelled mostly by 'creeping'

[15] Senator John Woodley, 'Matters of Public Interest: Food Marketing', *Senate Hansard*, 13 October 1999.

acquisitions, especially of multi-store enterprises. The packaged liquor market has been estimated at about $11 billion per annum, with Woolworths and Coles sharing about 45-50 per cent of the market.

The means to the rapid rise to market dominance by the two majors has not been uncontroversial. The most transparently questionable practices occurred in New South Wales. For an extended period, Woolworths and Coles Myer were engaged in persistent mis-use of their market power with respect to small-scale liquor retailing competitors. NSW liquor outlets are subject to licensing restrictions, and the two retailers made a practice of objecting to all applications by small liquor retailers for a new license or modification of the terms of an existing licence.

Woolworths and Coles threatened the small retailers with expensive delays in the application process, offering to desist from stalling objections if the applicants agree to continue to operate under restrictive conditions. Small retailers perennially agreed to these restrictive conditions to avoid litigation that they cannot afford. The ACCC noted that such restrictions involved restricting small operators from:

- ever opening a competing bottleshop or driveway facility for the sale of takeaway liquor
- selling takeaway liquor over the counter to hotel patrons
- advertising or conducting promotions for the sale of takeaway liquor over the counter to hotel patrons
- preventing the hotel from home delivery of takeaway liquor, eg for parties, functions or home consumption

The two retailers had even jointly retained a ‘top silk’ to develop deeds to impose on competitors, and in one instance had funded a third party to mount an objection against a small retailer who offered potential competition to an intended Woolworths outlet.

In June 2003, the ACCC initiated proceedings in the Federal Court under s 45 of the Act against Liquorland (Coles Myer) and Woolworths with regard to these restrictive practices against independent retailers – alleging 30 and 16 contraventions respectively. The investigation had begun in 2001, and the ACCC had to fight Woolworths in court to obtain documents relevant to the case. In April 2005, Coles Myer admitted culpability; the company has since been fined $4.75 million, plus costs. Woolworths continues to deny culpability, and the action against Woolworths is pending.

The large retailers’ relations with suppliers is representative of its dominance of all suppliers, although some detail is specific to the liquor trade. The common and unique features combine to place suppliers and independent retail competitors at a structural disadvantage. Even the giant wine company Southcorp was brought down partly because management accepted the ‘logic’ of the retailers’ pricing strategies.

Beer and wine suppliers sell at invoiced prices that are equal for all purchasers. The next tier is the ‘trading terms’ – discounts demanded of suppliers by the giant retailers for retailer warehousing costs, quantity purchased, favoured shelf position, range allowance (to carry non-core labels), and ullage allowance (breakages). Details are confidential, but estimates of discounts totaling 11-12 per cent are considered not unrealistic. Other undocumented 'discounts' exist – for example, supply of 15-16 bottles to the dozen. Disposal of the extra bottles is at the retailer's discretion – to be passed on to the consumer as a bonus or to be sold for profit.

There is also a potential tier of 'extended trading terms', discounts demanded for the retailers paying on conventional terms. The fourth tier is that of 'rebates', discounts expected after the sale, perhaps linked to quantity of stock sold but at the retailer's discretion. The quantum of the discounts and rebates is totaled in the retailers' periodical payment, bearing no relation to the formal invoice terms.

Independent retailers have different options with respect to their main product lines. Beer is, in principle, sourceable from the handful of brewers. However, direct wholesale prices to the independents are high, and quantity discounts are granted only as aberrations. Independents find themselves often sourcing key brands from the chains' retail outlets (where prices are cheaper than wholesale from the brewers) to be onsold in their own stores.

Because of the wide range of wines and spirits, independents find it convenient to use a wholesaler, and the dominant liquor wholesaler is Australian Liquor Marketers, a Metcash subsidiary. Many independent retailers compromise their formal independence by joining 'banner groups', in effect quasi-franchises, as a means of gaining greater concessions from collective bulk purchases. As with grocery retailing, Metcash is a third force that demands special terms from suppliers but it retains a significant percentage of acquired discounts and allowances for its own balance sheet.

Thus for common products the cost price for the two giants is less, and can be substantially so, than the cost price for independent retailers. The giants have extracted supplier concessions not merely for quantity purchases per se, but also through demands built on their market power.

The unlevel playing field can be judged by the prices of 'market leader' beers. In Victoria in March 2006, First Choice and Dan Murphy were competing to offer two cartons of Victoria Bitter stubbies at between \$60 and \$58. The wholesale price to independents (from Metcash's ALM subsidiary) was \$31.60, including GST, \$34.75. Safeway was offering two cartons of Crown Lager for \$80, whereas the wholesale price per carton was \$42.70, including GST, \$47.

In Sydney, Dan Murphy was selling 30-can blocks of Tooheys New for \$34.90; the wholesale price to independents (from ILG cooperative) for 24-can cartons is \$31.87, including GST, \$34.99. Dan Murphy was selling cartons of Cascade Light for \$24.90; the wholesale price to independents was \$24.81, including GST, \$27.29.

The large suppliers compensate for their reduced revenue from the two giants (and Metcash) by extracting higher wholesale prices charged to smaller retailers which sell to the same market as the giant retailers. Thus in liquor, an internal mid-2005 estimate at Fosters had Fosters' liquor revenue as being derived in the proportion 70% from independents and 30% from the two giants, whereas the latter's market share of package liquor sales was at the time about 45%. Large-scale suppliers thus act to provide the large-scale retailers with an additional cost differential by which the latter 'out-compete' their smaller competitors.

4.3 Petrol retailers

A key reflection of market power is the greater discretion over pricing. This dimension in the hands of large retailers has two distinct manifestations. The first is the distortion of supply prices to the retailers, with a secondary distortion to the supply prices of suppliers to other customers, especially to those competing with the large retailers.

The second is the cross-subsidisation of product lines, facilitated by the relative market power across these product lines. The 'shopper discount docket' is a perfect reflection of such cross-subsidisation. Shopper dockets for discount purchases appeared in a systematic fashion after Woolworths and then Coles Myer moved into petrol retailing. A discount of 4c. a litre for petrol purchases became institutionalised for customers of the retail giants' supermarkets, typically with the purchase of $30 of groceries.

Shopper dockets have now appeared for packaged liquor purchases leveraged off grocery purchases and for petrol purchases leveraged off liquor purchases. It has been reported (March 2006) that Liquorland (Coles Myer) in Western Australia was offering a 20c. per litre discount for a minimum packaged liquor purchase.

Current economic wisdom perceives cross-subsidisation of products within multi-product firms as undesirable, inhibiting cost-based pricing – witness the rebalancing of pricing in the multi-product banking sector. In the public sector, cross-subsidisation by public entities (especially of rural constituents) in the broader public interest has been deemed an unacceptable practice. Yet the cross-subsidisation across retail fields by the two retail giants has to date been deemed a legitimate commercial practice.

Woolworths moved into petrol retailing in 1996, dependent on access to imported petroleum. In May 2003 Coles Myer and Shell initiated a joint venture under which Coles would assume the management of Shell's service station network. Woolworths proposed a joint venture with Caltex in August 2003, brought to fruition in March 2004. Following these deals, the grocery retailers' command of petrol retail outlets comprised 584 and 450 respectively, totaling over 1000 outlets.

In October, Service Station Australia wrote to the ACCC, highlighting the dramatic rise in grocery retailer market share subsequent to Woolworth's introduction of shopper dockets into petrol retailing and Coles replication of the scheme following its deal with Shell. The SSA noted that 400,000 litres per month was the minimum turnover necessary for service station viability and that the likely sales of the two giants, given their mooted total number of outlets, would be about 790 million litres a month. The SSA estimated the total market at about 1,900 million litres per month, leaving 1,100 million litres per month for the remaining sites in the industry. Given the then current non-supermarket contingent of 7,000, over 4,000 of those were doomed to non-viability.

Notwithstanding the SSA's concerns, the ACCC authorised both the arrangements and the shopper docket schemes as pro-competitive. Following a February 2004 report into the grocery-petrol retailing structures, the ACCC 'found that the introduction of the shopper docket schemes has encouraged competition and lower prices in the fuel market. … These offers are pro-competitive because they drive competition between supermarkets and petrol retailers'.

The ACCC depended for their positive conclusion on the existence of grocery-petrol discounts in the UK and on the notion that shopper docket discounts are equivalent to a loyalty or marketing program like Fly Buys.

In the 2004 AGSM speech, Graeme Samuel claimed that these changes were driven by consumer preferences, that petrol had been chosen because 'it is the most consumer-price sensitive commodity in Australia today', and that it is not improbable that such schemes will be generalised by retailers of other consumer products.[16]

It is unfortunate that such an inadequate analysis can be delivered by the competition regulator. The reduction in petrol retail outlets is not a consequence of consumer preferences. The grocery giants moved into petrol retailing not because of its price sensitivity but because (like groceries and liquor) petrol is an indispensable component of family budget expenditure. Moreover, shopper docket schemes are self-evidently not comparable to loyalty programs.

Melbourne University academics Joshua Gans and Stephen King have produced a more jaundiced analysis of shopper dockets.[17] Gans & King note that in the UK groceries and petrol are jointly marketed in 'hypermarkets', and are not comparable to the joint ventures in Australia. The authors note:

> The bundling of essentially unrelated products in oligopolistic markets creates cause for concern. … both the retail grocery sector and petrol industry in Australia are relatively highly concentrated by international standards. … as this practice spread such bundling may result in a considerable loss of consumer welfare and a long-term erosion of competitive pressures in the relevant industries. …
>
> [Quoting] 'Profit margins on petrol tend to be less than 4p a litre and, unlike supermarkets, petrol retailers are not able to fund losses through other activities'. …
>
> Finally, the petrol companies that are left without supermarket partners may exit the industry in the longer term, leading to lower petrol competition and higher prices for all consumers. The bundling schemes may also lead to long term problems in the grocery industry. In addition to harming existing grocery retailers, the schemes make it harder for new entry to occur in the future.

[16] Samuel. 'Big Business V Small Business – vigorous or vicious competition?', Australian Graduate School of Management dinner, 4 November 2004, p.6.
[17] Gans & King, 'Supermarkets and Shopper Dockets: the Australian Experience', *Australian Economic Review*, September 2004, 311-316.

The co-author of this article, Stephen King, took up an appointment with the ACCC as Commissioner in June 2004. Mr Samuel's speech in November indicates that the Chairman had not absorbed the considered wisdom of his new Commissioner with respect to the merits of the shopper docket schemes.

5 Impact on rural and regional areas

Woolworths and Coles Supermarkets stores have been located predominantly in urban precincts. Urban saturation, coupled with the two giants' ambitious expansion strategies, has fuelled the intense pursuit of regional and rural sites and hitherto unattractive urban sites.

Woolworths has increased its supermarket store numbers by 15 in financial year 2005, and 120 in the last four years, bringing it total to 723 by June 2005. Coles increased its supermarket store numbers (including Bi-Lo) by 25 in financial year 2005, bringing its total to 'in excess of' 714. By June 2005, Aldi had opened 93 stores from its arrival in Australia three years previously, and was planning to have 200 stores within another three years.

Graeme Watson, a former Woolworths executive and now property consultant, noted in mid-2002:

> The supermarket chains are approaching saturation coverage; there are limited new opportunities and they must secure locations. … The scramble is on to achieve irreplaceable positions in prime locations.

Regional and rural sites of the retail chains have the potential for more extended impacts on local communities. Local independent stores source more supplies from local sources and retain more retail revenue locally. The proprietors of independent stores are more active, in commitment of both time and financial contributions, in community activities.

Instances of centralised sourcing by the retail giants comes from recent examples in Western Australia. For a decade, Foodland through its Action stores had been providing retail outlets for high quality lamb products under the 'Q Lamb' label produced by an alliance of local farmers. The Woolworths' takeover of the Action stores has jeopardised this extraordinarily successful local supply relationship. In 2005, Coles diverted its Western Australian meat supplies from a local supplier to a Queensland supplier. Apart from the loss to Western Australian agriculture, the seeming irrationality of the transport cost dimension of this diversion does not register on Coles' balance sheet because the Queensland supplier pays the freight, subsumed within the 'landed store price' to the supplier.

Independents also face the possibility of threats to viability through predatory pricing by the chains. The Baird Inquiry exposed instances of predatory pricing by the chains in regional centres and towns for which no redress has been available.

The pull of a large supermarket in regional centres can lead to the comprehensive purchasing of provisions in that centre, the loss of a critical retail mass in smaller towns and a resulting vicious circle whereby the town's commercial life and employment prospects is hollowed out. It is also important to acknowledge that some communities prefer small-scale commercial developments as a principle.

The expansion of the chains in new sites has not been without controversy. A significant instance of conflict is in train in Maleny, in the hinterland of Queensland's Sunshine Coast.

In 2002 Woolworths settled on a site, in conjunction with a Brisbane developer, in Maleny's main street, adjacent to the Obi Obi Creek. Woolworths had previously attempted to purchase the IGA, the town's only grocery store but much-loved, but the principals declined the offer. The foreshadowed development met with immediate opposition, with escalating conflict (including civil dissent) to date. It is estimated that 5,500 of the town's 7,000 population are opposed to Woolworth's presence. In 2004, Woolworths made noises about withdrawing, but apparently sought $8 million in compensation from the Caloundra City Council.

Maleny has a unique character, with a history of co-operatives and no representation of chain or franchised retailers. Dissent was also generated by the fact that a substantial platypus colony was threatened by the development. The project has now been completed (the platypus colony was duly destroyed in the aggressive land clearing) and it opened in early April 2006.

There has been a similar lack of sensitivity shown to community concerns with other prospective new site developments – the Woolworth's proposal for the Ropeworks site in Geelong West, regional Victoria, and a Coles-centred development in Sydney's suburban Oatley.

The Kinnears Ropeworks factory was closed down in 1999. In 2002, a developer proposed a 'three big box' development centred on a Coles Bi-Lo supermarket. The Ropeworks Action Group was formed to oppose the development, and the Geelong Council rejected the proposal in 2003, preferring a development emphasising a combination of open space, residential and strip shopping.

In late 2003 Woolworths purchased the site and soon publicised its intention to build a full line supermarket and accompanying car park, in spite of Council's previous rejection of a 'big box' proposal for the site. At the same time, State government funding was obtained and an independent consultant developed 'Urban Design Framework' guidelines for the precinct which were subsequently endorsed by the Council. The Woolworths' proposal contravenes the guidelines. Moreover, the site is still zoned industrial and would have to be re-zoned for commercial usage.

Of those locals who do support the Woolworths' proposal, many do so because their priority is for the derelict site to be developed as a matter of urgency. The site had deteriorated partly because the heritage factory building had been demolished in a dubious manner when the first development proposal was in train.

Woolworths has taken the position that the proposal (centred on a 3,800 square metre supermarket) is non-negotiable. The company has made modifications to the original proposal in response to community opposition, but the modifications are marginal and the proposal remains essentially intact.

The commercial proposition is itself questionable. A Council report estimated that the developed site would have to cannibalise existing retailers with the need to attract 30-35 per cent of trade from an area whose expenditure is only growing marginally. Woolworths currently occupies a smaller site not far away but has decided to sell pending occupancy rights to its competitor Coles Myer under the presumption that the Ropeworks development will go ahead. Over two years have elapsed since Woolworths purchased the site, and the proposal remains at an impasse.

The Maleny and Geelong experiences highlight Woolworth's lack of sensitivity to community concerns. Woolworths has contracted a substantial private security presence at its Maleny store, and even enjoys police security, courtesy of the Queensland taxpayer. Woolworths appears prepared to tolerate losses in Maleny indefinitely, and even the cannibalisation of its own stores in the region. Woolworths purchased the Geelong West site in spite of the Council having rejected a Coles-centred supermarket development on the site. The company has employed a public relations consultant whose involvement with the local press indicates an attempt to discredit the community opposition.

Even the social responsibility ratings agency Repu Tex has claimed that Woolworths 'risks dragging its corporate reputation through the mud at shareholder expense by setting up a supermarket against community wishes'. The prospects of a successful local boycott against the Maleny store would damage Woolworth's reputation and its ambitious expansion plans even further.

Oatley houses a peninsular community on Sydney's Georges River that values its relative isolation and with demonstrated success in forcing the removal of a mobile phone tower installed in a local park near a school without consultation.

Coles joined with a local developer who saw an opportunity in an area zoned 'general business' decades ago that had never succeeded as a commercial location. Most of the community is opposed to the development, and the proposal was rejected unanimously by the Hurstville Council in December 2004.

The developer had the Council decision overturned by a Commissioner of the Land and Environment Court in May 2005 on a technicality. The Hurstville Council's Local Environmental Plan endorses 'neighbourhood' structures with no commercial space greater than 400 square metres. However, the LEP document failed to include the full details of Council intentions, due to incompetent drafting by Council staff and staff indifference to its correction when highlighted by the project's opponents. The Council has had an amended LEP belatedly approved by the State Planning Minister, and is appealing the single Commissioner's decision, but the prospects of the appeal succeeding are slim. In the meantime, the developer is proceeding with the project.

The Oatley development possesses some key dysfunctional ingredients. The site is unsuited to the scale of the development, centred on a 1500 square metre supermarket, shops and offices, and 12 two-storey town houses. A massive excavation of solid sandstone has been necessary to accommodate two subterranean car-parking levels. Residents opposite the main entrance will lose their street parking amenities to facilitate truck access to the supermarket.

A secretive Coles survey of local residents indicated hostility to the development. Moreover, the general retail catchment area is already over-supplied with supermarket outlets. In spite of these adverse conditions, Coles is persisting with the development, and faces local community hostility and potential boycott, and the necessity to cannibalise existing supermarket outlets, including its own stores.

This aggressive stance of the retail duopoly in new site rollouts cannot be seen independently from a comparable longstanding culture within the property development and building sectors, for whom the retail giants are significant and profitable customers. The property development sector has recently confronted the necessity for acknowledgment of community dissent and the desirability of consultation.

There is a self-interest in this realisation in that consultation may reduced costly delays. But there remains a reluctance in the sector to accept the legitimacy of community interests. Greg Paramor, chief executive of James Fielding, the funds management arm of Mirvac building group, was quoted in October 2004 as claiming 'You get people spoiling for no particular reason except they have time on their hands and they want to take up a cause. They don't stop to think about of the benefit of the thing that's being proposed.'

It appears that the retailers' ambition is for blanket coverage of territory, even if irrational in terms of the local market, not least to preclude the entry of major rivals. Yet these conflicts in specific locations provide striking evidence that the dynamic of relentless expansion of the retail giants, underpinned and encouraged by the imperatives of the stock market and the property sector, has reached its natural limits.