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Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Email: economics.sen@aph.gov.au

Dear Sir or Madam,

Definition of Unconscionable Conduct

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

The question of unconscionable conduct is key to the interests of NARGA's members as both independent grocers themselves and their suppliers can be on the receiving end of such behaviour.

Up until now, in spite of concerns about practices in the sector, few cases have been successfully prosecuted under the unconscionable conduct provisions of the Trade Practices Act 1974. Cases that do go to court often do not result in a win for the aggrieved party because, we believe, of a lack of a clear definition of what constitutes such conduct and the tendency by courts to only recognise extreme examples.

Clarification of the definition of unconscionable conduct will result in a clearer understanding within industry of the type of behaviour that could attract prosecution under the Act and act as a deterrent to such behaviour.

The independent grocery sector now comprises less than 20% of the national grocery market, yet provides essential supplies to thousands of regional and remote communities, particularly those considered too small to be of interest to the major supermarket chains, as well as providing competitive pressure to those chains through larger stores in metropolitan and regional centres. Independent grocers also employ 53% of people in the sector.

A detailed review of the sector is provided by the attached study by Pricewaterhouse Coopers titled: *'The economic contribution of small to medium-sized grocery retailers to the Australian economy, with a particular emphasis on Western Australia.'*

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The ongoing viability of the independent network is dependent on their share of the market not shrinking to the stage where that wholesaling and distribution network becomes unviable, and on the survival of a wide range of suppliers to the sector capable of supplying goods and services at competitive prices.

This is highlighted in the above report:

As the wholesale and distribution arm of independent retailers, Metcash can effectively balance the bargaining power of the MGRs. It allows independent retailers to purchase as a single entity at competitive wholesale prices and gain the benefit of certain economies of scale that make independent retailing financially viable.

p.17

and:

There is also the "critical mass" argument; the concern that if independent grocery sales in WA were to fall by even 20%, it may not be viable any longer to keep the WA warehouse of IGA-Distribution (IGA>D) open. This would have a significant impact on local communities in WA, the WA economy and employment levels in particular.

p.44

Viability concerns extend to other sectors of the economy, particularly the farming community, as evidenced by the following statements from the report:

In addition, the decisions by a large number of retailers (varying in terms of size and demand) to source supplies from Australian producers and manufacturers play a pivotal role in the viability of many smaller primary producers and the continuing health of the Australian food manufacturing sector.

p.7

and:

In future, SMEs may play an even greater role in contributing to the viability of many smaller primary producers. SMEs generally require smaller quantities and whilst their bargaining power is gaining strength through banner groups and their alliance with Metcash, they have the opportunity to procure their products independently of Metcash. This arrangement increases the potential for the benefits of increasing retail prices to be shared by retailers and producers.

p.37

There are, however, many suppliers of grocery items whose ongoing viability is threatened by the behaviour of the major grocery chains as evidenced by the submissions made to the recent inquiry into the grocery sector conducted by the ACCC. The fact that suppliers were reluctant to give evidence to the inquiry of such practices is of itself evidence of that fact and is of concern:

*'...however, there were some complaints of buyer power being exercised where the complainant appeared to be genuinely reluctant to provide information to the ACCC out of concern about retribution if details were provided to the ACCC and investigated.'*¹

Such concern is based on the reality that any supplier that complains to the regulator is reliant on the two major supermarket chains for up to 80% of its turnover by volume, business that may not continue if that claim is investigated by the regulator – regardless of the outcome of that investigation. That is, of course, given that the regulator is of a mind to take action.

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¹ Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries, ACCC Canberra, July 2008 p357 (ACCC)

3.

There is a wide range of practices that affect the ongoing viability of suppliers, practices that exploit the difference in 'bargaining power' between the particular supplier and each of the major chains. These include:

- Unilateral changes in contracts or terms of trade, even after goods have been delivered;
- Demands for substantial levels of promotional expenditure;
- Demands for rebates on a wide number of pretexts;
- Demands for substantial slotting fees or ranging fees;
- Demands for preferential trading terms or settlement terms and / or further discounts for paying 'on time';
- Requiring suppliers to provide in-house staff to manage product range;
- Demands for exclusive access to products or packs;
- Transfer of risk back to suppliers;
- Transfer of cost back to suppliers;
- Requirement for a 'best price' guarantee;
- Return of unsold stock;
- Demands for bonus product – e.g. 15 to the dozen, sometimes 'off invoice';

Each of these practices relies on the power difference in the relationship between the supplier and the major chain. Suppliers live under a constant threat of delisting – especially in the current environment in which both major chains are increasing their range of private label products.

These practices also impact on the wider competitive environment as more favourable terms given to or demanded by the majors can result in higher prices for the independent, reducing their capacity to compete. This is referred to as the 'waterbed effect'.

NARGA gave evidence to the ACCC of an extreme case of the waterbed effect in the market for fresh milk. Here the price demanded by the majors for private label milk is so low that the wholesale price for the branded product has had increased at a faster rate – accentuating the difference between branded milk – more often sold in independent stores and convenience outlets – and private label brands. We also showed that, even though these private brands were sold to the public at significantly lower price than the equivalent branded product – the profit margin available to the major chain was higher.

It is clear that these practices have anti-competitive effects as the discounts offered are not merely related to economies of scale - they are the clear result of the stronger position that

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the major chains are in vis-à-vis their suppliers. They ensure, in the absence of a legislated prohibition on price discrimination, that the major chains can, in general, purchase their supplies at a lower price than independents can, a price that does not merely reflect the benefits attributable to the quantity of the purchase. In this way the competitive playing field is tipped in favour of the major chains.

The ACCC in its report did not, however, address the question of whether these practices were cases of the majors 'taking advantage' of their power in the market concluding instead that:

*'The inquiry was provided with little evidence to substantiate allegations of buyer power being exercised in an anti-competitive or unconscionable manner.'*²

This conclusion contrasts with that reached by the UK Competition Commission³:

10.11 We find that the exercise of buyer power by certain grocery retailers in relation to their suppliers of groceries, through the adoption of supply chain practices that transfer excessive risks and unexpected costs to those suppliers, is a feature of the markets for the supply of groceries by all grocery stores, which prevents, restricts or distorts competition in connection with the acquisition of groceries by large grocery retailers and some wholesalers and buying groups.

It should be noted here that the UK market is far less concentrated than is the Australian market, making suppliers less reliant on any one retailer.

ACCC did, however, record the fact that the major chains have the upper hand in negotiations with suppliers, but did not see that as a problem for them or for competition in the markets⁴:

Unless a supplier of a product has a powerful brand (or is able to build such a brand) which the MSCs perceive as important to a category, the terms that can be negotiated with the MSC will tend to favour the MSC and from the supplier's perspective may erode over time. This broad, but not universal, trend is reflected in the ACCC's analysis of supply terms over time.⁴ Further, in some cases, the MSCs were able to shift costs to suppliers and effectively unilaterally alter the terms on which goods are supplied, even after delivery.

The ACCC considers that this is a consequence of lack of real alternatives for the supplier in these instances.

Where a supplier has no 'real alternatives' he must capitulate to the demands of the chains or go out of business.

The question now arises as to when these practices are evidence of an abuse of market power and at what point are the practices seen as 'unconscionable'.

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² Ibid, p.357

³ The supply of groceries in the UK market investigation, Competition Commission, London, April 2008, p.179

⁴ ACCC, p.480

5.

A cursory examination of Australian case law suggests that courts are reluctant to typify behaviour as unconscionable – even in cases where the average person would have put the behaviour beyond the pale of reasonableness.

This suggests that one of the benefits of parliament providing a clear definition of 'unconscionable behaviour' may serve to reset the meter by bringing the definition of such behaviour closer to what the average person would see as unacceptable.

So how do other jurisdictions manage the issue?

In the UK the Competition Act 1998 prohibits any agreements that '*have as their object or effect the prevention, restriction or distortion of competition...*' Practices similar to the ones above, unconscionable or not, clearly do.

The USA deals with unconscionable conduct under contract law at both federal and state levels. Whilst in Australia unconscionable conduct is proscribed in both federal and state laws, it is not defined.

So what are the elements of conduct that is unconscionable? We would suggest the following:

- A significant difference in the negotiating or bargaining power of the parties, This difference could be based on (but not limited to):
 - Relative size or financial strength
 - Knowledge or understanding of the agreement or its consequences
 - Access to better or more timely advice
 - Differing levels of experience
- The presence of terms (or in cases where terms are not set out, practices or outcomes) in an agreement that unduly advantage the larger party and could be shown to be the result of the difference in bargaining power;
- The presence of a factor or factors that have either directly or by implication forced the minor party to accept terms that are disadvantageous;
- An understanding that either the terms of the agreement or the factors forcing its acceptance are seen to be unfair to the minor party;
- Evidence that suggests that the agreement would have been made on different terms had there not been a significant disparity in bargaining power or had there not been any factor present that forced the minor party to accept the terms in the agreement.

The following definition is offered of unconscionable conduct:

Unconscionable conduct occurs where a significant difference exists between the negotiating or bargaining powers of parties in an agreement and the stronger party exploits that difference to the substantial disadvantage or detriment of the weaker party.

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Having clarified what constitutes unconscionable conduct, we are still faced with the problem that suppliers will not complain about or take action against their larger customers who they rely on for the larger part of their sales volume, on the basis that they want that relationship to continue.

Historical evidence suggests that suppliers have gone out of business trying to maintain their relationship with the major chains, rather than take action against the chains.

One way that the parliament might change the Act in order to encourage affected parties to come forward would be to make it clear within the Act that the Courts can order the payment of substantial damages in cases where unconscionable conduct is proven and / or the establishment within the Act of substantial penalties for non-compliance.

Summary

NARGA confirms that the question of unconscionable conduct is of concern to the independent grocery sector and that we would like to see the issue addressed by:

- The development of a clear definition of unconscionable conduct and its inclusion in the Act;
- Better recognition by the regulator and the courts of the potential for damage to competition in the Australian economy through unconscionable conduct;
- A greater willingness by the regulator to address such matters;
- The development of guidelines as to what constitutes unconscionable conduct that the ACCC is prepared to act against; and
- Inclusion in the Act of guidance to the court as to the awarding of damages and / or substantial penalties for non-compliance.

Please contact us should you require further detail.

Yours sincerely

Ken Henrick
Chief Executive Officer