The supermarket revolution and its causes

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IMPLICATIONS FOR FOOD POLICY

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Abstract

This paper focuses on the application of competition law and policy to supermarkets, and more generally on the steps from food production on farms until its arrival on the plate of the consumer. Issues discussed include mergers, abuse of dominance, anticompetitive arrangements, unconscionable conduct, big business, small business relationships, and supermarket codes. The main focus is on Australia but with some reference to international experience.

Australia provides an interesting case study of the grocery retail industry. Over the last few decades, the industry has become highly concentrated as a result of a relaxed regulatory approach to mergers and company-specific factors such as bungled expansion strategies. Public concern and a general sense of unease about this high level of concentration has led to a number of regulatory and policy decisions being taken in recent years.

In the early 1980s there were four major retailers: Coles, Myer, Woolworths and Safeway. At that time, the independent sector accounted for more than 50% of the share of grocery sales. Controversially, a proposal to merge Coles and Myer was approved by the competition regulator in 1985. In the same year Woolworths and Safeway merged, leaving just two major players competing with a third substantial retailer, Franklins. A considerable independent sector, which consisted mainly of small stores supplied by a range of wholesalers, completed the picture.

Two subsequent developments led to a high degree of concentration. Firstly, consumers changed their behaviour over time by choosing the larger supermarkets, which were largely run by Coles and Woolworths, over the smaller outlets. In the 1990s the Australian Competition Tribunal (probably correctly) decided not to oppose a wave of mergers amongst wholesalers. Secondly, a watershed occurred in 2001 when Franklins pulled out of the Australian market. No new entrant appeared to take its market share.

Today, Coles and Woolworths account for approximately 80% of the dry grocery market and the wholesaler Metcash supplies most of the remainder. Together, they account for around 87% of all large supermarkets; that is, those that occupy an area of at least 2000 sq. metres (ACCC 2008 p.xv). There has been entry on a small but growing scale by ALDI, which has about 5% of the market after opening its first store in Australia in 2001. Another dynamic is the poor management of Coles over a number of years, although this seems to have changed recently with a new chief executive and ambitious plans to recoup market share with aggressive discounting campaigns. Woolworths, on the other hand, has steadily increased its market share and simultaneously increased its margins.

Market dominance aside, modern retail provides many undisputed benefits: an efficient supply chain, impressive choice, buyer power for consumers and supermarkets, the convenience of one-stop shopping, flexible opening hours, and most importantly for consumers, lower prices on a wider range of products.

The risk is, however, that market share accumulates until a tipping point is reached. With firm grasps on the market, the big supermarkets may start easing off on the discounts and reaping increased margins. Or, they can grow their margins by cutting out the middlemen (the wholesalers) and selling generic brands for lower prices than branded goods. There is then the risk that the price of generic brands will increase once the supermarkets have cast aside branded goods and consumers are left with very little choice or ability to buy elsewhere.

With Coles kicking off a fierce discounting war in January this year, it appears that Australia is in the latter stage of market maturity. Coles and Woolworths are growing their dominance and margins by increasingly by-passing wholesalers and processors and buying direct from farmers. We have seen as much with the milk war, which poses a difficult challenge for policy-makers given that producers are inevitably forced to accept lower farm gate prices as a result.

On the other hand, common sense dictates that competition is at work if the supermarkets are jostling with the other mouths on the supply chain. This is healthy and good for consumers.

It is a difficult balancing act that is not unique. While the details vary from one country and market to another, it is clear that in every country there is a level of concern about supermarkets' buying and selling power. The following questions arise: have supermarkets been allowed to grow without sufficient oversight and foresight by regulators and governments? Has the right competition approach been taken? Have laws, regulations and policy responses been effective?

This paper begins with a discussion of the development of modern supermarkets in India and China, which is followed by an examination of the Australian experience to date. Some cases that illustrate the ugly side of highly concentrated, organised retail are then discussed. This paper concludes with some comments on the future, particularly the challenges that will be faced by developing countries if effective competition policy is not adopted now.

India

Modern supermarket retailing was virtually non-existent in India just a decade ago. Since 2002–03, however, modern retail has grown strongly in India. The average yearly growth between 2003–03 and 2009–10 was 49%, five-times faster than GDP (Reardon & Minten 2011). Unlike other developing economies where foreign direct investment has been welcomed and encouraged, foreign investment has, to a large extent, been blocked. This has meant much of the growth is in domestic companies.

Despite much growth, modern retail's presence across the country remains uneven. While middle class suburbs of the major cities are home to some large supermarkets, politics has restrained growth to some extent because some parties view supermarkets as elements of capitalism to be opposed and there are strong concerns about the impact on farmers and the poor.

There are three unique realities that are shaping and to some extent curtailing the growth of modern retail in India. The first relates to culture. Little shelf space is provided to fruit and vegetables because of the preference by locals to buy fresh groceries from traditional small retailers.

The second relates to government restrictions on foreign investment, which have historically been high, preventing the widespread entry of foreign retail to date. For example, India currently allows up to 51% foreign direct investments in single-brand retail, 100% foreign direct investment in 'cash and carry' wholesale trade, and no foreign investment in multi-brand retail. However, it appears as though the ban on multi-brand retail is about to be removed.

In July 2011, the Committee of Secretaries, an expert panel advising the government, approved a proposal to allow 51% foreign direct investment in multi-brand retail, bringing the policy in line with its single-brand retail policy. The changes require cabinet approval, which could take the next few months given how politically charged this issue is, but the proposal reportedly has the backing of the Reserve Bank of India.

Whilst these changes will undoubtedly see the incursion of foreign retail, if they are passed, there will not be a free-for-all for foreign retailers given that the Committee has recommended the following conditions:

- investment must be at least US$100 million (effectively limiting the application of this law to large retailers);
- 50% of the investment must be channelled into building back-end infrastructure such as warehouses, cold storage facilities and more efficient supply chains; and
- 30% of supplies to the new retail business must be sourced from the micro, small and medium-size enterprises sector in India.

India's third characteristic is the composition of the retail sector. There are four key players:

1. the traditional informal sector, including wet-market traders, pushcarts and kirana ('Mum and Pop') stores;
2. cooperatives — shops are often located within rent-free or subsidised land;
3. Government-subsidised public distribution system — food procurement is organised by the government-controlled Food Corporation of India and the Public Distribution System, whose remit is to assure access to basic staples such as rice, wheat, sugar and kerosene. These staples are sold through Fair Price Shops and locals pay using a system of household consumer cards; and
4. modern retail.

The benefits of modern retail

For India, some of the well-documented benefits of modern retail may be slow coming because of the government's restrictions on foreign investment to date. The need for investment in the supply chain is great, with approximately 20–40% of perishable produce wasted due to multiple intermediaries, wastage during transportation and storage, high cycle times and an absence of cold storage systems (PWC 2006). However, domestic companies, which have been largely responsible for the rapid growth of modern retail in India, are slower to deliver these benefits.

While prices are lower at these modern retail outlets compared with their traditional retail counterparts, quality seems to be weak by comparison. There is some suggestion that domestic players have been slower to bring the improvements in supply chain that foreign retailers bring. At the wholesale level, where foreign investment is allowed, some of these benefits have been felt. For example, German chain store METRO and its three distribution centres in Bangalore and Hyderabad have launched a supplier relationship management portal to modernise supply chains and it has partnered with the government of Karnataka to improve the infrastructure for fisheries in the state by building and planning auction houses. It has invested over US$43 million in infrastructure to build humidity- and moisture-control facilities.

The concerns and potential costs

A key justification for foreign investment controls in India is a concern for the welfare of farmers. The fear is that farmers will be excluded from the supply chain as big retailers demand quality and safety standards that farmers do not have the resources to meet. There may also be socio-economic costs as the supply chain consolidates and intermediaries are removed, and further down the track there are the concerns that developed economies are grappling with at the moment, being the way in which farmers are forced to individually contract with supermarkets to secure long-term custom.

To some extent these fears are overblown. There are reasons that the rapid consolidation that has occurred in other countries will not occur as quickly in India, and the lack of distribution infrastructure and the high cost of importing force retailers to rely upon local farmers for their produce. German METRO, for example, claims that it sources 95% of its produce from Indian farmers, which has led to a willingness to invest in training to encourage farmers to clean, sort, grade and pack agricultural produce in line with international standards. However, the concerns posed by supermarkets cutting out the middlemen, being wholesalers and co-operatives, by contracting with farmers direct, will need to be carefully watched. It may be that social policies are more appropriate responses, given that certain benefits to consumers do flow when inefficiencies and middlemen are cut from the supply chains.

China

Regulation in the retail sector

In December 2004, in line with its commitment to the World Trade Organization, China opened its retail sector by removing all restrictions on foreign direct investment. While foreign investment in the retail sector has surged since then, this was from a low base and it has not transformed the supermarket sector so far. Nor is there an overwhelming presence of foreign companies. In fact, in June 2011, just 5% of all Chinese retail enterprises were foreign owned (Thomas White 2011).

Notwithstanding the rampant growth in modern supermarkets, no chain — foreign or local — has grown into a position of dominance. The biggest supermarket chain, state-owned Shanghai Bailian Group, has only 11% of the market. Walmart, the chain that many thought would dominate China, has 338 stores in 124 Chinese cities, with 90,000 employees and annual sales of about $7 billion. To put that in context, it is less than 3% of its sales in the United States.

While modern retail is forcing improvements in the supply chain, some of these benefits are taking longer to transpire than expected. With 80% of China's rural population working on small plots, there are few big farms so efficiencies and economies of scale have not yet come to pass. The movement of perishable goods is still a challenge because of the paucity of refrigerated trucks and distribution facilities. Most supermarkets deal with this by sourcing and distributing at a local level. Carrefour, for example, operates its stores as self-contained units that are responsible for their own purchases, which provides some added benefits such as close relationships with local suppliers and an understanding of local tastes.

Increased protectionism?

In the last few years, foreign retailers have expressed increased concern about protectionism. The central government has been open about its plans to assist domestic players, with policies published that seek to ensure that indigenous national champions emerge as the dominant forces in retail (McGregor 2010). There are also special bank loans available for domestic retailers who need funds to enable them to grow quickly.

This is not the extent of protectionism, however. In November 2010, the US–China Business Council published its annual member survey and found that concerns about disguised protectionism were growing, with about 40% of respondents indicating that they had seen protectionism manifest in standards setting, market access barriers, procurement, administrative licensing and government pressure on domestic companies to buy from each other. Uneven enforcement of laws was also noted, with 39% surveyed reporting that they had seen laws applied against foreign companies but not domestic companies.

The Chinese Government has passed discretionary laws and policies, which leave room for different standards to apply to domestic companies. There is also more room for local power plays and politics to dictate the properties and approvals granted to foreign retailers, with the central government recently placing the planning approval process in the hands of provincial governments. In Shanghai, for example, where the state-controlled Bailian Group dominates, all developers of hypermarkets must have their applications heard in public, with the local authorities able to decide whether or not adverse impacts on local communities would result from the opening of a foreign-owned hypermarket. It seems that there are clear conflicts of interest at local levels, with one retailer recently commenting in *The Economist* that: 'The prime space always goes to local players' (Schumpeter 2011).

Policy responses to the supermarket revolution in Australia

In Australia, given this country's experience of retail dominance in terms of market share and buyer power, several Parliamentary inquiries and regulatory reviews have set out to consider a range of policy responses and approaches. Whilst they are reactive rather than proactive developments, they are worth considering because they highlight the importance of anticipatory policies that prevent situations of market dominance and buyer power from emerging in the first place.

i) Merger law and divestiture

The merger law was reviewed and tightened in 1993. While the previous test had prohibited mergers that gave rise to dominance or increased dominance, this was replaced by a test that prohibited mergers that substantially lessened competition. Driving this reform was the experience of retail dominance described in the introductory section of this paper, the hope being that mergers would be prevented if the overall effect was a substantial lessening of competition, despite more than one major firm remaining in the market after the merger had taken place.

Since then a number of other options have been considered but not adopted. The most important was a proposal to introduce a 'creeping acquisition' test. This planned to address the problem of retail outlets gradually growing, store by store, to a position of dominance with negative consequences for competition.

A strong push by the National Association of Retail Grocers of Australia to set a ceiling or cap on the market share of the two major retailers was also rejected by a Parliamentary inquiry in 1999. The proposal to set the cap at any number (80% was proposed) created many practical problems. It seemed to prevent major retailers setting up businesses in new areas, even where they brought substantial benefits, and it would have forced them to sell established businesses elsewhere. Many small businesses were concerned that they would lose their opportunity to sell to major potential buyers of their business.

Another option was to adopt a divestiture power, which would enable courts to break up established businesses. This could be done in two ways. First, bestow a general divestiture power on the courts so that whenever the courts believed that concentration was too high, the dominant firm could be broken up. Second, bestow a specific divestiture power on the courts so that when abuse of dominance occurs, the firm at fault could be broken up. Neither of these approaches has been adopted. There are constitutional complications with the first approach because compensation may be payable. With regard to the second approach, the *Competition and Consumer Act 2010* (CCA) may not provide the legislative power to divest. In any case, divestiture should only be implemented as a policy if it achieves policy objectives.

(ii) Abuse of dominance — section 46 of the CCA

Another major policy option is to accept retail concentration but to regulate behaviour, in particular, by focusing on whether or not an abuse of market power has occurred. Over the years the law has been slightly tightened. In 1986 the *Trade Practices Act 1974* (Cth) (TPA) was changed to enable the law to be applied to an abuse of market power rather than simply an abuse of dominance. As with the change in the merger law, the aim was to catch oligopoly misuse of market power, rather than just single-firm abuse of market power.

While the Australian Competition and Consumer Commission (ACCC) has been successful in some prosecutions, it has not succeeded in others. A noteworthy failure by the ACCC in 2003 was against Boral in the High Court of Australia (HCA 2003). However, the ACCC has recently succeeded against Cabcharge, imposing record fines for predatory pricing and abuse of market power. The Federal Court Judge that approved the $15 million settlement noted that the deterrent effect was significant.

Section 46 of the TPA, now section 46 of the Competition and Consumer Act, is a complex provision that has been amended several times since 2007 to increase penalties and improve the ACCC's chances of success in bringing prosecutions under it. The court now has a list of factors that may be considered when determining whether a company has abused its market power, and the ACCC no longer has to prove that the company expected to be able to recoup its losses in later trading. The Cabcharge result may provide evidence that these amendments are having the desired effect.

Interestingly, the case was settled by the parties before it was heard in the Federal Court. The ACCC was seemingly well prepared, with 52 witnesses and important interlocutory arguments lost by Cabcharge (FCA 2010). Cabcharge ultimately agreed to the recommended penalties of $14 million plus $1 million for the ACCC's legal costs. This included a $3 million penalty for predatory pricing, 'the largest predatory pricing penalty in Australia' (Finkelstein 2010) and $9 million in fines for refusing to deal with a Western Australian based competitor. The recommendations were adopted by the Court.

(iii) Price policy

Another possible response to retail dominance is to impose maximum price controls. In the 1970s price controls were imposed on major retailers; however, even then the operation was extremely complex and seemingly ineffectual. Given how complex the supermarket sector is these days, no one talks of price or margin control in Australia. However, the Labor Government directed the ACCC to hold a public inquiry into grocery prices in 2007–08. This was seen as a response to concern about farmers being squeezed by big supermarkets (directly or indirectly), low food prices, high prices of some groceries such as fruit and vegetables, and the future of small retailers given the large supermarkets' expansion into small express stores and an inability to compete on price.

The ACCC made the following key findings.

1. Grocery retailing is 'workably competitive' but the following factors limit competition on price:
    - high barriers to entry and expansion because of lack of new sites and onerous planning regimes,
    - limited incentives for Coles and Woolworths to compete on price,
    - limited price competition that Coles and Woolworths face from the independent grocery sector, a key factor being the prices set by Metcash.
2. Price competition is strongest on key items such as bread and milk.
3. ALDI has brought about 'competitive responses' from Coles and Woolworths.
4. Increases in prices at supermarkets are not attributable to price gouging, but to local weather events, increased costs of production and international food prices.
5. Nothing is 'fundamentally wrong with the grocery supply chain'. There is no evidence that retail prices have risen while farm-gate prices have fallen.
6. Competition between supermarkets is at least strong enough to ensure that Coles and Woolworths cannot retain all the price cuts obtained on wholesale prices by buyer power (ACCC 2008 p.xiv).

There was some disappointment with the ACCC's treatment of the degree of competition between Woolworths and Coles. While in recent times since the report competition seems to have increased (largely due to Coles' recent price war), there are issues that should be acknowledged and at least debated in the policy arena: such as the lack of incentives for Coles and Woolworths to compete on price; the large supermarkets' behaviour by burying potential competitors in the planning law process when applications to open new stores are lodged; the restrictive covenants in leases in new shopping centres preventing the shopping centre owners from leasing floor space to competitors; the potential for generic brand goods to become so powerful that branded goods could disappear leading to less competition in the future; and the trend of vertical integration, seeing producers at the bottom of the supply chain pressured by the buyer power of supermarkets. While mentioning some of these issues, the ACCC reported that they were not particularly problematic. It glossed over the remainder.

The ACCC also seemed to overemphasise competitive issues in the wholesale market, blaming Metcash for the inability of independent retailers to match prices offered by Woolworths and Coles on key items such as bread and milk. The ACCC concluded that Metcash earns higher margins than it would if it faced direct competition in wholesaling, and implied that Metcash had sufficient economies of scale to be able to offer lower prices, despite the fact that Coles and Woolworths have their own wholesale arms and are presumably much more able to secure lower prices because of their higher market power. Metcash's relationship with independent grocers was also blamed for the fact that it is difficult for new rival wholesalers to establish themselves in the market.

Nevertheless, the review did result in some important changes for consumers.

First of all, a mandatory, nationally-consistent unit pricing regime was implemented in December 2009. It applies to grocery items sold by large supermarkets that sell a minimum range of food-based groceries, and is essentially a labelling system that shows prices per standard unit of measurement such as by volume or by weight. This has enabled consumers to make actual price comparisons in the supermarket, as opposed to guesses about the comparable cost when the sizes of food packages differ. While this was relatively expensive for supermarkets to introduce, it is generally viewed as an effective incentive to compete on price.

The second change involved a monthly comparison of typical grocery baskets across Australia. The idea was to provide some transparency around the cost of groceries in different areas, given that there was evidence that the supermarkets charged dramatically different prices according to location (the presumption being that prices are linked to the affluence of the area in which supermarkets operate). While the website was launched in August 2009, it was disbanded by the Federal Government for many reasons, the largest being the reluctance and in some cases refusal of the supermarkets to cooperate by submitting prices for inclusion.

While creeping acquisition was raised as a potential issue, the ACCC did not find the issue particularly relevant, largely because the supermarkets have not been acquiring many outlets to increase their market share. Only 10% of new store openings between 2006 and 2008 arose from the acquisition or displacement of independent supermarkets, according to the ACCC. The Federal Government did deal with the issue of creeping acquisitions in 2009 and made amendments to the CCA in 2010 substantially addressing these concerns.

(iv) Australian retail industry code of conduct

In 1998 Australia enacted provisions in a new Part IVB of the Trade Practices Act which provided for industry codes. These were of various kinds: purely voluntary; involuntary but once agreed legally enforceable by the ACCC and/or possibly by individuals in the industry; and fully mandatory, that is, enacted and enforced by the ACCC and/or possibly private parties.

The Retail Grocery Industry Code of Conduct was entrenched on a voluntary basis following a lengthy period of criticism of big retailers by small business interests. Much of their campaign focused on merger law but the Government was reluctant to change the merger law or the abuse of dominance provisions. Politically, it was easier to settle for a code of conduct with a Retail Industry Ombudsman. The Code certainly eased the pressure to make any drastic revisions to the laws and regulations that already existed.

It should be added that once the Government allocates time to the debate and publishes a code, purely voluntary measures are generally made mandatory.

A code of conduct was introduced in 2003. The emphasis was on supply disputes and mediation; however, some useful matters were settled between individuals and major buyers. This code was partly inspired by a fairly successful oil industry code, which did sort out a large number of problems between larger oil companies and service stations.

It seems that the present Retail Grocery Industry Code of Conduct (the Code) does some small things in relation to disputes between small sellers and big retailers but it is not very active.

Of note is that the Code is not transparent and there are few revealing reports or reviews of its impact. An independent evaluation of the Code was recently commissioned but the results were not made publicly available.

In broad terms the Code does not seem to have affected the behaviour of big retailers and the pressure they are known to exert over suppliers to extract the best possible deals. It should also be made clear that the Code has had no application to relationships between big manufacturers and retailers. To the extent that the Code has been applied, it has been applied to big retailers and farmers and perhaps a smattering of small suppliers.

The Code may then be a reasonable model for other countries to consider adopting, while recognising its limitations and its effect in diverting attention from some of the key issues of concern. In short, it should be looked to in the sense of lessons learned, and debate should be given to its fine-tuning for application in other countries.

(v) The law of unconscionable conduct

To put the legislative framework in context, the original common law doctrine concerning the sanctity of contract gradually changed to provide that in certain cases contracts are invalid if they were preceded by unconscionable conduct or involved unconscionable terms.

In the early 1990s the Trade Practices Act was amended to provide the ACCC with the power of enforcing the common law. The argument was that the victims of unconscionable conduct do not generally have the resources to take action against the powerful entities that engage in unconscionable conduct. It should be noted that businesses do occasionally bring civil claims alleging unconscionable conduct; however, this is more likely to be tied up with some other reason for litigation such as having a contract set aside.

While the law originally applied to relationships between consumers and business alone, at a later date the law was extended to transactions between big and small business.

In terms of competition philosophy, unconscionable conduct does not normally constitute behaviour that lessens competition. On the other hand, it would be correct to say that in most cases the law relates to situations where one party has total bargaining power in relation to another. Indeed, the cases make it clear that the behaviour occurs in a context where the victim has absolutely no choice or no alternative but to accept the conditions imposed by a powerful party. If they had some alternative option then the behaviour would not meet the preconditions for unconscionable conduct. So there is a somewhat sensible rationale for the law even it if stops short of the fairly high standards that we think of for anticompetitive conduct.

The provisions apply in principle to buyer–seller relationships but in reality have not been used. Their relevance to date has mainly been to shopping centre–tenant relationships.

Enforcement through the courts

In the last 20 years, several important cases concerning supermarkets have been successfully litigated under the Trade Practices Act, now the *Competition and Consumer Act 2010*. Three of these will be discussed in turn. The last case has not yet been decided by the Federal Court, although the matter has been heard in its entirety.

(i) Australian Competition & Consumer Commission v Australian Safeway Stores Pty Limited

The most important and interesting case in the last decade was *Australian Competition & Consumer Commission v Australian Safeway Stores Pty Limited* [2003] FCA FC 149. This case began with an attempt to engage in price-fixing in 1994 and 1995, by Safeway in Victoria, which is owned by Woolworths. Essentially, a small bread retailer was undercutting Safeway and Safeway responded by attempting to persuade it to engage in a price-fixing agreement. Safeway was ultimately found by the Federal Court of Australia to have made a price-fixing arrangement with one of its plant bakers.

More significantly, the ACCC also succeeded in an abuse of dominance action that was linked to the same case. The essence of this complex case and associated litigation by the Commission against George Weston Foods was that Safeway withdrew bread made by George Weston, a major bakery, from sale at particular stores in response to unusually cheap retail prices for that baker's bread at nearby competitive retail outlets.

Safeway argued that it had refused to accept any bread from George Weston in an attempt to secure the most favourable trading terms from suppliers and avoid appearing uncompetitive in its pricing. It argued that its actions were a normal commercial response to competition — it had a competitor that was undercutting it, they were both supplied from the same source, and it was therefore possible, they implied, that George Weston was offering secret discounts to the small retailer. Of course this was highly unlikely to be true given that Safeway's competitor was a very small store in comparison.

It became apparent during the hearing that the circumstances were driven more by anticompetitive motives. The ACCC alleged that Safeway's actions were designed to induce George Weston Foods to require the independent supermarkets to raise their prices. The smooth commercial explanations offered for Safeway's actions were undermined by evidence that the withdrawal of bread applied not only to stores which supplied the small retailer but to a whole range of stores in nearby areas where competition from one small retailer was not an issue.

One of the debates in Australia that followed this decision was whether Safeway had a substantial degree of power in the relevant market if it was ultimately unable to force independents to raise prices. Another debate has concerned the test for 'taking advantage' of market power and whether or not the business rationale for conduct is relevant to that test.

In summary, the majority of the Full Court held that in relation to four incidents, Safeway misused its market power in contravention of section 46 of the TPA. A hefty fine of $8.9 million was imposed ($8 million for misuse of market power and $900,000 for price-fixing). The penalty sent the message that in calculating a penalty for restrictive trade practices offences, the court considers the specific circumstances of the offence as well as the general deterrence that can be achieved by the penalty.

(ii) ACCC v Liquorland (Australia) Pty Ltd & Woolworths Limited [2006] FCA 879 — heavy fines for anticompetitive agreements

In New South Wales (NSW), there are liquor licensing laws applied by the NSW Liquor Administration Board. This case began with allegations that Woolworths and Liquorland, a wholly owned subsidiary of Coles Group, had entered into and given effect to allegedly anticompetitive agreements with liquor licence applicants between 1997 and 2000.

Essentially, prospective liquor licensors would seek liquor licensing from the Board. However, the laws were relatively easy for an existing licensor in a particular area to object to. It was often difficult to fight any such objection and obtain a licence.

Many applicants found themselves facing objections from Coles or Woolworths. Once these applicants realised that they were up against powerful opponents there was concern that the hearings would be lengthy and expensive and there was fear that they would have little hope of winning.

The large retailers began to reach agreements with the applicants, which led to the large retailers withdrawing their objections, provided that the applicant accepted the terms of a restrictive agreement with the retailers, which essentially imposed conditions on the sale of liquor. The ACCC alleged that this practice was so common it was almost routine: standard forms of agreement followed standard forms of objection.

In May 2005, Liquorland admitted that it had entered into illegal agreements with five applicants for liquor licences. Liquorland was subsequently penalised $4.75 million by the Federal Court of Australia for these contraventions. The case against Woolworths continued before Justice Allsop in the Federal Court in 2006.

In June 2006, Justice Allsop found that the four agreements Woolworths entered into with liquor licence applicants contravened the TPA by containing unlawful exclusionary provisions and had the purpose of substantially lessening competition.

Importantly, there was no dispute that Woolworths made an arrangement by entering a deed in relation to each episode and gave effect to it by withdrawing its objection or threatened objection to the liquor licence application.

Justice Allsop found that in two of the episodes the purpose of the agreement was to prevent, restrict or limit the supply of takeaway packaged liquor to future customers, thereby contravening the TPA's prohibition on exclusionary provisions.

In the other two episodes the ACCC was unsuccessful in establishing exclusionary provisions. However, in all four episodes there was found to be conduct that resulted in the substantial lessening of competition in a market. Ultimately, pecuniary penalties totalling $7 million were imposed on Woolworths for entering into and giving effect to illegal anticompetitive agreements.

(iii) ACCC v Metcash Trading Limited [2011] FCA 967

In June 2010, Australia's largest wholesaler announced its plans to buy 77 Franklin stores from South African retailer Pick n Pay. As 8 franchised Franklins stores also exist, the deal would provide Metcash with the right to supply these stores as well, increasing Metcash's share of the wholesale market from 11% to 17% in NSW.

In November 2010, the ACCC announced that it would oppose the acquisition on the basis that it was likely to substantially lessen competition by removing the only genuine competitor for wholesale supply in NSW. The ACCC added that other parties are interested in buying Franklins and these other parties do not raise the same competition issues.

As Metcash and Pick n Pay decided to proceed with the acquisition notwithstanding the ACCC's objections, the ACCC commenced proceedings in the Federal Court in December 2010 seeking:

- an injunction restraining Metcash from completing the proposed acquisition; and
- a declaration from the Federal Court that the proposed acquisition would contravene section 50 of the TPA (now the CCA).

In a recent judgment by Justice Emmett, handed down on 25 August 2011, the Court ruled against the ACCC on a number of grounds. Firstly, the court held that the appropriate market to consider when examining whether a substantial lessening of competition is likely to occur is not the wholesale supply of packaged groceries to independent supermarkets in NSW and the Australian Capital Territory (ACT) as the ACCC claimed, but the market for the supply of groceries generally by retail. Secondly, the court found no evidence of alternative bidders in the event that the Metcash bid is blocked. To the contrary, Justice Emmett held that this was 'pure speculation' and alternative bidders, acceptable to Pick n Pay, are unlikely to exist.

There are some important aspects of the case for merger law more generally. The decision has clarified the threshold set when considering what may occur if an acquisition does not proceed for the purpose of section 50. For the ACCC to succeed in future, it will need to obtain strong and credible evidence in support of the counterfactual that it seeks to rely upon so that it can prove that one of its counterfactuals is more probable than not to occur if the acquisition does not proceed. In addition to this, the ACCC must prove that as a result of this counterfactual occurring, there is a real chance that that there will be a substantial lessening of competition if the acquisition proceeds.

More practically, this is the first time in more than 5 years that merger parties have ignored the ACCC's informal merger clearance process and forced the ACCC to resort to legal action. Whilst an expensive approach, it demonstrates that forcing the ACCC's hand in the Federal Court may be a viable strategy for merger parties in appropriate circumstances.

The ACCC announced on September 9 that it will appeal the judgment.

The 'milk wars' — the supermarkets' cost cuts and the manifestation of competition concerns

In January 2011, Coles cut the price of its generic brand milk by 33% to $2 per 2-litre bottle. Woolworths followed on the same day and ALDI and Franklins followed soon after.

From the moment these price cuts were announced, there was widespread concern about the impact these price cuts would have on farmers further down the supply chain. The anxiety stems from the power balances in the supply chain — the suspicion was that supermarkets would maintain their own margins by forcing processors to accept lower prices, which they would in turn pass down the chain to farmers. The result would be lower prices at the farm gate, lost profits, bankruptcy, and in some cases, withdrawal from the industry altogether.

Before considering these potential impacts and whether or not the cause requires a policy response, it is worth stating the benefit that these reduced milk prices are providing to consumers. According to Coles Managing Director (Mr Ian McLeod), the price cut saves consumers $1 million every week (see e.g. SERC 2011 p.13). For a good that is largely price-inelastic, this is a substantial saving for most Australians.

Effects on the supply chain generally

It is also worth briefly describing the way in which the milk industry has changed over the last decade. First of all, the rise of generic brands of milk has changed the landscape. While processors have historically bought milk from farmers, processed it and branded the finished product ready for distribution to supermarkets, the rise of generic brands has seen supermarkets demanding lower prices for generic brands, which they use to increase demand and push branded goods higher up the shelves. In the UK, the rise of generic brands has gone one step further. Supermarkets have started buying milk direct from processors or farmers, contracting out the manufacturing, then packaging the finished product in home brand bottles. In both Australia and the UK, the price differences between the two have grown exponentially.

In Australia, the price difference was just 18 cents per litre in 2000. A decade later, that difference grew to 71 cents per litre. As the price difference grows, the supermarkets' generic brands naturally grow at the expense of established brands. This is not just significant because of the market share processors have lost over the last decade. It is significant because farmers have always obtained higher prices from branded milk. The lower prices for generic brands and the dramatic rise in demand have seen farmers' margins retract.

It is in this context that the impact on farmers was considered by the Senate Economics Committee. The Committee investigated the following concerns:

1. reduced milk production as investment in dairy farms dries up and new generations enter different industries because of the uncertainty and reduced profits;
2. farmers cut costs that affect regional communities as they look to protect their margins; cost cuts potentially include wages to local workers and reduced use of local services;
3. lower property prices as the market for dairy farms shrinks;
4. a structural shift to long-life milk (otherwise known as UHT milk), possibly sourced from other regions and overseas;
5. inability of smaller retailers to compete with the supermarkets, given that most small retailers cannot obtain the same wholesale prices as supermarkets; this combines with the reality that consumers buy other groceries when they buy milk;
6. regional communities hurt if farmers withdraw from the industry and/or sell their farms; for every dollar created at the farm gate, an additional $3 is created in regional communities because of the services that exist to supply and serve the dairy industry (for example, shops in towns, vets, fertilisers, rural services, etc.);
7. reduced market for processors and distributors, with the supermarkets negotiating directly with farmers and manufacturers to process the milk.

The Committee has not yet issued recommendations; it is expected to do so in October (2011). The ACCC has also conducted a review into predatory pricing following allegations that the cost cuts were designed to eliminate or substantially damage competitors. In short, the ACCC concluded that there is no evidence of predatory pricing. To the contrary, the ACCC found that the price cuts were evidence of competition, which has benefited consumers.

Policy implications

As briefly discussed above, farmers sell to processors or supermarkets under fixed-price contracts that are negotiated every 12–18 months. Some of these contracts are coming up for renewal for the first time since January's price cuts and there have been a few departures from current arrangements that indicates to some that farmers are now being squeezed as a result of the price cuts. For example, Woolworths has recently re-negotiated contracts with NSW processors to obtain milk for its home-brand lines. While Lion used to hold this contract in NSW and sourced the milk to fill this contract from a farmers' cooperative (Dairy Farmers Milk Co-operative), Parmalat won the contract in

July and walked away from negotiations with Lion to source milk from the same co-operative. That has led to the concern that Parmalat will try to negotiate with farmers direct and beat them down further on price. Should these suspicions reveal such impacts, thought should be given to social support for farmers that are dislocated as a result of changes in the industry.

Conclusion

Supermarkets pose policy challenges that the world's biggest emerging markets are only just starting to grapple with. Developed countries such as Australia have been dealing with these challenges for decades, and many lessons can be learned from their experiences.

Australia has, for the most part, managed the retail sector with soft regulatory hands. Market forces have shaped the size and structure of the retail sector over time, creating an environment conducive to all of the benefits of modern retail. Consumers and society more generally have indisputably benefited from the retailers' investment in supply chain management and more efficient business practices, as well as the lower prices and greater product choice that flow from economies of scale.

However, Australia provides evidence that there comes a tipping point when these retailers reach a position of dominance. Anticompetitive behaviour has been aired in Australian court rooms, and various policies have been implemented with limited success.

A possible generalisation from these experiences is that retailing can be thought of as developing through two stages. In the first stage, modern retailing is necessary in order to achieve major efficiencies in distribution. The dilemma is that when this happens it inevitably moves to stage two, a situation where an oligopoly, and quite possibly a duopoly, emerges. In turn this implies substantial seller and buyer power, which may operate against the public interest.

The lesson for developing economies is that effective competition policy needs to be in place well before the second stage is reached, both to deter anticompetitive behaviour and to evaluate the extent to which retail power is being used to unfairly disadvantage smaller retailers and their customers. The sources of retail power need to be understood to ensure that abuses of power are curbed before they occur and weighed against the benefits brought by modern retailers, which must not be unduly hindered.

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