NARGA

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Retail Inquiry
Productivity Commission
GPO Box 1428
Canberra City ACT 2601

By email to: retail@pc.gov.au

Dear Sir/Madam

Submission: Economic Structure and Performance of the Australian Retail Industry

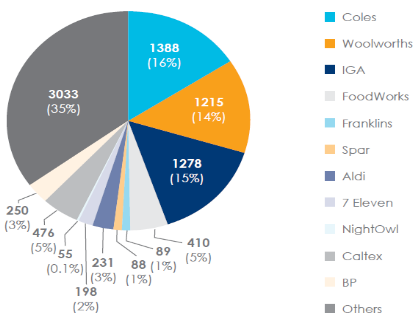
NARGA represents the independent retail grocery sector comprising over 5000 stores employing more than 225,000 people.

The independent grocery sector now comprises less than 20% of the national grocery market, yet provides essential supplies to thousands of regional and remote communities, particularly those considered too small to be of interest to the major supermarket chains, as well as providing competitive pressure to those chains through larger stores in metropolitan and regional centres.

In addition to the 5000 independent supermarkets represented by NARGA there are around 3300 convenience stores, a significant proportion of which are associated with petrol outlets.

The store number breakdown is given by the following pie chart taken from a report on the grocery food chain prepared by Accenture Australia[1] (the Accenture report – copy appended).

Fig 31. Grocery Retail Number of Stores (2009)

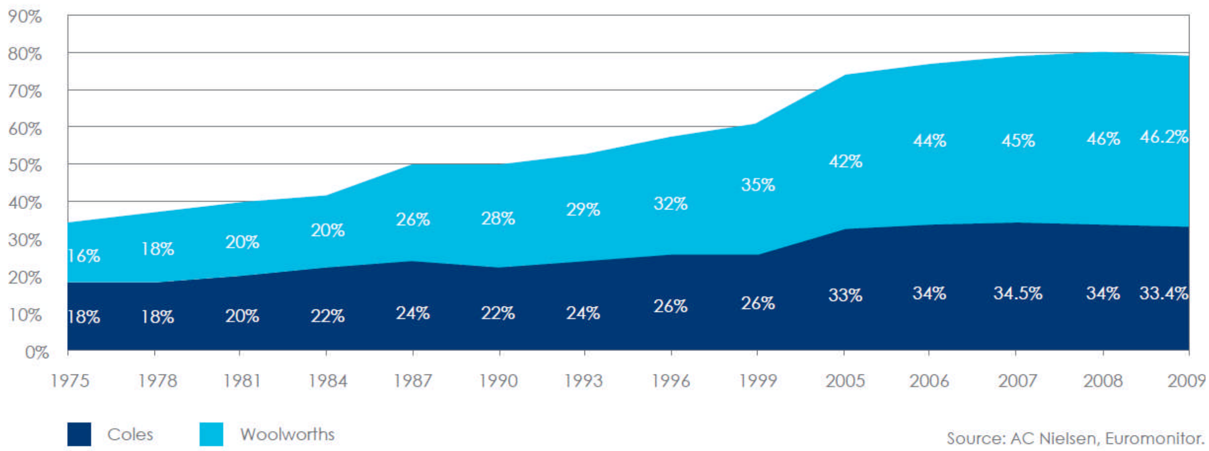


Source: Euromonitor, Retailing in Australia 2009. Companises annual

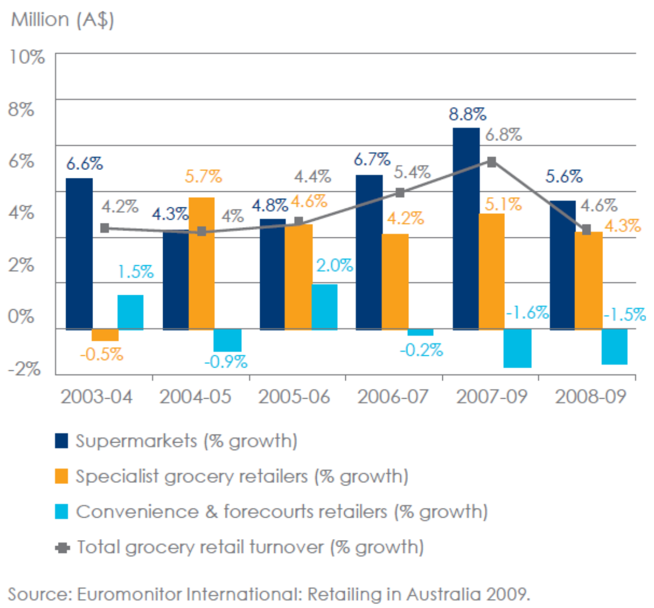
[1] The challenge to feed a growing nation, Accenture Australia, November 2010

The same report shows that the retail grocery market is dominated by the major chains which between them have close to 80% of the market, a share that has been growing steadily since the mid 1970s as shown by the graph below:[2]

Fig 30. Growth in Market Share of Woolworths & Coles (1975-2009)



The Accenture report also tracked growth by retail channel, comparing growth in supermarket turnover to growth in specialty stores and convenience stores. As shown in the chart below, whilst the first two categories of stores show good growth, convenience store turnover has declined in the last three years and in the prior three years has shown significantly lower below growth rates than have the other two categories of stores, growth rates well below industry trends.



This decline in turnover is due to the drift of business away from convenience stores to larger stores and the resultant closure of small independent stores.

[2] Ibid p.

The picture in the retail grocery sector is one of continuing consolidation and high market concentration as measured by turnover.

Other sectors of the retail industry also exhibit increasing levels of concentration – liquor, fuel, hardware, electronics – involving the businesses that also own the major retail grocery chains with the result that it is estimated that some 43 cents in every retail dollar goes through the cash registers of Woolworths and Wesfarmers related companies.

The Accenture report attached has highlighted the impact of retail grocery concentration on the food supply chain where in the fresh food sector vertical integration with owned and/or contracted producers has affected the ability of the farm sector to supply the variety and quality of inputs to the market, resulted in a decline of local food processing and an increase in food imports.

The concentration in the sector has resulted in concentration further up the supply chain and the removal of smaller and perhaps the more innovative producers and processors.

The degree of concentration in the processing sector is demonstrated in the current debate over grocery prices, but is evident throughout the supply chain. It has resulted generally in higher prices to consumers.

Whilst the major retailers suggest that their current approach to milk pricing is saving consumers money, the concentration of milk sales into low priced generic brands has led processors to increase the prices of other dairy products such as yoghurt and ice cream, where prices are now much higher than in equivalent international markets.

High concentration in the carbonated beverage sector, where one company has an 80% market share, has resulted in higher prices for Australian consumers.

These companies – and other larger players in the broader retail market – act as gatekeepers to the range and quality of the products available to the Australian public and dictate the prices paid.

Concentration in the supply of retail space and the policy of some shopping centre owners of giving preference to 'chain' merchants (often franchised), further affects price and limits choice.

It is not surprising, therefore, that consumers seek the alternative sources of supply available on the internet. The benefit of internet shopping from overseas sources is access to a wider variety and quality range of goods, often at lower prices. We believe that both range (variety and quality) and price are important in the choice consumers make in going to the internet.

The Commission's issues paper confirms the relatively high profitability of the larger retailers (p.7) and the difficulties faced by smaller retailers where, according to the issues paper '47.3 per cent made a loss in 2007 – 08'.

We would suggest that, in the retail grocery sector at least, current levels of return do not fully reflect the margins made by the major chains, as each have a significant proportion of poorly performing stores that are carried by the remainder and pull down the overall result. This reality is demonstrated by the recent decision by Coles to off load some 45 stores to Foodworks. Store numbers are maintained for a variety of reasons, including competitive reach and volume purchase benefits. However, the luxury of hanging on to underperforming operations is not open to independent store owners.

One of the issues identified by the Commission as contributing to higher prices in Australia is higher occupancy costs. The Commission's paper confirms that 'compared to their overseas counterparts, many retailers in Australia pay higher rental and occupancy costs as a percentage of their turnover.'(p.30) We suggest that this too is related to market concentration and market power where larger stores seen as 'anchor tenants' pay substantially lower rents than do smaller stores, or where the centre is actually owned by a major retailer, the rental from smaller retailers are used to subsidise the major store's occupancy costs.

Higher rents paid in shopping centres of course have a flow on effect to rents paid outside those centres.

The current situation results generally in higher prices across the board where smaller stores can only survive in a high priced market and larger stores have the market power to charge higher prices knowing that they are, in general, safe from any competitive challenge – except from the internet.

The issues paper calls for comment on competition issues, including market structure and conduct. NARGA has consistently raised market concentration as an issue, only to be told by the ACCC in its grocery price investigation[3] that in spite of the market having an HHI much higher than would be considered highly concentrated in the ACCC's own merger guidelines document, the market was 'workably competitive'.

A significant consideration here is the choice of models used to define a competitive market – whether the traditional approach in competition theory is used – one involving many players competing with each other and thereby reducing prices and promoting innovation – or the model based on the concept of contestability.

It is evident that the latter is in vogue, in spite of the fact that the key determinant of a contestable market – one of costless entry and exit – is notably absent.

In fact, competition theory literature suggests that if a market were to be truly contestable that the contestability theory based model would, in the limit, be equivalent to the traditional model used to define a competitive market.

It is our view that the approach to competition policy and practice in Australia, particularly in relation to the question of market concentration, has resulted in markets that are less than optimally competitive and now find themselves challenged by internet based overseas merchants.

The Commission's issues paper makes mention of the conclusion reached by the ACCC in relation to creeping acquisitions. (p.32) Whilst the paper correctly quotes the ACCC conclusion we believe that the conclusion reached by the ACCC disguised the reality that nearly 40% of sites acquired over the last 15 years were from competitors according to the ACCC's own figures[4] *after leaving out of those figures the acquisition of the Franklins and Action chains.*

The issues paper also reports the ACCC as concluding that they were not presented with examples of predatory pricing by the major chains but at the same time suggested that an example brought to their notice by NARGA – Woolworths Cootamundra – was not a case of predatory pricing because, although goods were sold below cost it was only for a limited period and was 'for the

[3] Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries, Commonwealth of Australia, July 2008
[4] Ibid p.428

purpose of vigorously competing with a refurbished store reopening...(and) ...not directed at or could have resulted in eliminating or substantially damaging, the newly refurbished competitor.'[5]

Other examples mentioned in the ACCC report are similarly dismissed.

We should note here that the hurdle to proving predatory pricing behaviour is very high. A complainant has to show that the prices offered by the competitor with a substantial share of the market were below relevant cost (when they do not know the competitors cost), for a sustained period for the purpose of damaging competition (needs 'smoking gun' evidence).

The major difficulty in the retail grocery market – and perhaps in other markets as well – is that the major chains can sell below a smaller competitor's cost without themselves selling below cost. This is because of their buyer power. This means that these companies can compete with smaller stores on price without making a loss. It also means that in many cases where predatory pricing is suspected, the low purchase price available to the major chain means that a breach of the Act has not occurred.

This means that smaller stores can come under intense competitive pressure without the competitor having been in breach of the Act.

This problem is addressed in all other OECD markets by including in their competition law a prohibition against anti-competitive price discrimination or, in the case of New Zealand, including a presumption of intent.

Australian competition law had such a clause (the then S.49) in the Trade Practices Act 1974 until it was removed on the recommendation of the Hilmer Committee in 1995. However, during the period that section (S.49) of the Act was in place, neither the ACCC nor its predecessor the Trade Practices Commission, had taken a case on price discrimination to court. The only case to be taken to court was a private case which was successful.

Note here that the Hilmer Committee report did not suggest that anti-competitive price discrimination was acceptable, but that it could be addressed using other sections of the Act, namely sections 45 and 46. However since that time no action has been taken on anti-competitive price discrimination and, judging by the behaviour of many suppliers to the retail sector, the current view appears to be that such behaviour is now legal.

It surprises us therefore that according to the Commission's issues paper on page 32 that the ACCC 'assessed that existing provisions were sufficient to address instances where price discrimination is used in an anti-competitive manner' as, to our knowledge, the ACCC has not ever taken a single case to court using either S.49 when it was in place or S.45 or s.46 following its demise.

Further, we cannot understand the logic behind removing the then S.49 from the Act as that section made it clear that the view of the parliament was that anti-competitive price discrimination was illegal – as every other OECD country has confirmed. The reliance on other parts of the Act has de-emphasised the significance of this damaging behaviour to the extent where now even the regulator chooses to ignore it.

A parallel example would be the removal of a specific prohibition in the traffic code on the basis that it can all be covered under a prohibition against dangerous driving!

[5] Ibid p.432

In summary, we suggest that the problems experienced by the industry in relation to lower priced goods coming in from internet based suppliers overseas is in part due to poor competition in local markets resulting from high levels of market concentration in many retail sectors, and the reduced ability of smaller retailers or entrants to compete because of a key deficiency in our competition law – the absence of a prohibition of anti-competitive price discrimination. Smaller retailers are simply are not in a position to put downward pressure on local prices and/or offer the degree of innovation needed to maintain market dynamism. For a market to be competitive we need competitors that can compete in a level playing field.

Please contact me should you require any further information.

Yours faithfully,

Ken Henrick
Chief Executive Officer