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The power of two: squaring off with Australia's large supermarket chains*

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The level and nature of competition in supermarket retailing in Australia has been hotly debated as a policy issue in recent times. The creeping acquisitions of smaller groups by Coles and Woolworths have led to several investigations amid claims that consumers will be disadvantaged by the growth of the two big chains. Yet little convincing evidence has been found to support these assertions. Although on occasions the big two may have used their power vertically to squeeze suppliers, consumers have experienced highly competitive retail markets. In this paper, it is argued that it is market conduct, not structure, that should be the prime focus of regulatory and policy interest, and that recent corporate activity may lead to a third force in supermarket retailing in Australia that could not only ensure continued competitiveness in the industry, but could also help to constrain the successful exercise of vertical market power by the two big chains. Accordingly, it is argued that intervention as a general policy in supermarket retailing would not be socially efficient, at least not until a wide range of objective and quantitative assessments have been carried out on the operation of the supermarket sector.

Key words: competition, market power, mergers and acquisitions, supermarkets.

1. Introduction

In their papers in this issue, originally presented to the 49th AARES Annual Conference, Cotterill (2006) and Smith (2006) have added to their considerable research on various aspects of supermarket competition and regulation. Together, they present an important assessment of many of the theoretical, empirical and policy issues that surround one of the biggest retailing sectors in Australia. Supermarket retailing is important from a policy perspective, as it affects the welfare of almost every Australian consumer. It offers a smorgasbord of analytical and policy issues relating to location; design; marketing; advertising; scale and scope economies; growth; choice; countervailing power;

* This paper is based on the commentary (updated to allow for recent events) by the author on the papers by Ron Cotterill and Rhonda Smith, originally presented at the 49th AARES Annual Conference held at Coffs Harbour in February 2005, and now published in this issue. I am grateful to the conference organisers, and in particular to Garry Griffith, for inviting me to be the discussant on these papers, and to the referees and editors for their helpful suggestions on this paper. The content, opinions, and analyses should of course be ascribed to me alone and not to any other person, nor to any organisation with which I am connected. Any errors are solely my responsibility.

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mergers and acquisitions; horizontal and vertical use of market power; strategic behaviour; barriers to entry, expansion and exit; the five forces of competition (a term first coined by Porter (1980) to describe competitive forces arising from existing rivals, potential rivals, other broad substitute products, suppliers, and customers); consumer protection; product and geographic diversification; vertical integration; product differentiation; and mergers between suppliers to give them greater bargaining power against the retail chains. An example of the last listed issue occurred early in 2005 in the United States when Procter and Gamble announced that it was seeking to acquire Gillette in a US\$54 billion deal, in order to give the combined firm greater clout to respond to the pressures placed on them by retailing giants like Walmart.

The focus on supermarkets in Australia has been more at the policy and regulatory level rather than in terms of economic research, as more and more individual supermarkets and small chains have become marginalised and taken over by the big two – Woolworths and Coles. The decline of small business, lack of choice, and convenience for consumers, the concentration of market power in two companies, and the pressure put on both large and small suppliers to supermarkets, have been the subject of government inquiries (see, for example, Joint Select Committee on the Retailing Sector (1999), ACCC (2002), and the Dawson Inquiry into the Trade Practices Act in 2003) and much political debate. But the power of the two continues to grow, although in May 2005 the IGA group sought to acquire a large number of supermarkets from the Foodland group, suggesting that a new third force will emerge that at least in some respects has the potential to curb any misuse of their market power.

Nevertheless, there are still many unanswered questions. For example, in the wholesale functional market, do suppliers have any degree of bargaining equality with the two big chains? In the retail functional market, how well are consumers protected from the power of two? Can they rely on intense rivalry between the two chains as they fight for market share? Does this rivalry produce genuinely competitive outcomes? Do the big two create strategic barriers to entry or expansion by smaller chains or individual stores, or are there inherent structural barriers to any entry that could effectively constrain the incumbent operators? Do the big chains pass through to consumers all or any part of the lower prices they extract from their suppliers?

Whose fault is it that we have to ask all these questions? Are politicians to blame for not curbing through the law the expansion of Coles and Woolworths? Is the Australian Competition and Consumer Commission (ACCC) at fault for not having taken enough legal action to halt whatever anticompetitive conduct the big chains might have engaged in, or for not stepping in sooner to stop their acquisitive activities? Have the ‘creeping acquisitions’ become the ‘galloping grab’? In other words, when should we say ‘enough’? Have the courts penalised the two chains too lightly when they have been found guilty of breaches of the Trade Practices Act?

The overarching research, policy and regulatory question is this: have we passed the point of no return in Australia, with two giant national chains

dominating almost every geographic retail market for the bundle of products that they sell, with no real prospect of commercially significant entry or expansion by rivals that will be able to constrain them in a sustainable manner? Regardless of the answer, we need to ask what should be done about the industry – leave it to market forces, or intervene (and if so, on what grounds, and to what extent)? It is on such issues that Cotterill and Smith have focused our attention.

2. The shopping list – research questions and policy issues

Cotterill (2006) and Smith (2006) present research bundles and agendas that are complementary. Cotterill focuses on theoretical and estimation issues like modelling and data availability, and on critically evaluating the overseas research. In contrast, Smith devotes her attention to Australian policy and enforcement issues. Both authors recognise that market power exists in the hands of the big supermarket chains. Both argue that we need to discover more about its origins and effects along the whole supply chain, from the supermarket back to the producer of raw material inputs. Both express concern that suppliers to supermarkets as well as retail customers are vulnerable to the market power of the big chains, should they choose to exercise it in an attempt to convert the surplus of these groups into their own private surplus. Both recognise the need for sound policy guidance and efficient regulatory attention.

Between them, Cotterill and Smith cover many research issues, including the problem of defining the relevant analytical market; the use of unilateral and coordinated horizontal market power; problems in empirically distinguishing between market power and efficiency effects; the use of vertical market power and the pass through to consumers of any subsequent savings; home brands; vertical and horizontal acquisitions; the chains acting as ‘gatekeepers’ for upstream and downstream market participants; and whether there exists a policy and social need to support small independent supermarkets. In this paper I will comment on some of these issues, and offer an assessment of their arguments and how relevant these might be in late 2005, given the likely emergence of a third national supermarket chain that should be able to provide sustained competitive constraints on Coles and Woolworths.

3. Market definition

None of the four theoretical dimensions of a market – product, geographic, functional, and temporal – are easily defined in relation to supermarkets. There are too many overlapping factors that result in a lack of definitional clarity in these boundaries. This makes empirical work more difficult, and often results in ‘last resort’ data being used that comes from analytically inappropriate, even though factually correct, national data. The relevant markets for supermarket retailing are recognised as being relatively narrow, geographically speaking. Yet government committees of inquiry into supermarket retailing

make their recommendations based on imperfect data relating to so-called markets that are statistical aggregations rather than relating to proper economic markets. Good policies cannot come from such inappropriate empirical foundations. Better data are needed, to be fitted to better delineated markets that accord with shopping realities as well as being theoretically apposite.

Market definition is a means to an end – to assess whether a firm's conduct is anticompetitive. It is a process by which to group together all those firms whose actions will have a lasting constraint on the firm in question. As Franklin Fisher (1979) pointed out, it is much better to ask this question directly rather than indirectly through the inaccurate process of market definition. But old habits die hard, even if they may not be particularly helpful in light of new theories or measurement techniques.

Few would dispute that the 'product' sold by supermarkets is really a bundle of goods, services, customer convenience, and other shopping characteristics that yield greater utility to consumers in the bundle than if the bundle were disaggregated and all constituent items were purchased separately. But this begs the question of what constituent goods should be included in the bundle, and how big the supermarkets should be (in terms of floor area) to give shoppers the package dimensions that they want. What is put in the bundle, for example, will determine what type of retail outlets are classified to the market, and this will determine the limit to which constraints are looked for when assessing the conduct of the chains in question.

One indisputable fact that emerges from both Cotterill's and Smith's papers is that, no matter how markets are defined, supermarkets operate in highly concentrated markets around the world. But a word of caution is needed – concentration statistics or even market shares attributable to individual firms by themselves tell us nothing about the dynamics of competition within a relevant market. They present a snapshot only, and tell us neither how firms obtained those market shares, nor whether those shares are currently increasing or decreasing, and they certainly offer no guide as to what might happen as future market conditions change. Researchers need to go behind concentration data and look at what firms actually do, and how they react to each other strategically.

4. Horizontal market power issues

By itself, size does not matter. Firms may be big because they are better, and customers recognise this, or because they treat their suppliers fairly and so inputs of the desired quality and quantity are always available. But unquestionably, the larger a firm becomes, the greater is its potential to exercise unilateral market power to the detriment of customers or suppliers, and the greater become its opportunities to work with (or even coerce) rivals in a coordinated use of horizontal market power (generally known as coordinated effects). Cotterill (2006) provides us with a timely review of some of the overseas evidence, mainly from the United States, of this phenomenon. Prices

and profits are significantly related to concentration and/or market share, with this relationship being due to market power effects rather than to the superior efficiency thought by some to be associated with large market shares. These results seem to hold true regardless of methodology, time period, or type of market/product investigated. Mergers have been shown to lead to significant price increases. On the basis of these findings, United States merger policy towards supermarkets acts in a structural way, based on critical concentration levels for the relevant market. However, it must be doubted whether such overseas findings should be used as the basis for stopping supermarket mergers in Australia, as comparable research has yet to be carried out. Also, the adage 'if it ain't broke, don't fix it' seems to be apt, certainly from the consumer's point of view.

In contrast to Cotterill, Smith (2006) focuses on the underlying characteristics of Australian supermarket retailing, and discusses how scale and scope economies are important in explaining the structure of the industry, and how small units find it hard to compete with the vertically integrated chains, except through membership of banner groups, which gives a brand image and provides some scale economies in marketing and buying. Nevertheless, these smaller units do survive by emphasising different elements of the bundle, such as temporal shopping convenience, faster checkouts, gourmet foods, and easier parking. Yet despite this, their numbers are declining in Australia, through either natural attrition or creeping acquisitions by the large chains.

As these chains get larger, the harder it becomes for a new entrant or a smaller chain to expand sufficiently to enable them to compete on equal terms. Suitable sites are hard to find. Scale and scope economies are difficult to achieve on a comparable level. However, such entry or expansion barriers have not been strategically raised by Woolworths and Coles, but rather have developed as a result of market forces and the ability of these chains to grow because they have satisfied consumer preferences. Entry has occurred, even at the chain level, with the Aldi group for example, albeit on a small scale and not offering the same bundled product as Coles and Woolworths. It may be that this entry has forced the two chains to counter with new strategies based on cheaper home brands that are themselves differentiated within any given product – giving the consumer a choice of home brands for any one good – something not heretofore available. Such responses suggest the competitive process is alive and well in the supermarket industry, at least at the retail functional level.

Nevertheless, Smith points out, correctly, that an information imbalance exists between consumers and retailers, as search costs can be prohibitive when trying to discover and compare the prices and service levels of each chain. This encourages the chains to promote the idea of buying on reputation to save consumers the costs of search. Once such brand loyalty is obtained, it gives them market power over consumers, due to the undesirability of incurring switching costs if a search has to be made for a new preferred chain. These micro foundations of supermarket power present a research area that cries out for the attention of economists.

5. Vertical market power

Vertical market power can be used forwards and backwards in several ways. Cotterill (2006) documents the recent explosion of research in this area, and highlights the problem of coalescing power that can be used by big chains and brand name manufacturers to raise prices to final consumers and lower the prices paid to raw material suppliers. This is an interesting phenomenon, but to be successful the chain must be unconstrained by rivals, through sheer size or through collusive agreements, and the raw material suppliers must have no alternative purchasers of their product. Neither of these scenarios appears to be present in Australia. More interesting, perhaps, is Cotterill's vertical collusion game in which a dominant retailer extracts a lower price from a supplier than do rival retailers, and then raises its selling price in such a way that the rivals make more profit than before, leaving final consumers worse off. Such conduct in Australia, if it exists (unlikely, I believe), might be difficult to attack under s.46 of the Trade Practices Act, although action could possibly be taken under s.45 as a case of tacit collusion between retailers.

Cotterill spends some time on double marginalisation, which comes about when two vertically adjacent firms in a supply chain each seek to maximise profits. This can raise retail prices, decrease final output, and lower total supply chain profit. Vertical integration eliminates the problem, but in practice a chain cannot buy all of its suppliers nor can a monopoly manufacturer buy all of the supermarkets it supplies. Private labels can reduce double marginalisation (as can trade promotions), and consumers will pay less, so long as they are happy to buy the private label product. It will be instructive to observe consumers' acceptance over time of the tiered private label offerings of Coles and Woolworths, and to measure the savings to be made compared with the equivalent branded products, and also to assess the relative price differences between private labels and brand names for a range of different goods.

Throughout Cotterill's assessment of vertical market power, there is an implicit assumption that losses to final consumers, farmers and other input suppliers are socially bad. That may well be so in a private sense, but net social welfare is hard to measure, and the welfare standard that is used must be carefully spelled out. Cotterill appears to favour a consumer welfare standard of sorts, in which distributional issues are important. Others might support the use of a total welfare standard, in which it is the overall gain to society that should be maximised – the size of the pie – rather than who gets the biggest or fairest slice. In the recent decision of the Australian Competition Tribunal in the Qantas/Air New Zealand matter (*Qantas Airways Limited* 2005 ATPR 42–065; [2005] ACompT 9, at paras 166–191), the total welfare standard was endorsed for use in Australia, subject to due consideration being given to the weight that should be applied to gains in the hands of firms that are not passed through to customers.

Smith (2006) identifies the basic conditions under which the power of supermarkets as buyers can be used to the disadvantage of suppliers. Woolworths

and Coles hold the aces here, in the form of a shortage of shelf space in their stores (relative to the demand for it by product manufacturers), and the greater value of this shelf space compared to that held by rival groups, due to customer preferences for the bundle offered by the two big chains. If manufacturers want access to these customers, they have to deal with the big chains. If they are not 'in', they are likely to be 'out' with consumers, because, as Smith points out, consumer loyalty to a store or chain is likely to be greater than it is to a brand, and few products are regarded as 'must have'. The cost of switching brands within a store if the preferred one is not available is likely to be less than the cost of going to another outlet.

Smith points out that through their buying power over their suppliers, the big chains can extract listing fees, shelf fees, and promotional support from them that the smaller supermarkets cannot obtain. But these manufacturers cannot seek to recover the lost profits (income transfer) from their smaller customers – the independent supermarkets – as to do so would mean increasing the prices charged to them, which would make them less competitive in the retail market, leading to lower sales volumes for them and greater sales going to the big chains, giving them even more power to deal with the manufacturers.

It is important to realise that a chain first develops the horizontal market power, and from this follows the vertical power. Without the first it cannot have the second. If misuse of vertical power is of concern, the first-best line of attack is on the horizontal power. But if the big chains are competing hard for the consumer's dollar, then little justification exists for intervention, unless it is on distributional grounds – and this is a policy decision, not an economic one based on efficiency considerations.

6. Horizontal acquisitions and market conduct

6.1 Current and future levels of competition

The markets in which Australian supermarkets compete are dynamic in terms of innovation and offering consumers real choices. In these circumstances, markets can produce results not foreseen by economic theories. Market outcomes in one country will not necessarily be replicated in another. An empirical or theoretical outlier in one country could be the norm in a different institutional context. If it is thought desirable to seek new policy directions for the Australian supermarket industry, they must be carefully tailored to reflect the local, and ever-changing, institutional framework. Some of the assessments and recommendations put forward by Cotterill (2006) and Smith (2006) must be seen through this lens.

It is not market shares that determine the level of competition, but the battle between rivals to secure a lasting competitive advantage over each other (which is likely never to occur in any sustained way in Australian supermarket retailing, short of some commercial mishap or funding disaster). Co-ordinated market conduct is unlikely in such circumstances, especially where

a fringe of independent rivals exists that could expand in the event of collusive behaviour by the bigger chains. That market behaviour and not market shares should be the key element for determining whether a market is likely to be competitive was stressed by the Australian Competition Tribunal in the reasons handed down in mid-2005 in its decision to approve an application by Qantas and Air New Zealand to form a strategic alliance that would coordinate and control all aspects of their pricing, flight scheduling and operations on flights into, out of, and within both Australia and New Zealand (see *Qantas Airways Limited* (2005) ATPR 42–065; [2004] ACompT 9, at paras 429–446).

Although many have been critical in recent years of the growing dominance of Coles and Woolworths, at least in structural terms (Woolworths currently has an estimated 41 per cent of the market and Coles 35 per cent (see Jimenez and Andrusiak 2005)), consumers do not appear to have suffered. It cannot be said that they are facing less competition in the retailing of the supermarket ‘one-stop-shop’ package. There is intense ongoing rivalry between the chains to attract the customer at the margin, in terms of prices, the range of goods sold and services offered, store innovations, and the roll-out of new stores. Concern has been expressed at the relentless ‘creeping acquisition’ by Woolworths and Coles of small independent supermarkets and retailers in other areas such as petrol and liquor retailing, but competition is fierce both between the big two and with other rivals in each of these areas of retailing.

The Australian Consumers Association appears not to be concerned about increased market concentration, saying in May 2005 that ‘prices had come down with consolidation in the industry’ (reported in Jimenez and Andrusiak 2005). This comment was in response to an announcement that Woolworths was seeking to increase its market share further through gaining control over 20 supermarkets and three development sites currently owned (and mainly situated in Western Australia) by the Foodland group. The other 60 Australian supermarkets operated by Foodland will be acquired by Metcash, the operator of the IGA chain, which will also acquire Foodland’s extensive wholesale grocery business that supplies to independent supermarkets across Australia, likely generating significant back office and sales force economies. This acquisition will add only marginally to the Australia-wide strength of Woolworths, but will result in it overtaking Coles in Western Australia in terms of the number of outlets operated (Hughes 2005 reports that Woolworths currently has only a 30 per cent share of the market in Western Australia.)

On 19 October 2005, the ACCC announced that it would not oppose the acquisition by Woolworths of 19 of the 20 Action stores it sought to acquire. The ACCC did, however, insist that the other Action store sought by Woolworths be acquired instead by Metcash, as a result of its concerns about diminished local-area competition. In making its assessment, the ACCC took into account regional and local market characteristics as well as national factors.

It has been the ACCC’s habit to look at relatively narrow geographic markets when assessing mergers between small independents or local chains, the argument being that consumers tend to do supermarket shopping within a

relatively small radius of home. Given the tendency of supermarkets to co-locate in order to maximise their customer reach, the ACCC needs to check that in any given area an acquisition will not lead to a substantial lessening of competition, or will not deter potential competitors from entering the area. It found that many of the stores sought by Woolworths did not compete in the same local markets as existing Woolworths' stores, and those that did currently compete with Woolworths would continue to face strong competition from Coles, Foodland, Aldi, and other independently operated supermarkets. In addition, it had sought evidence from participants in the relevant markets as to whether the acquisitions by Woolworths would be likely to result in a substantial lessening of competition in any procurement or supply market, but no such evidence was forthcoming.

This move by Woolworths is indicative of the fact that internal or organic supermarket growth is becoming more difficult for the two big chains. Obtaining suitable development sites is a problem, and with high market shares, both individually and collectively, the battle for the customer at the margin is an intense and expensive one. Coles' and Woolworths' aggressive expansion of capacity in recent years has been well ahead of population growth (Evans 2005). Changed shopping habits have prompted their expansion into convenience-type outlets. The most efficient way, both privately and socially, for the two big chains to grow now may instead be through external growth via acquisition.

Although there appears to be no shortage of hard competition in supermarket retailing, the emergence of the IGA group as a strong third player will be a socially desirable outcome of the Woolworths' acquisition of the Foodland outlets. Consumers and suppliers will benefit. It is highly unlikely that such a position could have been obtained through internal expansion by IGA, certainly not in the short run. In addition, second-tier operators have not had much success in obtaining a competitively significant market share in Australia to date. The entry by Aldi, the German discount chain, used a no-frills and limited lines business model that suggests it will always be a niche player, unless the one-stop package falls out of favour with Australian shoppers. However, any concerns that Woolworths and Coles might recognise their interdependence and coordinate their selling strategies can be safely dismissed. Australian supermarket retailing is poised to enter a new phase of even more intense competition.

There are three groups of market participants who will likely be better off as a result of the acquisition by Woolworths and Metcash of the Foodland stores – final consumers, independent retailers and small regional chains, and suppliers of groceries and other products to supermarket chains.

6.2 Gains to consumers

Consumers will be better off as the already high levels of competitive activity will increase, and there is likely to be an increased emphasis on innovation in

the retailing package (there are some who believe that Coles and Woolworths, as duopolists, have not been as innovative in retailing as they could have been, especially compared with their overseas counterparts (see Jimenez and Andrusiak 2005)), either by the big two in order to keep the IGA group at bay, or by the IGA group to position itself for organic growth and to seek those customers at the margin who had never before considered shopping at an independent supermarket. The old adage 'two's company, three's a crowd' is equally applicable to supermarket retailing – to survive in a market crowd of three, each group will need to find new and sustainable ways of appealing to consumers. Savings that the chains may enjoy on the supply side through their greater buying power should be passed on in the form of greater consumer benefits.

It is of course not guaranteed that prices will fall significantly. Although the IGA group's customers may find lower prices than before (but it must be remembered that IGA is a banner group for independently owned supermarkets, each of which is free to determine its own prices), prices in the Woolworths and Safeway, and Coles and Bi-Lo, supermarkets may not be competed down below current levels. Margins are already low. But the third force will provide the competitive tension needed to keep prices low – and perhaps they could fall a little further at least until the IGA group has established a market presence. The threat of the ACCC taking action under s.46 of the Trade Practices Act, which prohibits a firm with a substantial degree of power in a market from taking advantage of this power to deter competitive behaviour in the market, or to eliminate or substantially damage a competitor, should ensure that no predatory tactics are used by Woolworths or Coles to retard unfairly any expansion by the IGA group.

However, consumers may in the short run suffer from some lack of choice of brands, if Woolworths and Coles successfully implement their preferred strategy of stocking two or three levels of private label product and only one or two brand labels. Smith (2006) notes that consumers could be disadvantaged by the power of these chains if it results in less innovation, lower levels of quality and less choice. Such problems do not appear to have occurred to date in Australia, except perhaps for those consumers who would have preferred to shop at the smaller stores which have exited the market or have been acquired by the big two. Whether the new brand strategy succeeds will very much depend on consumer reaction, especially if key preferred elements of their shopping package are no longer offered by the big two, and on what stocking strategy is adopted by the expanded IGA group.

Whether the loss of smaller retailers, especially in country areas, can be ascribed to the market power of Coles and Woolworths is a matter of debate. As Smith points out, small independent supermarkets undoubtedly support their local communities, whereas the big chains have focused on larger cities whose population supports their bigger store and preferred uniform product range (rather than catering to local tastes). However, in the 1990s service activities were increasingly rationalised into regional centres, and such business was combined by consumers with a shopping trip for convenience reasons,

as well as for the lower prices on offer. In addition, the big chains have adapted and developed smaller format stores that have made it more profitable for them to either set up outlets or acquire small independent stores in smaller cities. In the face of centralisation and agglomeration economies, the decline of small country and regional retailers is inevitable and cannot be directly ascribed to the power of the big chains.

6.3 Benefits for independent supermarkets and suppliers

Independent retailers and small chain owners should also be better off as a result of the Foodland sale. Following the increased size resulting from Metcash's acquisition of the Foodland stores not acquired by Woolworths, giving it an estimated national retail market share of around 18 per cent, approximately half that of Coles, it should be able to do better deals with suppliers and have an enhanced ability to compete with Coles and Woolworths that would not otherwise have been available.

Suppliers to Coles and Woolworths should also be better off. This might appear to be a paradoxical statement, given the greater buying power that could be expected to accrue to Woolworths, and given the strategies employed by Coles and Woolworths in recent years to squeeze their suppliers (e.g., product listing fees, shelf fees, a squeeze on suppliers' profit margins, and moves to have fewer branded goods and more home-brand goods in any given product category). But now suppliers face a different outlook. Many brand-name manufacturers, especially smaller ones, have been facing the much less profitable prospect of life without exposure in Woolworths' and Coles' supermarkets, and a fight to shave margins to secure contracts for less profitable home-brand supply contracts. This pressure may now lessen, if suppliers have an alternative group through which to sell, although if the two big chains feel threatened by the expanded IGA group, they may try to force even more concessions from their suppliers. However, there have been recent indications that Woolworths and Coles are seeking supply chain improvements leading to cost savings, but to achieve more they will have to rely on the goodwill and support of manufacturers. Thus, as Whyte (2005) suggests, in order to improve supply chain logistics such as on-time delivery and shelf-ready packaging, some bargaining power may have to be conceded to the suppliers.

A supplier may no longer have to yield to heavy pressure from the big two for fear of losing business. There will now exist an alternative viable chain, albeit one that might want good deals and that might use some of its new buying strength to achieve price concessions. However, manufacturers, especially small- and medium-sized ones, and the IGA group, face a two-edged sword. Each clearly needs the other to achieve profitable growth, but each might like to take advantage of its new-found power. In a bilateral bargaining position like this, each party should realise that a 'win' could well prove to be a Pyrrhic victory, with the ultimate winners being Coles and Woolworths, and so they should be supportive of each other rather than seeking to exploit

their trading partner. Those manufacturers that might previously have been squeezed by the big two may decide to favour IGA stores with priority treatment in new lines and favoured supply quantities, secure now in the knowledge that if they offend the big two they do have an alternative outlet to supply.

7. Competition enforcement issues

Smith (2006) spent some time considering policy problems and enforcement issues, noting the concern held about high concentration levels and the decline of the independent supermarket sector, but she emphasises that the role of the Trade Practices Act is to protect the competitive process, and not the health of individual competitors.

Mergers between grocery wholesalers have been considered by both the Federal Court and by the Australian Competition Tribunal in recent years (see *QIW Retailers Limited v Davids Holdings Pty Limited & Ors*; *Attorney-General of the Commonwealth v Davids Holdings Pty Limited & Anor* (1993) ATPR 41–226, in which the Federal Court rejected the attempt by Davids to take over QIW; and *Re Queensland Independent Wholesalers Limited* (1995) ATPR 41–438, in which the Trade Practices Tribunal, as it then was, approved a merger between Davids and CBL, another wholesaler, on the grounds that it would create a ‘Fourth Force’ in grocery wholesaling). An inspection of the *Annual Reports* of the Trade Practices Commission and its successor, the ACCC, in the early to mid-1990s indicates the extent of merger activity in grocery wholesaling at that time.

Smith argues that the creeping acquisitions by the big two chains are difficult for the ACCC to stop under s.50 of the Trade Practices Act, which only prohibits acquisitions if they are likely to substantially lessen competition in a market. Given the very small market shares being acquired, it is unlikely that this could be proved in court – the incremental decline in competition, if it existed at all, would not be substantial by any calculation. Although it is perhaps feasible to argue that these acquisitions form a pattern and so should be treated jointly in order to meet the substantial test, this would be an innovative argument whose likely success in court cannot be predicted.

What the ACCC has tried to do, when chains have been up for sale due to an exit strategy (as was the case with the Franklins group) or for some other reason, has been to broker the allocation of the available stores between the chains so as to enhance the chances of a relatively pro-competitive outcome, and this is what it has sought to achieve in the Foodland carve-up. But the greater the share of the market acquired by the chains, the harder it is for any new entrant or for a current small chain to expand, so as to become a constraining force on the incumbents. The regulator does not have an easy job here.

Apart from merger activity, the Woolworths group has been subject to investigations into its market pricing conduct, which have led to court actions. A major case (*ACCC v Australian Safeway Stores Pty Limited (No 2)* (2002) ATPR (Digest) 46–215) involved Safeway, a subsidiary of Woolworths, being

charged with price-fixing arrangements and misuse of market power. At first instance Woolworths was cleared of these charges, but on appeal, a majority of the Full Federal Court largely upheld the ACCC's allegations (*ACCC v Australian Safeway Stores Pty Limited* (2003) ATPR 41–935). Woolworths also admitted in 2003 to a price-fixing arrangement in the retailing of liquor in the Northern Territory (*ACCC v Woolworths (South Australia) Pty Ltd (Trading as Mac's Liquor)* 2002) ATPR 41–941). Such behaviour indicates less constraints being applied to its behaviour than is socially optimal, and so the development of stronger rival retail chains is a welcome event.

The report by the ACCC (2002) into the pricing practices of Coles and Woolworths, in response to a Senate direction, was unable to conclude that the chains could induce from suppliers discriminatory prices in their favour and against independents. Smith does point out, however, that discrimination may occur in many ways that are hard to detect, and so the ACCC's finding is not definitive on this issue.

8. Summary and conclusions

The power of supermarkets – for many years now the power of two in Australia – is a topic that produces considerable passion and argument at commercial, social, regulatory and political levels. It is one that has been the subject of parliamentary committees of inquiry, adds to consultants' pockets, keeps regulators, lawyers and judges busy, and provides provocative material for the media. But our understanding, and empirical assessment, of this market power is far from complete. The papers by Cotterill (2006) and Smith (2006) point the way for much-needed research in Australia, and for the development of data sets that can be used to further our understanding of how supermarkets operate, and to whose advantage or disadvantage. Cotterill stresses the need for disaggregate analysis for each functional market. It is hard to disagree with that, and also with his point that much more research is needed on the transmission of prices along the supply chain, on the vertical pricing practices that firms can use because of their market power, and on the links that permit vertical strategies to reinforce horizontal anticompetitive behaviour.

The horizontal and vertical relationships involving supermarket chains are still largely unexplored in any systematic manner by economists in Australia, although some aspects of their behaviour have been subject to scrutiny by the Federal Court, at least with respect to price-fixing and misuse of market power. But a much deeper understanding is needed before we can be confident that the two big chains are acting both individually and collectively in the public interest, in the total welfare meaning of that term recently established by the Australian Competition Tribunal.

Casual observation suggests that the prospects now are promising for competitive market behaviour by the supermarket chains. After years of increasing market share for Woolworths and Coles, in part due to creeping acquisitions and in part due to internal growth and policies of offering consumers low

prices, greater convenience and continual improvement in the retailing package offered to them, we now see the emergence of strong rival third (the IGA group) and fourth (Aldi) forces in the market, each of which appears to be in the market for the long haul. The outlook for consumers, currently good, looks even better. Suppliers may be less threatened than previously with 'take it or leave it' attitudes by Woolworths and Coles, and they may have more options than was the case only recently.

Market realities in Australia may have turned the tables on economic theory and predictions based on overseas evidence. The regulatory message at the moment is clear: intervention as a general policy in supermarket retailing would be socially inefficient. What is needed to guide long-run policy is a wider range of objective assessments of the supermarket sector, at all of its functional levels, in terms of static and dynamic efficiency issues, sources and effects of market power, coordinated effects, and also of distributional outcomes. We need to know exactly who gains and who loses from the activities of the two big chains, both within and between each functional market in which they operate. From this we can determine the total impact of their activities on social welfare.

Only with such research can policy and enforcement issues be fully informed. The costs of unjustified intervention can easily outweigh the costs of not intervening when it is called for. Although some functional aspects of the supermarket supply chain and some regional markets may require attention on an ongoing basis, any comprehensive investigation is likely to find that, despite the fact that the supermarket sector is one of the most important in the whole economy, government attention and regulatory intervention could in most cases be better directed into market failure problems in other markets in order to maximise total social welfare.

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