





Submission to Senate Economics References Committee

**Inquiry into the Australian Competition and Consumer
Commission (ACCC) Franklins decision**



29 November 2010



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1 Introduction

1.1 The Inquiry

CHOICE appreciates the invitation to comment to the Senate Economics References Committee (Committee) on the Inquiry into the ACCC's announced intention to oppose the acquisition of Interfrank Group Holdings Pty Ltd (Franklins) by Metcash Limited (Metcash). We note the Terms of Reference for the Inquiry:

On 23 November 2010 the Senate referred to this committee for investigation the decision of the Australian Competition and Consumer Commission (ACCC) to oppose the proposed acquisition of the Franklins supermarket business by Metcash Trading Limited, with particular reference to:

- (a) the basis of the ACCC decision to oppose the proposed purchase;
- (b) the competition impacts of the decision at the retail and wholesale levels;
- (c) whether the Franklins' distribution warehouses, supplying eight franchised stores, could be regarded as an independently sustainable wholesale business; and
- (d) any other related matters.

1.2 CHOICE's involvement in the grocery sector

As members of the Committee will be aware from the Committee's recent review of the GroceryChoice proposed website, CHOICE has been active in the area of grocery competition for several years. Grocery competition is an issue that regularly appears at the top of our members' concerns and through its magazine and policy work, CHOICE has:

- promoted mechanisms to improve price transparency, such as unit pricing legislation;
- investigated supermarket loyalty schemes and "shopper docket" petrol discounts;
- reported on sales techniques used by supermarkets to increase spending;
- reported on the expansion of Australia's two large supermarket chains into liquor retailing;
- examined and reported on price promotions that do not offer the value claimed in advertising.

CHOICE staff, including CEO Nick Stace, have also conducted numerous meetings with industry participants on these matters over several years.

Overall, CHOICE is concerned that the structure of the Australian grocery market is not as competitive as it should be and that the duopoly supermarkets have used their position to entrench their power, deny consumers choice and increase prices.

1.3 Status of the transaction

On 29 July 2010 the ACCC commenced a review of the proposed transaction under the “informal” merger clearance process. The timetable for review was suspended for a time before the ACCC published a Statement of Issues on 22 September 2010. On 17 November 2010 it announced that in its view the proposed transaction would contravene section 50 of the *Trade Practices Act 1974* (TPA) and that it would oppose the transaction on competition grounds if the parties were to proceed with the transaction. A public competition assessment has not been issued at the time of this submission.

We understand from media reports that Metcash and the ACCC have agreed to have the matter heard by the Federal Court as soon as possible and that the ACCC has initiated proceedings seeking an injunction.

2 Notes on the Terms of Reference: competition in the grocery market

2.1 Basis of the ACCC’s decision

Term of reference (a) enquires into the “basis” of the ACCC’s decision.

2.1.1 Legal basis

While the Senate probably refers to the factual and analytical basis with the first of the terms of reference, the *legal* basis of the decision is also significant. In a strict sense, there is none: the TPA assigns no specific power or function to the ACCC to provide merger parties with an informal view on proposed transactions.¹ Rather, the current process is based on established convention that the ACCC will review proposed transactions (either confidentially or publicly) and advise the parties of its view against the merger test in section 50 of the TPA. The process is set out in the *Merger Review Process Guidelines 2006* (“Merger Process Guidelines”).

This is significant for two reasons. First, although the ACCC has come to a decision in the general sense, there is no decision in the technical legal sense of being determinative of an issue of fact falling for consideration.²

Second, it is significant because, if the parties disagree with the ACCC’s preliminary view on the competitive effects of the merger, they are not foreclosed from pursuing several other avenues to have the merger assessed under the TPA. They can seek a formal clearance from the ACCC under s. 95AD ff. of the TPA (which limits the ACCC to considering only the

¹ The ACCC’s practice of offering parties clearance could be covered by paragraph 28(1)(a) of the TPA, which is a power to provide *general* information to a business on the functions and powers of the ACCC. This appears to be the basis that the ACCC itself relies on, based on comments in its *Merger Review Process Guidelines 2006*, at least in regard to issuing a Public Competition Assessment (“While the publication of public competition assessments enhances the transparency and accountability of the ACCC’s actions, it has an additional benefit. Over time, a body of detailed reasons for decisions will be established, providing merger parties, their advisors and investors with a reasonable understanding of the ACCC’s approach to merger proposals.” at para. 4.86).

² The ACCC’s decision under the informal merger process is not reviewable under the *Administrative Decisions (Judicial Review) Act 1977* (ADJR Act).

competition effects of the proposed transaction). A formal clearance can in turn be reviewed on the merits by the Australian Competition Tribunal (“Tribunal”) and subject to judicial review. The parties could also approach the Tribunal directly for authorisation under s. 95AT (which then allows the parties to provide evidence of public benefits that outweigh a substantial lessening of competition). Alternatively, they could apply to the Federal Court for a declaration that the transaction will not contravene section 50. Finally – as is the case in this instance – the parties can indicate an intention or desire to proceed with the transaction despite the ACCC’s concerns under the informal procedure and thereby prompt the ACCC to initiate proceedings in the Federal Court. Each of these courses of action has advantages and disadvantages for the merger parties but all remain open even if the parties have approached the ACCC under the informal procedure.

The significance of this to the current Inquiry is that the merger parties are yet to pursue any avenue to having the proposed transaction reviewed that would lead to a “decision” in the legal sense.

2.1.2 Factual and analytical basis of the ACCC’s decision

As the ACCC has not yet issued a Public Competition Assessment in this matter, it is not possible for CHOICE to comment on the factual and analytical considerations which led the ACCC to indicate its opposition to the proposed acquisition.

CHOICE has no reason to believe that the ACCC would have departed from its usual procedures under the Merger Process Guidelines. These procedures have been developed over many years and have formed the basis of a large number of mergers. In this particular case, it is also relevant that the ACCC conducted an inquiry into the grocery sector in 2008. Based on these considerations, there seems little reason to doubt the ACCC was well placed to reach the view it announced on 17 November 2010.

2.2 The competitive impacts of the decision

CHOICE is not in a position to offer the Committee a detailed market analysis of the relevant grocery markets or a full competition assessment. However, as indicated above, CHOICE has campaigned in this area for some time and is able to offer some observations based on its own experience and partly on the findings of the ACCC’s 2008 Grocery Inquiry.³

Relevant markets

CHOICE agrees with the ACCC’s view expressed in its Statement of Issues of the relevant markets, namely that there is a State-based wholesale market and local markets for the supply of groceries at the retail level.

Nature of competition in the grocery sector

In our view, the key to ensuring a competitive grocery sector is to preserve competition at the wholesale level. Although it may once have been possible for independent supermarkets to deal directly with suppliers of standard grocery items, the complexity and range of products

³ *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008 (available at <http://www.accc.gov.au/content/index.phtml/itemId/809228>).

that must be supplied by even the smallest supermarket today makes it impossible for grocery retailers to operate without appropriate wholesale and distribution services. As Smith notes:

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.⁴

In the absence of some regulatory intervention, there appears no prospect of Woolworths or Coles supplying wholesale services to their retail competitors to any significant extent. Central to their business model is combining a complex arrangement of supplier agreements with their own logistics operations and extensive retail presence to operate an integrated supply chain. ALDI operates on a similar model but with a focus on supplying grocery items itself from local and foreign sources.

In Australia, the competing model to the integrated supermarket chain has been a combination of centralised distribution through one company, delivering grocery items under agreements (usually exclusive agreements) to independent and franchised retail stores. This is the model operated by Metcash nationally (through its IGA>D distribution business) and by others such as SPAR in some states. Franklins operated a hybrid model that combined a number of its own retail stores with some independently owned outlets.

Accordingly, in New South Wales, the merger of Franklins' and Metcash's distribution businesses would create an effective monopoly at the wholesale level of the market.

The interaction between wholesale and retail markets

The most obvious response to concerns about wholesale concentration would be that retail competition would impose competitive discipline on wholesale suppliers. However, in CHOICE's view there is little evidence that this would be the case.

In its 2008 Inquiry, the ACCC found:

... Metcash appears to price under the umbrella set by the MSCs [major supermarket chains]. The ACCC has found no evidence that Metcash sets wholesale prices that enable independent retailers to aggressively pursue market share through price discounting. Evidence indicates that Metcash-supplied independent retailers who compete aggressively with the MSCs on price achieve small net margins on the products that Metcash supplies to them. These retailers do this to attract sales on products they do not source from Metcash, such as fresh produce, on which they achieve larger margins.⁵

The ACCC also noted that Metcash has consistently improved its EBITA performance. Since the Inquiry Report was published, Metcash's EBITA has continued to increase, from \$335.1 million in 2008 to \$382.5 in 2009 and \$415.4 in 2010. Against the background of a struggling economy and in a period when food inflation has been very low, it seems inconsistent with the proposition that wholesale suppliers were constrained by retail competition that their earnings would show such robust growth.

⁴ R. L. Smith, "The Australian grocery industry: a competition perspective", 50 *Australian Journal of Agricultural and Resource Economics*, 33-50 at 35.

⁵ ACCC Grocery Inquiry 2008, p. 128.

Although CHOICE has not been able to conduct market research, our own experience and anecdotal reports are consistent with the ACCC's results. There is little evidence that Metcash-supplied independents provide aggressive price competition to the major chains and in fact they may in many cases be more expensive. Although this may be due to other costs incurred by the smaller stores, CHOICE does not consider that Metcash enables the stores it supplies to engage in discounting.

Rather than Metcash being constrained in the exercise of market power, the competitive dynamic is that Metcash can price its wholesale offerings using the prevailing retail prices as a benchmark.

Proposed undertakings under section 87B

Metcash has offered undertakings under section 87B of the TPA that it will not enforce exclusivity at the wholesale level. However, this undertaking was offered in the knowledge that Coles and Woolworths have no incentive to offer wholesale products to competing retail suppliers, so that independent retailers would have no option but to obtain supply from Metcash.

2.3 Whether the Franklins' distribution warehouses, supplying eight franchised stores, could be regarded as an independently sustainable wholesale business

Term of Reference (c) raises one possible situation that might arise if the proposed transaction does not proceed. CHOICE cannot provide the Committee with a commercial assessment of that situation but it would seem very unlikely that such a business would achieve the economies of scale necessary to be an effective competitor.

This counterfactual is only one of several that may result if the proposed transaction does not proceed. Franklins currently operates 77 of its own retail stores and a possible alternative is that an existing market participant in either NSW, another state or from overseas would seek to purchase the entire business and either use it to expand an existing business or as a basis for future expansion.

2.4 Conclusion on matters raised by the terms of reference

Overall, CHOICE is of the view that Metcash's acquisition of Franklins would be likely to contravene section 50 of the TPA. Further, we do not consider that the most likely counterfactual would be that outlined in Term of Reference (c) is the inevitable outcome if the proposed acquisition does not proceed.

However, CHOICE is not equipped to make a full assessment of the matters raised by the Terms of Reference and in section 50 of the TPA. The ACCC is the proper body to undertake the complex analysis required to make the competition assessment and CHOICE is not aware of any consideration that should cause the Committee to doubt the ACCC's capacity to make that assessment.

3 Concerns regarding this Inquiry

CHOICE takes the opportunity to express its concern at the involvement of the Senate Economics Committee in reviewing the transaction and respectfully submits that the Senate should discontinue the Inquiry.

There are several grounds for this concern:

- the review of individual ACCC decisions by the Committee creates an avenue of merger review that is without a basis in the TPA and which lacks clarity as to process, the evidence to be considered and the nature of findings or recommendations that may result;
- the terms of reference developed by the Senate in this case are not the same as the tests and factors the ACCC is required to apply under section 50 of the TPA, which will cause considerable uncertainty as to the proper basis of assessment of the proposed acquisition;
- in addition to the standards set out in the Terms of Reference, the inherently political nature of a Senate Inquiry creates a risk that other, unstated considerations will influence the Committee's findings;
- the prospect of review by the Committee is likely to make the ACCC unduly conservative in its approach to assessing mergers informally and may cause the ACCC to limit the availability of this procedure;
- it is likely the ACCC will have to re-allocate resources from other merger tasks (including preparation for the Federal Court proceedings relating to this transaction) in order to prepare submissions and appearing before the Committee;
- the precedent of reviewing individual proposed transactions in this way creates the risk that parties disappointed by the ACCC will in the future seek intervention by approaching the Senate to conduct similar inquiries.

As discussed above, there are numerous forms of review available to merger parties if they consider the ACCC's informal views to be incorrect. All of these forms of review allow the relevant decision-maker to consider the competition matters raised in the Terms of Reference for this Inquiry. At the election of the parties to the transaction, the authorisation procedure also expressly allows the Tribunal (and any courts reviewing the Tribunal's decision) to consider public interest matters beyond competition and expressly empowers the Tribunal to consult with third parties (under s. 95AZD) and requires it to consider submissions from any party.