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The Australian grocery industry: a competition perspective*

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This article discusses whether at a theoretical level the large and growing role of the vertically integrated supermarket chains raises a buyer-power concern because of potential harm to other retailers, suppliers, and/or consumers. Even if this is possible, whether it is a real concern depends on whether provision exists to constrain the exercise of that power through market responses, such as entry, or through regulatory provisions, such as those contained in the Trade Practices Act.

Key words: buyer power, competition policy, supermarkets.

1. Introduction

Relationships between vertically integrated grocery chains and their suppliers and customers have attracted the attention of politicians and competition regulators in recent years. In essence, the concerns stem from increasing industry concentration as the independent sector continues to contract, and from the expanding range of product categories offered by the grocery chains, with the apparent threat that this poses to specialty retailers. If this confers or reflects the exercise of buyer power, it may impact adversely on suppliers, including farmers and their customers, the food processors. However, so long as grocery retailing remains competitive, generally it is expected that retailers will be responsive to consumer requirements and so consumers will benefit as reduced supply costs enable lower retail prices.

The aim of this paper is not to provide an empirical study of the grocery industry, although it does suggest some areas for investigation. Rather, it enquires whether, in a theoretical sense, the large and growing role of the vertically integrated supermarket chains raises a buyer-power concern because of potential harm to other retailers, suppliers, and/or consumers. Even if this is possible, whether it is a real concern depends on whether provision exists to constrain the exercise of that power through market responses, such as entry, or through regulatory provisions, such as those contained in the Trade Practices Act (TPA).

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The paper begins by identifying the economic characteristics of the grocery industry that are responsible for its present structure, including market concentration. Next, some possible implications for suppliers, including farmers who may be affected both directly (fruit and vegetable supply) and indirectly (processed primary products) by these structural characteristics, are considered. This is followed by some observations on the implications for consumers. Finally, consideration is given to the ability of the TPA to address any competition concerns associated with the grocery industry, and possible policy implications of any perceived deficiencies.

2. The economics of grocery retailing

Although some farm produce (fruit and vegetables) is supplied direct to wholesalers, most is processed before being passed to wholesalers who also acquire some food products from overseas.

Traditionally, wholesalers supplied numerous independent retail outlets, many of which were specialty stores (green grocers, butchers, bakers, and the like). Today, vertically integrated wholesale–retail grocery chains handle the majority of grocery products: Coles and Woolworths account for approximately 80 per cent of packaged groceries sold in Australia. Nevertheless, independent wholesalers and retailers, including numerous specialty retailers, remain.

Until relatively recently, unlike marketing specialists, economists contributed little to the understanding of retailing. Steiner (1991, p. 161) observed that:

... economics has not seriously tried to understand the process by which goods move from manufacturers through the wholesale/retail channels of distribution to household consumers. Worse still, the discipline has tended to ignore these downstream markets entirely by the tacit assumption that they are inert and perfectly competitive, so their omission from economic models does not bias the results.

Consequently, economic texts and journal articles on this subject are in short supply; exceptions include Bliss (1988) and Betancourt (2004). This deficiency is particularly significant because standard economic tools, such as marginal cost, do not always translate easily from theory of the firm into a theory of distribution.

2.1 The grocery product

The first common misconception about the grocery industry relates to its product. The output of both wholesalers and retailers is not merchandise, but services that enable buyers to purchase the merchandise. Wholesalers and retailers add value to manufacturers' products by transporting and displaying the items for sale and by providing other services associated with sale.

Indeed, at the retail level, arguably the product is access: access for suppliers to retail customers and access by retail customers to a range of goods and services. Retailers provide the interface between the two and this may have significant implications for the way in which retail businesses may evolve in the future.

In addition, at both the wholesale and the retail levels, goods and services are supplied as a bundle. Grocery wholesaling involves not only the acquisition and supply of products sold by grocery retailers, but also the supply of services to retailers, including arranging promotional support by manufacturers and, for independent retailers, provision of, or access to, financial and accounting services. Similarly, grocery retailers supply a variety of goods ranging from fresh produce to dry goods to nongrocery products. In addition, they supply services, such as locational convenience, parking, and in-store amenities, such as lighting, check-out facilities, and customer assistance. Although the composition of the bundle of goods and services supplied by grocery wholesalers and retailers may vary (for example, a particular store may not provide parking or it may supply less of a particular service, such as check outs), these products cannot be completely unbundled.

Overall, enough revenue must be collected to cover all costs, including merchandise costs, and contribute to profit; and so cost-plus pricing is the norm. Gross margins are likely to be set to influence the consumer's choice of product bundle, choice of store, and perception of the store's pricing policy. Consequently, although items such as fresh fruit and vegetables tend to carry above-average margins, reflecting perishability, staple items and specials carry lower margins.

2.2 Economies of scale

The industry is characterised at each functional level by high fixed costs relative to variable costs. Some service costs can be adjusted in response to changes in turnover (e.g., labour costs), but the relationship between costs and turnover may not be close because costs may vary with the number of customers rather than the level of sales. In these circumstances, economic concepts, such as average and marginal cost, are difficult to apply to an analysis of the grocery industry.

Nevertheless, given the industry cost structure, economies of scale are extremely significant in explaining how the industry operates, as well as the observed changes in industry structure. The vertically integrated chains for the most part buy direct from the producer, and carry out their own centralised wholesaling operations. There are many sources of economies of scale in the operation of integrated chains. These mean that small operators find it difficult to compete on price with large vertically integrated chains. For the independent retailer, merchandise costs depend on the independent wholesaler's ability to match the bargaining power of the integrated chains, the scale of orders and economies of scale and scope in receiving and distributing

goods to retail customers, as well as the wholesaler's incentive to pass on cost decreases or promotional monies to retailers. Membership of a banner group provides the individual store with a brand name, and provides economies of scale in some areas of the business, particularly in marketing.

Historically, the supply costs of the independent retailers usually have been higher than those of the chains. Small stores attempted to justify the higher prices that resulted by claims that they offered a higher level of customer service; in addition, regulated trading hours meant that they had a captive customer base at certain times. However, with the deregulation of trading hours in most Australian states, a crucial differentiating aspect of the product offering of smaller retailers was removed. In addition, customer preferences favoured the store format adopted by the chains, but most small retailers lacked access to the capital required to convert to a similar format. Some independent retailers have established large-format stores and compete successfully with the major chains; others have developed specialist offerings, such as gourmet foods. In general, however, independent retailers failed to adapt. For the vertically integrated chains, economies of scale come not simply from expanding store size; the national supermarket chains achieve economies of scale by operating multiple outlets. Again, lack of access to capital limits this option for most independent retailers. In addition, in the latter half of the 1990s the major supermarket chains introduced variations on their standard, large-store format to compete more directly with convenience stores, as well as in response to changing consumer requirements in city locations and in regional areas.

These factors have resulted in a significant decline in the share of grocery sales through independent grocery outlets, as well as a decline in the number of outlets. However, there was an uncharacteristic increase in the share of independents in 2001–2002 when Franklins exited the market and some of its stores were acquired by Metcash. As the independent sector contracted, the unit costs of independent retailers increased further and some sold their businesses, often to the supermarket chains, a process sometimes referred to as 'creeping acquisitions' (see succeeding discussions). Loss of retail business further raised the unit costs of the independent wholesalers and this in turn raised the input costs of remaining independent retailers (creating something of a vicious circle). This resulted in significant rationalisation of the wholesaling function. In the early 1990s, there was at least one major independent wholesaler in each state; today, there are just two major independent wholesalers, Metcash and Foodland, and the former has now made a successful takeover bid for the latter.

2.3 Economies of scope

The most significant costs for the grocery industry are common costs, but economic theory provides little guidance as to how these costs should be allocated across products. Nevertheless, common costs and the economies of

scope to which they give rise are important in shaping the grocery industry. Within the limits of available shelf space, a constraint more significant for suppliers than for retailers, the more different types of products offered for sale through a grocery outlet, the lower the retailers' unit costs associated with supplying any one product group. Thus, grocery retailers, particularly the supermarket chains, have expanded their product range to include products traditionally sold by specialty retailers (fresh fruit, bread, meat, and fish) and other items, such as paper products, newspapers and magazines, and plants. Some supermarkets have added services, such as in-store banking facilities and more recently the major chains have led an incursion into petrol retailing. In 1996, Woolworths added petrol to its range, and in 2003, Coles entered into an arrangement whereby a discount of 4 cents per litre of petrol purchased from Shell service stations is offered if a Coles docket for grocery purchases in excess of \$A30 is produced. Development of the 'one-stop-shop' has proved attractive to shoppers whose opportunity cost of time is increasing and for whom entering a store is a fixed cost. The latter tends to mean that shoppers are more loyal to the store than to the brand and this has helped to alter the balance of bargaining power in favour of retailers and away from suppliers (Rey 2001, pp. 491–492).

2.4 Barriers to entry

The structural characteristics of the grocery industry indicate that larger scale firms with a more diverse product range are likely to be more efficient than smaller firms with a narrower product range. Vertical integration may enable more effective supply chain management, as well as better quality control, and may attract higher levels of promotional support from manufacturers. However, imperfect capital markets may limit the ability of independent operators to adjust their business structure in response to these factors.

Nevertheless, in the absence of significant structural and/or strategic barriers to entry into grocery retailing, the decline of independent grocery retailers and specialty food retailers is unlikely to raise competition concerns and hence issues for suppliers and/or consumers. However, there are significant barriers to entry into grocery retailing, including a scarcity of attractive retail sites. Even if entry and exit barriers to grocery retailing are low on a single store basis, they are high for an integrated chain, partly because of the high sunk costs associated with establishment, and this is likely to be the form of entry required to constrain the vertically integrated grocery chains (OFT 1997, *ACCC v. Safeway Stores Pty Limited* 2001). Views about whether economies of scale are a barrier to entry differ. However, when an incumbent has a large market share and, as a consequence, access to significant economies of scale, this may deter entry. This may be particularly so in circumstances where the potential entrant decides that it will take too long to win sufficient market share for it to achieve a cost structure similar to that of the incumbent, although if it could do so it would be at least as efficient as the incumbent.

This is likely to be the position even for a new chain. Furthermore, entry is likely to be deterred because shop leases are generally signed for a long period and contain punitive provisions that make exit difficult.

Despite these issues, entry has occurred. To some extent the corner store was reinvented with the establishment of chains of convenience stores, often associated with petrol retailing. In part, the new small format introduced by the supermarket chains was a response to this competition. Then, of course, the Coles/Shell and Woolworths/Caltex alliances of late 2003 and early 2004 saw the supermarket chains relieved of competitive pressure from this source. The other significant competitive challenge to the chains was the arrival in Australia of the German retailer, Aldi, which has gradually established a number of stores, although it still accounts for only around 4 per cent of grocery sales. It offers a limited range of grocery products, consisting mainly of private-label products, but these products are typically 25–30 per cent cheaper than the standard shelf prices of the major supermarket chains. The chains have responded by revisiting house brands and generics; and Woolworths decision to negotiate ‘everyday low prices’ with its suppliers may also have been influenced by Aldi’s pricing, a move now being followed by Coles. Arguably, entry has not imposed much of a constraint on the decision-making of the national chains to date. If this is the case, then for the market to remain competitive, it is necessary that competition between the chains for retail sales is maintained.

3. Supplier relationships

Although elementary microeconomics often abstracts from relationship issues, the interface between producers (whether farmers or manufacturers) and distributors (wholesale and/or retail) is all about these issues. To the extent that they consider the wholesale–retail interface, economists tend to assume market power on the part of suppliers, rather than on the retailers. Although this may have been true in the past, generally it is not the case today, especially in relation to the grocery industry. One issue raised by increasing industry concentration is whether it confers buyer power on the chains that directly or indirectly disadvantages suppliers and ultimately retail customers. However, an alternative reason why chains may have initiated changes with respect to the supply chain was because suppliers were unable to respond to changing market requirements, rather than because they possess or are exercising buyer power.

3.1 Buyer power

‘Buyer power’ may be described as ‘... the bargaining strength of the downstream firm in a vertical agreement with an upstream supplier’ (Bloom 2001, p. 395). More expansively, Collins (2001, p. 435), defined retailer buyer power as existing when, in relation to at least one supplier, a buyer could ‘... credibly

threaten to impose a long-term opportunity cost ... which, were the threat carried out, would be significantly disproportionate to any resulting long-term opportunity cost to itself'.

A necessary condition for buyer power is that barriers to entry/exit into the downstream retail market are relatively high. Otherwise, the supplier could refuse to agree to the buyer's terms and instead establish its own retail activity. Given this, a buyer may have market power relative to its supplier/s if a significant reduction in purchases by that buyer would substantially reduce the supplier's profits. This will occur if there are inadequate alternative buyers to compensate for the loss of the buyer, or if there are significant switching costs in redirecting supply to other buyers. The first of these is particularly significant where the supplier's sales depend on the ease with which consumers can access the product; and/or where the supplier depends on the firm with buyer power to 'underwrite' its cost of production and to provide access to economies of scale. Collins (2001, p. 343) captures the essence of the manufacturer's reliance on retailers when he states:

Suppliers of high-volume branded goods seek to maximise efficiencies and achieve economies of scale in manufacture and marketing (including advertising and promotional activity) by ensuring the widespread availability of their products in all outlets where consumers may wish to purchase them. Hence, if a supplier's products are not stocked by a particular large retailer, the manufacturer may be foreclosed from a significant part of the retail market.

Although major supermarkets, such as Coles and Woolworths, carry many thousands of different items, from the perspective of suppliers there is a shortage of shelf space. Producers of quite different products compete for the shelf space that the retailer controls. This imbalance has worsened as the national supermarket chains rationalise the number of suppliers with whom they deal (in order to reduce transaction costs). Entering into contracts, often with smaller manufacturers, to supply quality private-label products ensures alternative supply for the grocery retailer and may impact on the value of the proprietary brands. As a consequence, retailers are in competition with the suppliers of branded products. This reduces the bargaining power of manufacturers relative to retailers, for example because it tends to devalue the manufacturer's brand and because the retailer gains access to information concerning competitors that is commercially advantageous. However, to date, this is less of an issue in Australia than overseas because generics and private-label products have not been accepted as close substitutes for branded products.

Grocery retailers typically carry a broad range of products, and so may be able to refuse to stock one particular brand with little impact on its total sales. Whether this is the case depends on consumer loyalty to the brand compared to consumer loyalty to the store. If the former is weak relative to the latter, then the supplier will be in a weak bargaining position relative to

the buyer. There are a number of reasons why consumer loyalty to the store is likely to be greater than that to a particular brand.

First, there are few products today that would be regarded as 'must have' brands, although Coca Cola may be one such product. Brand loyalty will be less if products are not highly differentiated and there are at least a few alternative suppliers, even if they are smaller. This provides an incentive for the retail chains to enter into arrangements with small to medium suppliers for alternative supply, including house brands. It may also have encouraged the transfer of product promotion (but not its cost) away from the manufacturer to the retailers.

Second, as Rey (2001, p. 491) suggests, the cost to the consumer of switching brands when a preferred brand is not available is generally less than the cost of going to a second store, as the fixed cost of visiting a second store is high (additional time and travel costs, difference in store layout and the like), whereas the opportunity cost of buying another item within a store is comparatively low. This is reflected in the growth of the one-stop-shop concept.

Third, the retailer promotes customer loyalty in various ways, including by reducing the shopper's search costs, in part by providing quality assurance or certification, based on the retailer's own reputation and position in the market. This is more important in relation to infrequently purchased experience goods (generally not grocery products) and some new products. To the extent that consumers benefit from this assurance, they may be prepared to pay a price premium for it.

Finally, retailers rather than manufacturers interface with consumers, and developments in information systems have supplied retailers with very detailed information about their customers and their shopping habits. For various reasons, including cost, this information is often not available, at least in a timely manner, to suppliers. This may help to explain why there may be a difference in buyer power between the vertically integrated chains and the independent wholesalers. Although the former have direct access to consumers, the latter do not and generally they have limited influence over the independent retailers who do.

The existence of greater loyalty to the store than to a particular brand should not be taken to suggest that consumers will not switch retail grocery suppliers. (In Australia, effectively this is likely to mean switching from one national grocery chain to the other.) Such a switch occurred from Coles to Woolworths in the latter half of the 1980s. Such switching may be in response to persistent and significant stock-outs, to changes in relative store offerings with respect to product offering and/or pricing policy, or to innovation by one retail chain, but not the other.

3.2 Possible consequences of buyer power for suppliers and competition

In order to consider how buyer power may adversely impact on suppliers, assume the market for grocery products is characterised by bilateral monopoly

(OFT 1998, pp. 17–18, Rey 2001, pp. 488–492). If the firms recognise their mutual interdependence and neither has sufficient power to impose a price on the other, quantity will be set to maximise joint profits. The price at which the output will be supplied will be between the monopoly price and the monopsony price depending on the relative bargaining strength of the parties. If the bargaining strength of the two is approximately equal, the price may approximate the competitive level. In effect, what is negotiated is the allocation of the economic rents between the parties, although this may have implications beyond mere distributional effects.

Of course, the grocery industry is not a bilateral monopoly. There are currently four major buyer groups, Coles, Woolworths, Metcash, and Foodland, the last two buying on behalf of independent grocery retailers. On the supply side, there are thousands of suppliers, including many within each product group, competing for access to retail space – the chains control that retail space, the independent wholesalers do not. Together with the factors discussed previously, this suggests that bargaining power is likely to be weighted in favour of the supermarket chains in most cases. From a policy perspective, the issue is whether this results in hard bargaining that benefits consumers or whether it results in allocative inefficiency.

Obviously, if as a result of its buyer power the supermarket chains force the return to the manufacturer below normal profit, then in time the manufacturer is likely to exit the market and the retailer will be deprived of supply. Such an exercise of buyer power would seem to be irrational. However, assume that the manufacturer supplies two different types of customers – the first is supermarket chains and the second is independent grocery outlets that are a less cohesive group and so have less bargaining power even when a single independent wholesaler buys on their behalf. Given this, manufacturers could seek to achieve normal profits over all sales by raising the prices charged to the independent sector. This, in turn, will reduce the competitiveness of independent grocery retailers compared to the retail outlets of the chains, causing them to lose market share. The consequent loss of economies of scale will raise unit costs and reduced independent wholesaling activity will further raise retailers' costs. Thus, competition at the retail level may be substantially lessened as an indirect result of an exercise of buyer power.

Conversely, manufacturers unable to secure a supply contract with one of the chains may offer supply to the independent sector on favourable terms. In part, this assumes that manufacturers retain sufficient sales to achieve minimum efficient scale, selling only to the independent sector. It also assumes that, as a consequence, independent retailers do not come to be viewed as supplying mainly second-tier brands.

Even if manufacturers supply to the chains and independents on different terms, rather than discriminate in relation to list prices, the difference may be in the amount of promotional support provided by the supplier to the retailer to fund store marketing and specials. However, the Australian Competition

and Consumer Commission (ACCC) found no evidence to support such claims (see below).

In addition, or alternatively, manufacturers who are 'squeezed' by the supermarket chains may themselves be able to exert buyer power with respect to some of their suppliers. A likely target group is farmers. Griffith (2004, p. 334) provides a summary of the few Australian studies of the relationship between profitability and industry structure in relation to food industries, and he concluded that:

... the empirical literature does not provide any specific indications about whether increasing concentration in food retailing adversely impacts on farm suppliers. Part of the problem no doubt is that the empirical models are searching for significant and persistent deviations from a competitive norm, whereas in the real world, markets are complex and subject to almost continual displacements in one form or another, making it unlikely that any consistent and persistent noncompetitive behaviour could be separated out from the surrounding noise. However, the extensive anecdotal evidence of problems with supply contracts ... would seem to be too pervasive to ignore ...

Farmers often face significant barriers to exit. As a consequence, the response to a reduction in returns may be reduced expenditure on inputs, such as fertiliser, repairs and maintenance, and capital replacement. Over time this may lead to a reduction in productivity. Also significant for farmers supplying direct to the chains are the contractual arrangements for supply and the extent of the discretion of the chains to reject supply, generally, but not exclusively, based on quality. Direct supply to supermarket chains may give growers access to plant variety rights that they could not otherwise acquire, although growers of tree crops are subsequently 'locked in' to supplying the chain, and may reduce grower marketing costs. Nevertheless, to the extent that better supply chain management results in improvement in the quality of produce available to consumers, consumers are better off, and this may result in increased demand. However, as direct supply has become more significant for some horticultural products, it is likely that wholesale markets have become residual markets and, as a consequence, price variability is likely to have increased. If so, this may further reduce the competitiveness of specialty retailers who rely on these markets, and ultimately reduce choice of retailer for consumers.

4. The impact on consumers

Whether attempts by the chains to increase efficiency and/or reduce competition result in adjustment costs in the supply chain is of no significance to consumers so long as such costs are borne by others and consumer choice

is not impaired. The usual view is that although the retail market remains competitive, consumers will benefit from the more aggressive relationship between retailers and their suppliers because, at least in part, savings will be passed through in the form of lower prices.

Cotterill (2005) argues that rather than depressing supply prices, the retail grocery chains may accept prices in excess of competitive levels. This will benefit the supplier because retail prices are typically a percentage mark-up on the supply price. However, this requires that consumer demand is relatively price inelastic, and all retailers receive similar supply prices. The latter may be assured if at least one of the grocery chains has most favoured customer agreements with most suppliers. This hypothesis has not been subject to empirical testing in Australia.

Leaving the Cotterill hypothesis to one side, whether markets that have a competitive structure operate competitively depends significantly on consumer participation in the market. Failure of consumers to engage in price search for whatever reason may result in noncompetitive pricing outcomes. In grocery retailing, where constant adjustment of service and prices occurs, consumers might be expected to engage in continual price search up to the point where the marginal cost of search equals the marginal benefit from search. However, the price and service level of different grocery retailers are difficult to observe and compare in a timely manner. This is due to several factors, such as the large number of items available, the continuous introduction of new items, the introduction of bar-coding that has removed the need for items to bear a price label, and frequent price changes, including temporary reductions when products are on special. The most obvious guide to prices at a particular retail outlet is the amount paid for the weekly groceries, but this varies from week to week as the purchases themselves vary. Furthermore, it reveals nothing about pricing in stores not visited. Thus, consumers have incomplete information regarding prices at any given time.

This creates an environment within which it is possible for retailers to create a reputation based on their price-service offering, and for consumers this becomes a substitute for acquiring comparative pricing information. Given this, consumers identify the best-value package for them and become loyal customers of a particular retailer. As a consequence, search activity is reduced on the assumption that the retailer will maintain this relative value. Consumers have access to partial information regarding the activities of competing retailers, for example from media advertising, and only if this information raises doubts about relative values will search be triggered. If, as a consequence, consumers find that their chosen store has not maintained the value of its offering relative to other stores, they are likely to leave the original store and will be extremely hard to win back. Given this, restoring the original offering will not be enough; a better offering will be needed. This may well have been the reason why Coles supermarkets lost sales in the latter half of the 1980s – they built a reputation for low prices, but their pricing deteriorated relative to their competitors.

Even when information is available, consumers may fail to use it. A developing area of economics, behavioural economics, analyses consumer behaviour and has found that often consumers appear to behave irrationally – for example, they fail to fully utilise information that is available to them that would reduce purchase costs and/or increase satisfaction. Consequently, many consumers assume that large volume products are cheaper per unit than smaller volume products when this may not be correct, but could be verified. Similarly, to the extent that consumers do not compare prices or do not read the listed product ingredients, products that are compositionally identical can be placed in different locations in the store and can be offered at different prices, for example for human consumption and as pet food.

Economists usually assume that consumers value choice and, in part, brand proliferation reflects this. Exercise of buyer power may diminish consumer choice. For example, if manufacturers' returns are reduced and/or they face difficulty and costs in obtaining access to the supermarket shelves, then investment by suppliers, including that in innovation, may be discouraged, adversely impacting on product quality and variety.

The significance of this depends on the extent to which product innovation is deterred or product range is otherwise reduced; the extent to which buyer power facilitates innovation at the wholesale and/or retail level; and the extent to which consumers value choice in grocery products. In relation to the first of these, Rey (2001, p. 494) points out that buyer power is most likely to adversely impact on product quality/variety if supply is imperfectly elastic; buyers are not fully able to appropriate customer gains from quality/variety; buyer demand is in part a function of quality/variety; and different buyers have different preferences for quality/variety. However, aggressively competitive conditions may encourage product innovation and differentiation when there are few alternative retailers. Second, even if suppliers curtail innovation (most new products are produced under licence rather than developed in Australia anyway), innovation or the adoption of new technology at the wholesale–retail level may still confer a net benefit on consumers. Examples include improved supply chain management that results in better quality horticultural products being available to consumers, and the adoption of electronic funds transfer (EFTPOS) that makes payment more convenient. Finally, choice generally imposes higher search costs on consumers. For many basic products, such as groceries, consumers may not place much value on product variation. This is reflected in the significance of house brands and generics in supermarkets in the UK, although not in Australia at present.

Consumers may be made worse off if industry rationalisation deprives them of a preferred retail format. However, there is no evidence to support such a claim. Indeed, as the supermarket chains expanded into rural areas, often with modified formats, consumers switched away from local independent retailers whereas at the same time decrying the demise of local businesses – this might be seen as something of an externality.

5. Policy issues

Since the early 1990s, numerous competition concerns have been raised in relation to the grocery industry in Australia. The high degree of market concentration and the absolute and relative decline of the independent sector have given rise to concerns about the market power of the chains and about fairness in the marketplace. Increased concentration in the grocery industry has caused redistribution between the various participants in the supply chain to the detriment of some. However, empirical study has yet to be undertaken to establish whether on balance there has been an increase in consumer welfare and/or in total welfare.

In Australia, competition issues are dealt with under the Trade Practices Act 1974. At the risk of over-simplifying, the TPA prohibits anticompetitive conduct but does not prevent the acquisition of market power by efficient firms. The policy objective is '... to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection' (S.2). The role of the TPA is not to protect competitors, but to protect the competitive process because usually this ensures economic efficiency, especially dynamic efficiency.¹ To this end, provisions in the TPA prohibit contracts, arrangements, and understandings that have the purpose or effect of substantially lessening competition; mergers that are likely to result in a substantial lessening of competition; and use of substantial market power for an anticompetitive purpose. Other provisions prohibit unconscionable conduct in relation to transactions between large businesses and consumers and between large businesses and small businesses.

5.1 Enforcement

The ACCC has investigated a number of issues in relation to the grocery industry in the last decade or so. These have typically been in relation to mergers or claims of predatory conduct. The mergers between independent wholesalers referred to earlier were assessed to determine whether they were likely to substantially lessen competition, but were ultimately found to be likely to be procompetitive by strengthening the independent sector relative to the chains (*QIW Retailers Limited v. Davids Holdings Pty Ltd & Ors; Attorney General of the Commonwealth v. Davids Holdings Pty Ltd & Anor 1993*; and *Re Queensland Independent Wholesalers Limited 1995*).

However, the gradual acquisition of independent retailers by Coles and Woolworths seems not to be caught by the TPA. Section 50 prohibits the acquisition of assets that has the effect or likely the effect of substantially

¹ To allow for market failure, businesses may seek an exemption (authorisation) from these provisions (except in relation to the use of market power) where the conduct is likely to result in a net benefit to the public.

lessening competition in a relevant market. However, in relation to creeping acquisitions, the difficulty is to establish that any single acquisition is likely to have a substantial effect on competition given the very small market shares generally being acquired. Thus, when Franklins decided to withdraw from Australia in 2001, the ACCC did not prevent acquisition of the Franklins stores by Coles and Woolworths, although it did influence the allocation of the stores between the chains and the independent sector. To establish substantiality, it may be argued that the acquisitions are part of a broader strategy of acquisition and so should be treated jointly, although it is uncertain whether a court would be inclined to accept such a view.

Yet, creeping acquisitions do not merely transfer market share from the independent sector to the integrated chains. Given the significance of economies of scale and scope, they may reduce the competitiveness of the sector, and limit the ability of new independents to enter because they cannot gain access to suitable sites. Proposed legislative amendments, such as capping market shares, may specifically address this issue, but seem likely to give rise to numerous new problems.

Numerous complaints by smaller retailers about the conduct of the major chains have been investigated by the ACCC. A common complaint relates to the chains engaging in predatory pricing, by matching or undercutting the specials offered by small, often specialist, suppliers to draw customers into their stores. These claims have not resulted in litigation. However, in 1999 the ACCC took action against Safeway because of alleged price fixing and resale price maintenance, as well as misuse of market power in relation to the acquisition of bread from the major bakeries (*ACCC v. Australian Safeway Stores Pty Limited* 2001). It was claimed that bakeries supplied small retailers, such as fruit shops and market stalls, with cheap bread that was branded differently from the bakeries' premium branded product because it helped to use spare capacity. When it became aware of such supplies in a particular location, Safeway sought supply on what it described as similar terms, although it actually seemed to be seeking supply of premium brands. If supply on these terms was not forthcoming, it deleted that baker's products and introduced a 'fighting' brand from another baker. On appeal, Safeway was found to have exercised its substantial market power for an anticompetitive purpose.

5.2 Industry inquiries

The National Association of Retail Grocers of Australia (NARGA) has been extremely critical of increasing concentration in the grocery industry and the market power that it believes has been acquired by the national supermarket chains. Thus, despite the Safeway case, NARGA argued that anticompetitive conduct by the chains, especially predatory pricing and price discrimination, is not capable of being caught by the TPA in its current form. As a consequence, NARGA lobbied the government, seeking its intervention in the operation of the industry on behalf of independent retailers.

These concerns, together with more general concerns about the position of small businesses, resulted in a number of government inquiries into the grocery industry. Following a wide-ranging inquiry, the Joint Parliamentary Committee on the Retailing Sector (the Baird Inquiry) (Parliament of Australia 1999) recommended the introduction of a mandatory code of conduct for the major supermarket chains (Recommendation 5). However, although generally supportive of the inquiry's report, in December 1999 the government introduced a voluntary code of conduct that aimed to foster self-regulation in the grocery industry. The Code was not implemented until September 2000, and as a result of concerns about its effectiveness, it seems likely that a mandatory code will be introduced.

Early in 2001, the Senate directed the ACCC to inquire into 'the prices paid to suppliers by Australian grocery retailers for goods they resell, and whether retailers and wholesalers of a similar scale are offered goods on like terms and conditions'. In effect, the inquiry concerned the possibility that pricing discriminated against independent retailers. The ACCC (2002) reported that its inquiries indicated that suppliers in the Australian grocery industry do not favour any particular buyer. The Commission's Media Release of 30 September 2002 stated that:

Major retailers such as Woolworths and Coles have buyer power and while they may obtain better wholesale prices more often than the independent wholesalers, the market does not appear to exhibit anti-competitive conduct ... However, the ACCC's findings need to be put into context as they do not necessarily mean that there is no competition issue. Firstly, the Inquiry was mooted for some considerable period before it occurred. Secondly, trading terms are incredibly complex and may not be fully documented. Thirdly, buyer power may be exercised not only through price discrimination, but also through development of private label products, nonprice discrimination loss leading/selling below cost, and various vertical restraints. Large retailers may have the ability to enter into supply contracts that contain much harsher conditions for suppliers (for example in relation to delivery and product quality) than smaller retailers.

Even if it could be established that price discrimination was occurring, the ACCC (2002, pp. 48–49) concluded that it would be unlikely to breach the TPA. If terms were discriminatory, they were unilaterally imposed by the supplier on nonchain customers and were not the result of an anticompetitive agreement involving the chains. Nor would such discrimination be caught as a misuse of market power by the chains because to do so it would have to be established that the chains (rather than the suppliers) used their market power for an anticompetitive purpose and no doubt the chains would claim that their purpose was to obtain the best possible terms for their customers.

Issues relating to the relationships between small and large businesses were pursued further by the Independent Review of the Trade Practices Act (the

Dawson Inquiry). Notwithstanding the provision in the TPA specifically intended to protect small business from unconscionable (unfair) conduct or dealings by big business, small business claimed that no cases had been successfully prosecuted and it was inadequately protected. These concerns were central to the recommendations by the Senate Economics Reference Committee Report on the effectiveness of the TPA in protecting small business, in March 2004. They included:

1. Clarification of the treatment of predatory pricing.
2. Redefining small business for the purposes of dealing with unconscionable conduct (s.51AC), to be businesses with transactions of less than \$10 million per annum, rather than as at present, \$3 million.
3. Changes to facilitate collective bargaining by small firms when dealing with large suppliers.
4. Strengthening the mergers provision to enable it to deal with creeping acquisitions.

It remains to be seen how these recommendations will translate into legislation.

6. Conclusion

The structural characteristics of the grocery industry are conducive to market concentration and it is often assumed that as a consequence there is a competition problem. However, given the presence of two national supermarket chains that appear to be competitive with one another, it is not evident that this alone gives rise to a competition concern. Indeed, consumers may be net beneficiaries. However, the exercise of buyer power by the chains in relation to their suppliers may indirectly impact adversely on retail competition, especially as barriers to entry into grocery retailing are relatively high, and especially if it reduces the viability of farmers and food processors, causing reduced investment and reduced efficiency. Empirical investigation of these issues is required.

Like past inquiries, future attempts to address alleged competition issues in this industry are likely to focus on the TPA. Although future amendments may make it better able to address such concerns, at present it seems that its effectiveness is limited. However, other policy instruments may be more helpful. For example, to the extent that markets do not operate competitively because consumers fail to engage adequately in price search, policies designed to make it easier for consumers to acquire and process information may assist (e.g., by requiring display of per unit prices as well as the total price of items).

To the extent that there is concern about the survival of independent small retailers, the appropriate policy solution is not to 'prop up' inefficient businesses, but rather to facilitate the development of those businesses that are, or can reasonably be expected to be, efficient. It appears that specialty retailers and larger, independent grocery retailers with attractive store formats, may be

competitive with the chains. In this respect, the acquisition by Metcash of Franklins' outlets on behalf of independent retailers may be one means of achieving this, especially as Metcash is well positioned to judge the viability of the operators. However, ability to compete may be limited by supply conditions that raise the costs of these retailers. The announcement early in November 2005 that Metcash will acquire Foodlands' Australian wholesale and retail operations will confer economies of scale that should help to address the relative cost-competitiveness of supply for independent retailers compared to the chains. Suppliers will benefit from a vigorously competitive and more diverse grocery industry; so too will consumers.

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