



Australian
Competition &
Consumer
Commission

22 September 2010

Statement of Issues — Metcash Trading Limited - proposed acquisition of Franklins Supermarket Business

1. Outlined below is the Statement of Issues released by the Australian Competition and Consumer Commission (ACCC) in relation to the proposed acquisition of Interfrank Group Holdings Pty Ltd (**Franklins**) by Metcash Trading Limited (**proposed acquisition**).
2. A Statement of Issues published by the ACCC is not a final decision about a proposed acquisition, but provides the ACCC's preliminary views, drawing attention to particular issues of varying degrees of competition concern, as well as identifying the lines of further inquiry that the ACCC wishes to undertake.
3. In line with the ACCC's *Merger Review Process Guidelines* (available on the ACCC's website at www.accc.gov.au) the ACCC has established a secondary timeline for further consideration of the issues. The ACCC anticipates completing further market inquiries by 15 October 2010 and anticipates making a final decision on 11 November 2010. However, the anticipated timeline can change in line with the *Merger Review Process Guidelines*. To keep abreast of possible changes in relation to timing and to find relevant documents, market participants should visit the Mergers Register on the ACCC's website at www.accc.gov.au/mergersregister.
4. A Statement of Issues provides an opportunity for all interested parties (including customers, competitors, shareholders and other stakeholders) to ascertain and consider the primary issues identified by the ACCC. It is also intended to provide the merger parties and other interested parties with the basis for making further submissions should they consider it necessary.

Background

5. On 29 July 2010, the ACCC commenced a public review of the proposed acquisition after receiving a submission from Metcash Trading Limited (**Metcash**) seeking ACCC clearance of its proposed acquisition of Franklins.

The parties

Metcash

6. Metcash is an Australian Stock Exchange listed marketing, wholesaling and distribution company that services independent grocery retailers throughout Australia.
7. Metcash is Australia's largest independent grocery, fresh produce and liquor wholesaler and distributor. Through its IGA Distribution (IGA>D), IGA Fresh (IGA>F), Campbells Wholesale and Australian Liquor Marketers businesses, Metcash is a wholesaler and distributor of groceries and liquor to independent grocery retailers. In addition, Metcash provides marketing and promotional services to independent grocery retailers. Metcash also provides expansion support to independent retailers, including loans, leasing retailing sites on behalf of retailers and holding head leases.

Franklins

8. Franklins is owned by Pick n Pay Retailers (Pty) Ltd (**Pick n Pay**), a South African company.
9. Franklins supplies 88 Franklins branded stores throughout NSW. Franklins owns and operates 80 stores (**the corporate stores**) and supplies eight franchise stores, which are owned and operated by Franklins franchisees (**the franchise stores**).
10. In 2005 Franklins established its own distribution and logistics capabilities and buying team after terminating its supply arrangements with Metcash. Franklins stores are supplied via two leased distribution centres. Picking, packing and transport services at the Franklins distribution centres (**DCs**) are provided by third party logistics contractors. As a result, the ACCC considers that Franklins is a wholesale supplier of grocery items to at least the Franklins franchisees.

The transaction

11. On 1 July 2010, Metcash entered into an agreement with Pick n Pay to acquire the shares of Interfrank Group Holdings Pty Ltd. The agreement is conditional upon ACCC approval. The proposed acquisition would involve the acquisition of 80 Franklins corporate stores. Metcash would also take over Franklins' franchise agreements, and in relation to the franchise stores would:
 - retain the role of franchisor;
 - retain the role of landlord/lease holder, where that is currently the case; and
 - continue to be bound by the terms of the franchise agreements, including the obligations regarding supply to franchisees.

12. The ACCC understands that the franchise stores would not be automatically re-branded as IGA stores and franchisees would be able to choose whether or not to remain as Franklins franchisees.
13. Metcash proposes to implement a store sale program to sell the Franklins stores to new or existing independent retailers. Metcash would operate the stores whilst the store sale program is completed.

Industry background

14. There are many different grocery retailing models in Australia, ranging from full vertical integration to a complete split of ownership and control between retailing and wholesaling.
15. In 2008 the ACCC conducted a thorough examination of the grocery supply chain. The findings of the ACCC were published in the ACCC's *Inquiry into the Competitiveness of Retail Prices for Standard Groceries (Grocery Inquiry)* report.
16. There are three distinct levels in the supply chain. These are discussed below.

Retailers

17. The current market participants at the retail level can be broadly categorised as outlined in the table below.

Table 1 Retailing models in Australia

Approximate description of level of vertical integration	Stores which fit the description
VERTICALLY INTEGRATED RETAILERS	
Full vertical integration between retailing and wholesaling	ALDI, Coles, Woolworths (other than Tasmania) and the 80 company-owned Franklins stores (as distinct from the franchise stores) ALDI, Coles and Woolworths have their own wholesale operations. However, they only supply grocery items to their own stores
INDEPENDENT RETAILERS	
The wholesaler has a 'banner' agreement with the retailer, which gives the wholesaler some limited influence over the retailer's operations (e.g. branding, promotions). In some cases the wholesaler also owns a minority interest in the retailer, which may increase the wholesaler's level of influence/ control	Most of the IGA branded stores in Australia (the wholesaler is Metcash) Metcash owns a minority interest in some IGA stores and chains of IGA stores, such as Ritchies
The wholesaler has a franchising agreement with the retailer, which gives the wholesaler some influence over the retailer's operations (e.g. branding, promotions, range)	SPAR, some Franklins stores and some IGA stores
The wholesaler is run as a joint venture	Tasmanian Woolworths, IGA and independent stores each have an interest in Tasmanian Wholesaler Statewide Independent Wholesalers
A collection of retailers have a 'banner group' agreement, which gives the collective a degree of control over each retailer's operations. The collective negotiates with wholesalers on behalf of all the stores	FoodWorks (which acquires dry groceries as a collective from Metcash)
Independent retailers who have no banner group agreement or shareholding links with wholesalers	Non-IGA independents supplied by Metcash

18. At the retail level, the vertically integrated supermarket operators compete not only with each other but also with independent retailers. The level of competition differs depending on factors such as the size, product range and proximity of the stores. Retailers compete to attract customers on price, service levels, convenience, brands, community involvement, loyalty programs, discounts, promotions and other factors.
19. Retailers vary in many ways, including the range of stock, the size of the store, prices, service levels, and as a result how these stores are seen by consumers. The ACCC has received information from market participants suggesting that Metcash supplied retailers in NSW are viewed by many consumers as convenience-style stores, where the range and size of the store

is limited and prices are expected to be higher than those of competing full-line supermarkets.

20. These market participants submitted that Franklins, on the other hand, is seen by consumers as having a greater range, generally larger stores and more competitive prices, and is therefore considered as offering a comparable experience to Woolworths and Coles, which offer consumers a full-line supermarket. However, the ACCC notes that certain market participants disagree with these characterisations of IGA and Franklins supermarkets.

Wholesalers

Metcash

21. Metcash's IGA>D business is Australia's largest grocery wholesale distribution and marketing company with six major DCs located in New South Wales (two DCs), Queensland, Victoria, South Australia and Western Australia. From these DCs IGA>D distributes packaged grocery products (dry, chilled and frozen) and general merchandise across Australia. Metcash carries approximately 29,000 grocery product lines.
22. IGA>F distributes fresh produce, meat, delicatessen and bakery product nationally, with a distribution network underpinned by ten dedicated fresh produce warehouses and two meat processing facilities.
23. Metcash supplies independent retailers under the IGA banner including Supa IGA, IGA, IGA X-press and Friendly Grocer. 'IGA' is a registered trade mark of IGA Inc under licence to Metcash Trading Limited.
24. Metcash also supplies retailers under the FoodWorks banner and other non-branded independent retailers.

Franklins

25. Franklins' wholesaling operation is comprised of two DCs, one for fresh produce and one for packaged groceries. The Franklins DCs are operated on behalf of Franklins by two third party logistics operators.
26. The two Franklins DCs collectively hold approximately 18,000 lines of stock. Approximately 90% of the stock purchased by Franklins is delivered into these warehouses, with the remainder delivered directly to stores.

SPAR

27. SPAR Australia Limited (**SPAR**) is a Queensland based wholesaler of grocery products. SPAR's major activities include:
 - procurement, storage, and distribution of fast moving consumer goods;
 - liquor warehousing and distribution services;

- marketing and retail support services to SPAR and 5 Star supermarket outlets;
 - retailer training programs; and
 - retail property development.
28. SPAR supplies grocery products and marketing and retail support services to approximately 300 independent retail supermarkets including the SPAR and 5 Star banner groups. The majority of SPAR-supplied supermarkets are located in Queensland, although SPAR also supplies some retailers in New South Wales, the ACT, Northern Territory and Pacific Island areas.
29. SPAR's distribution centre is located in QLD and carries approximately 14,000 dry grocery lines. SPAR is able to supply a further 2,000 frozen/chilled product lines warehoused under contract through VersaCold Logistics' Coldstore distribution centre in Murarrie, QLD.

Other

30. The ACCC understands that there exist other specialist wholesalers that supply certain products to independent retailers in NSW, but inquiries indicate that none of these have the ability to supply all or even most of the needs of a full line supermarket.

Products sold in supermarkets

31. Most products sold by supermarkets are packaged groceries, which comprise dry, frozen and chilled groceries. The ACCC understands that the majority of packaged groceries are sourced from their producers and manufacturers by wholesalers on a state or national level, reflecting the long shelf life of these products.
32. Fresh produce, which includes fruit, vegetables and bread, has a limited shelf life and is often sourced direct to store by retailers, rather than through a warehouse, on a state or local level.
33. The main wholesale acquirers of the products sold in supermarkets are vertically integrated retailers, such as Coles Group Limited (**Coles**), Woolworths Limited (**Woolworths**) and Franklins, and wholesalers such as Metcash. Other acquirers of grocery products include specialist stores, convenience stores and other independent wholesalers, such as SPAR.

The ACCC invites market participants to comment on wholesale supply options

The ACCC invites comments from market participants regarding the ability of full line supermarket retailers to obtain supply from wholesalers other than Metcash, Franklins and SPAR. Please provide details of the wholesalers, including details of the type of products supplied, the ability of these wholesalers to supply independent retailers in diverse geographic areas and the ability of these wholesalers to begin supplying additional products (such as fresh produce).

Please also provide any relevant information or examples of additional transaction costs and/or inconvenience associated with obtaining supply from multiple sources rather than from a single wholesaler.

Areas of overlap

Wholesale

34. The operations of Metcash and Franklins overlap in the wholesale supply of grocery items and the provision of other marketing/brand support services to independent retailers in NSW.
35. The ACCC notes that independent retailers can and have switched between Metcash and Franklins for supply of grocery items and marketing and brand support services.
36. Metcash and Franklins also provide banner and marketing support to retailers; for example the IGA banner, which is provided under a licence agreement from Metcash, and the Franklins banner, which is owned by Franklins.
37. The ACCC notes there is a key difference between Metcash and Franklins in terms of their wholesale supply to independent retailers. To date, with very limited exceptions, Franklins has chosen to provide wholesaling services to the Franklins franchisees only (and the corporately owned Franklins stores), whereas Metcash supplies both IGA and non-IGA branded retailers.

Retail

38. The operations of Franklins and Metcash overlap indirectly at the retail level, via competition between Franklins retail stores and Metcash-supplied independent retailers.
39. Post-acquisition, the Franklins supermarket stores are likely to be owned or operated by independent IGA store operators. Accordingly, the ACCC considers that there is potential overlap between individual IGA and Franklins retail supermarket stores within local retail areas.

Procurement

40. The operations of Metcash and Franklins overlap in their procurement of products sold in supermarkets from growers and manufacturers of grocery items.

With/without test

41. In assessing a merger pursuant to section 50 of the *Trade Practices Act 1974*, the ACCC must consider the effects of the transaction by comparing the likely competitive environment post-acquisition if the transaction proceeds (the “with” position) to the likely competitive environment if the transaction does not proceed (the “without” position or “counterfactual” position) to determine whether the proposed acquisition is likely to substantially lessen competition in any relevant market.
42. There are a number of possible counterfactuals which the ACCC is exploring in relation to its assessment of the proposed acquisition. These counterfactuals include:
 - Pick n Pay continues to operate Franklins (**counterfactual 1**);
 - Franklins is sold to an alternative single buyer or consortium (**counterfactual 2**); and
 - the sale stores would be sold off individually or in groups and would continue to be operated as supermarket stores, while the wholesaling operations would be closed down (**counterfactual 3**).
43. The ACCC has received conflicting information from market participants in relation to the likely situation without the proposed acquisition.
44. The ACCC notes that some interested parties have suggested that counterfactual 1 is highly unlikely to occur due to the recent performance of the business and the investment strategy of its owner. Similarly, certain market participants have suggested that there is no other likely acquirer for the Franklins business, indicating that counterfactual 2 is unlikely to eventuate.
45. However, the ACCC has also received information indicating that Pick n Pay’s incentive in the absence of an acceptable bid would be to continue to operate the business in the short to medium term (at least). The ACCC has also received information supporting the view that there are other parties who would wish to acquire the wholesale and retail business or alternatively the retail stores if given the opportunity.
46. On the basis of information received to date, the ACCC has not yet ruled out any of these three possible counterfactuals and will make an assessment as to the likelihood of each counterfactual prior to making its final decision in this matter.

47. The ACCC notes that the analysis of possible competition issues is likely to differ to some degree depending on whether each of the above counterfactuals is considered likely. Where the competition analysis is contingent on one of these possible ‘without’ scenarios, this is identified at the relevant point of this Statement of Issues.

The ACCC invites market participants to comment on the likely counterfactual

The ACCC invites market participants to provide information and evidence as to the likely competitive environment if the proposed acquisition does not proceed, including specific information to assist the ACCC in forming a view as to the likelihood of counterfactuals 1, 2 and 3 identified above occurring.

Market definition

48. The ACCC’s preliminary view is that the following markets are relevant to the proposed acquisition:
- the wholesale market for the supply of packaged groceries to independent supermarket operators in NSW;
 - the wholesale market for the supply of fresh produce to independent supermarket operators in NSW;
 - the market for the supply and distribution of grocery products¹ to consumers in NSW (encompassing both wholesale and retail dimensions);
 - the NSW market for the procurement of grocery products by wholesalers from suppliers and growers; and
 - local markets for the retail sale of grocery products in supermarkets.
49. The ACCC considers that there are several distinct fields of rivalry in this industry, which overlap to some extent. The rivalry manifests itself not only at a local level between individual retailers and at a wholesale level between individual wholesalers, but also more broadly between vertically integrated chains and others. As the ACCC takes a purposive approach to market definition, it has defined each of these areas of rivalry as a distinct relevant market for the purpose of this analysis.

Wholesale markets

50. The ACCC is of the view that the wholesale supply of packaged grocery products to independent retailers and the wholesale supply of fresh products to independent retailers form separate markets.

¹ Defined broadly to mean products sold in supermarkets.

51. While there are a number of alternative wholesale suppliers of fresh produce, there are only two (or at most three)² potential wholesale suppliers of packaged groceries to independent supermarket operators in NSW.
52. While there appears to be some degree of demand side substitutability between certain types of fresh produce and packaged groceries, there are functional differences between fresh produce and packaged groceries.
53. Substitution between fresh fruit and vegetables and packaged groceries, such as frozen or canned fruit and vegetables, is only likely to occur at the margins.
54. On the supply side, on the basis of information received to date, the ACCC does not consider that wholesale suppliers of packaged groceries are close substitutes for fresh produce wholesale suppliers to independent supermarkets.
55. Supplying fresh produce requires different infrastructure, including specialised warehousing expertise and distribution mechanisms. Therefore the ACCC considers that packaged wholesale suppliers are unlikely to be able to easily switch to supplying fresh produce as a result of the specific nature of fresh produce wholesaling.
56. The ACCC considers it is even less likely that fresh produce suppliers could easily switch to supplying packaged groceries given that supplying packaged groceries requires greater scale and infrastructure than fresh produce supply.
57. Market inquiries indicate that obtaining wholesale supply of packaged groceries or fresh produce from a wholesaler outside of NSW is not viable for the majority of retailers. Accordingly, the ACCC takes the preliminary view that the geographic dimension of the markets is appropriately defined as being limited to NSW.
58. The ACCC recognises that vertically integrated chains may have some role within these markets, but that role is limited. While most vertically integrated chains do not compete directly to supply independently owned retailers (Franklins being an exception to this), vertically integrated chains provide some degree of indirect competitive constraint through retail competition. However, the most direct constraint on wholesale suppliers comes from other independent wholesalers. Evidence presented to the ACCC in the Grocery Inquiry suggests that independent wholesalers have a degree of pricing power which is not eliminated by the indirect constraint posed by vertically-integrated chains.³
59. The ACCC therefore considers that the relevant markets are:

² This depends upon whether SPAR, a Queensland-based wholesaler, is considered a potential wholesaler. The ACCC's inquiries have indicated that SPAR is not generally considered a real alternative in terms of wholesale supply of packaged groceries for full line supermarkets in NSW.

³ This degree of pricing power is likely to be sufficient for a hypothetical monopolist to impose a SSNIP to independent retailers.

- the wholesale market for the supply of packaged groceries to independent supermarket operators in NSW; and
- the wholesale market for the supply of fresh produce to independent supermarket operators in NSW.

Market for the supply and distribution of grocery products to consumers in NSW

60. The ACCC has considered that the proposed acquisition may affect an overarching market that includes both wholesalers and retailers. This market could be characterised as the NSW market for the distribution of grocery products via vertically integrated supermarket chains and independent wholesalers supplying independent retailers.⁴
61. As noted at paragraph 18, the level of competition between supermarket operators depends on factors such as the size of the store, product range and service levels. The ACCC considers that large vertically integrated supermarket operators (such as Woolworths and Coles) compete most closely with each other, particularly on price and product range. The ACCC considers that smaller non-vertically integrated stores (such as IGA and other Metcash-supplied retailers) provide limited price competition to the major supermarket chains and are more likely to compete on factors such as convenience and service levels.
62. This market includes both the wholesale and retail levels of activity. As noted in its Grocery Inquiry report, the ACCC found that competition between independent retailers and the major supermarket chains (Coles and Woolworths) does competitively constrain Metcash to a degree. As such, while Metcash does not operate as a retailer, but rather is the wholesale supplier to retailers, the ACCC is of the view that it also relevant to analyse the proposed transaction in the context of a broader market that encompasses the supply chains of both the vertically integrated supermarket chains and the Metcash/independent retailer relationship.

Local retail markets

63. With respect to the retail markets, the ACCC considers that the relevant markets should include supermarket retailers operating under a range of different retail business models including the vertically integrated chains, franchises, members of buying groups and independent retailers supplied by Metcash.
64. In previous matters the ACCC has generally considered, as a starting point, the geographic scope of local supermarket markets to be the area within a 3-5km radius surrounding the supermarket to be acquired. However, in assessing the relevant market in any supermarket acquisition the ACCC will consider geographic factors, such as the layout of roads in the area or the rural

⁴ A similar market definition was considered by the Trade Practices Tribunal in *Re. QIW Ltd* (1995) 132 ALR 225.

location of stores, which are potentially important when defining the geographic scope of a local market.⁵

Procurement market

65. Consistent with its consideration of previous supermarket acquisitions, the ACCC has also considered the proposed acquisition in the context of a state-wide (NSW) market for the procurement of products sold in supermarkets by supermarket wholesalers (including vertically integrated supermarket chains which provide their own 'wholesaling' services) from growers and suppliers of products sold in supermarkets.

The ACCC invites market participants to comment on market definition.

The ACCC welcomes any comments from market participants regarding the ACCC's preliminary views on market definition.

In particular the ACCC seeks views on whether there exists an overarching market for the distribution of grocery products to consumers via vertically integrated chains and independent wholesalers supplying independent retailers.

The ACCC welcomes any comments as to geographic dimension, including whether there are any significant elements of local competition between Franklins and Metcash-supplied independent retailers.

Market inquiries

66. On 30 July 2010, the ACCC commenced its first round of market inquiries regarding the proposed acquisition. A range of interested parties provided responses, including suppliers of packaged groceries, supermarket operators and competitors of Franklins and Metcash.
67. All interested parties are now invited to make submissions on the issues raised in this Statement of Issues prior to the ACCC's final decision.

Statement of issues

68. For the purposes of this Statement of Issues, the issues in this matter are divided into three categories; 'issues of concern', 'issues that may raise concerns' and 'issues unlikely to pose concerns'.

⁵ "Market definition is not an exact physical exercise to identify a physical feature of the world; nor is it an enquiry after the nature of some form of essential existence. Rather, it is the recognition and use of an economic tool or instrumental concept related to market power, constraints on power and the competitive process which is best adapted to analyse the asserted anti-competitive conduct. ... Thus, once one appreciates the integrated legal and economic notions involved in the concept of a market and its purposive role ... one is unlikely to find utility in a debate about the precise physical metes and bounds of a market": *ACCC v Liquorland (Australia) Pty Ltd* [2006] FCA 826 per Allsop J at [429]-[430].

Issues of concern

Market for the wholesale supply of packaged groceries to independent retailers in NSW

69. The ACCC's preliminary view is that the proposed acquisition is likely to result in a substantial lessening of competition in the market for the supply of packaged groceries to independent retailers in NSW.
70. In particular, the ACCC is concerned that, as a result of the proposed acquisition, Metcash is likely to have significantly greater unilateral market power.
71. The ACCC has considered whether the competitive environment with the proposed acquisition constitutes a substantial lessening of competition relative to the counterfactuals identified above.

Competitive constraint from the prospect that independent retailers would switch to Franklins

72. As noted above, market inquiries have provided some evidence of independent retailers switching their wholesale supply from Metcash to Franklins. This has involved these retailers changing from the IGA banner to the Franklins banner.
73. Currently, independent supermarkets in NSW can become franchisees of Franklins and maintain ownership and operation of their stores. This provides the closest available structural alternative to the Metcash supplied independent retailer network.
74. The ACCC considers that the alternative of the Franklins wholesale supply and banner currently constitutes a real competitive 'threat' to Metcash in NSW.
75. This is also reflected in the fact that Metcash's banner group IGA has in the past written to its members seeking to discourage them from becoming Franklins franchisees.
76. Market inquiries have indicated that Franklins has been and continues to be a vigorous competitor and real alternative to Metcash for the wholesale supply of packaged groceries in NSW.
77. Market inquiries have indicated that Metcash is currently constrained in its dealings with independent supermarkets in NSW as a result of the alternative supply model offered by Franklins. For example, independent supermarket operators are in a stronger bargaining position when asked by Metcash to sign supply agreements because of the (explicit or implicit) threat that they might switch to Franklins if Metcash were to insist upon retailers signing such an agreement. Market participants have expressed concern that the proposed acquisition would have the effect of removing this constraint on Metcash in NSW.

78. Market participants have indicated that in the event that the alternative supply model offered by Franklins is removed, Metcash is likely to be in a much stronger position to exercise its increased market power through one or more of the following: increased prices, seeking to tie retailers to obtaining supply from Metcash through contractual and/or lease terms, or a drop in service levels.
79. Further, market participants have raised concerns that the loss of the high profile 'No Frills' private label product would remove a constraint on other supermarkets' generic brands, and in particular Metcash's wholesale pricing of Black and Gold products.

Barriers to entry and expansion

80. The ACCC considers that barriers to entry and expansion in the market are substantial, and that if the proposed acquisition proceeds, entry or expansion on a scale sufficient to provide a competitive constraint on Metcash is not likely within the foreseeable future
81. Market inquiries have indicated that successful entry into the market is not only costly (including substantial sunk costs), but is largely dependent on having access to, and the ability to compete for, a large number of retail supermarkets as customers. Without achieving scale, a wholesaler is unlikely to be able to viably operate and compete as a wholesaler of packaged groceries.
82. In turn, retailers are not in a position to establish wholesale operations without establishing sufficient scale to support such a warehouse as well as ensuring that they have access to competitive supply arrangements to use during the period when they are establishing a warehouse.
83. Market participants have submitted that this presents a 'catch 22' problem that can only be overcome by instantly acquiring both the retail scale and the wholesale operations. Market inquiries have indicated that given the number of stores and Franklins' existing wholesale infrastructure, the proposed acquisition would eliminate the last real opportunity in the foreseeable future for a new entrant in the market for the wholesale supply of packaged groceries to independent retailers in NSW.
84. Market inquiries have suggested that the time and scale barriers involved with establishing an entirely new wholesaling operation could be largely overcome by acquiring Franklins. Market participants noted that Franklins already has established wholesaling operations and the volume provided by a large network of retail outlets, both of which are crucial in establishing a rival wholesale business to Metcash.
85. The ACCC is of the preliminary view that an acquisition of the Franklins business would present a unique opportunity for a new entrant as it overcomes significant hurdles faced in setting up a new wholesale business.

86. Market inquiries have also indicated that there are significant barriers to expansion in the market. Many Metcash-supplied retailers have signed medium to long term supply agreements with Metcash for the supply of grocery items. The ACCC has received information from market participants suggesting that the supply agreements effectively act as a barrier to independents switching to, or sourcing some products from, another wholesaler.
87. Market participants have also raised concerns that Metcash intends to sell Franklins stores only to IGA retailers which sign supply agreements with Metcash and that Metcash is likely to take over the head lease at many of these stores. The ACCC considers that this would effectively tie the stores to Metcash so that they are not contestable by any new entrant to the wholesale market.
88. The ACCC considers that such supply agreements, head lease arrangements, and any shareholdings by Metcash in retailers is likely to have the effect of increasing the already high barriers to entry in the market for the wholesale supply of packaged groceries to retailers. The proposed acquisition would strengthen Metcash's dominant position in the market, and would remove an irreplaceably large pool of supermarkets, including many medium and large supermarkets, which may otherwise be contestable by a new wholesale competitor, thus making new wholesale entry even more unlikely.

Constraint imposed by vertically integrated chains

89. The ACCC also recognises that Metcash faces indirect competition from the vertically-integrated chains. Metcash must offer wholesale prices and services to independent retailers in a manner that enables the retailers to make a profit in the face of competition from the vertically-integrated chains.
90. However, while competition with the vertically integrated chains does, to some extent constrain Metcash, the ACCC is concerned that independent retailers are in many cases unable to compete on price with the supermarkets of the vertically integrated chains. Market participants have indicated that this arises in part due to the prices at which they source their products, particularly packaged groceries, from Metcash. This in turn is partly attributed to Metcash's incentives as a non-integrated wholesaler to maximise profits at the wholesale level, which contrasts with vertically integrated operators' incentive to maximise total profits regardless of whether they are earned at the retail or the wholesale level.
91. The ACCC found in the Grocery Inquiry that Metcash appears to set its wholesale prices to independent retailers under the retail pricing 'umbrellas' set by Coles and Woolworths. This wholesale pricing was found to limit the ability of independent retailers to aggressively pursue market share from Coles and Woolworths through price discounting.

92. In the ACCC's view the risk of losing business to Franklins provides a significant constraint on Metcash over and above the indirect constraint imposed by the vertically-integrated chains.

Other potential constraints

93. The ACCC has considered whether there would remain any effective constraints on Metcash post-acquisition in the market. The ACCC notes that while there are other wholesalers of packaged groceries such as the Queensland-based SPAR, there appear to be a number of factors that would limit these wholesalers' ability to constrain Metcash going forward. These factors include that the wholesalers:

- have historically supplied smaller format stores;
- have either a limited range or highly specialised range; and
- are not in a geographic location suitable to service independent retailers in NSW.

94. The ACCC does not consider that alternative banner groups would be able to effectively competitively constrain Metcash post-acquisition by establishing their own wholesaling operations. Even those banner groups with a large number of full line supermarkets are unlikely, on their own, to be in a position to bypass Metcash and offer wholesaling services to other independent retailers. The issues of scale and timing referred to above are relevant to this view.

95. Market inquiries also noted that direct to store supply of the majority of products, in particular packaged groceries, is not a viable substitute to obtaining supply from a wholesaler.

96. As noted above, while recognising the indirect competitive constraint on Metcash imposed by the vertically-integrated chains, the ACCC is of the view that this constraint is not sufficient to replace the threat of losing independent retailers to Franklins.

Conclusion

97. In light of the limited competitive constraints on Metcash post-acquisition and the height of barriers to entry, the ACCC is concerned that the proposed acquisition would remove the only alternative wholesale supplier able to supply full-line retailers and Metcash's closest competitor in NSW.

98. The proposed acquisition may also prevent enhanced competition by denying any other party the opportunity of utilising the effective wholesale distribution operations developed by Franklins and the large volumes accounted for by the existing Franklins stores as part of a strategy to enter the market as a competing wholesaler.

99. The ACCC is concerned that as a result of the proposed acquisition Metcash may be able to raise prices or reduce service levels to independent retailers compared to the counterfactual, as there would be insufficient competitive constraints post-acquisition to prevent this. Further, Metcash may not be forced as a result of competition to pass on benefits received as a result of the increased volume of products going through the Metcash warehouses as there would be no credible alternative to Metcash post-acquisition.
100. The ACCC notes that these concerns arise when comparing the situation with the proposed acquisition against either counterfactual 1 or 2.
101. Under counterfactual 3, Franklins would no longer represent an alternative to Metcash in the NSW market for the wholesale supply of packaged groceries. The competition outcome under counterfactual 3 in the wholesale market is likely to be different to the outcome under counterfactual 1 and 2.
102. However, the ACCC notes that competition concerns may also arise under counterfactual 3. A sale of its stores by Franklins may result in stores being sold to independent retailers who would have the potential to join together to sponsor entry at the wholesale level. When compared with the situation with the proposed acquisition, this may enhance competition between supermarkets in certain local retail markets, and may also provide a potential retail base for the entry of a new wholesaler.

The ACCC invites further information and specific examples in relation to whether you consider:

- Franklins and Metcash are each other's closest competitors for the supply of wholesale packaged grocery products to independent retailers in NSW;
- Franklins as a wholesaler is a credible threat to Metcash, and constrains Metcash in its pricing to independent retailers;
- Other wholesalers are likely to act as effective competitors to the merged entity for the supply of packaged grocery products to independent retailers, and whether it is likely that existing independent retailers or interstate wholesalers could set up a full scale wholesale operation in NSW;
- The proposed acquisition would increase barriers to entry into grocery wholesaling, including by removing an established vertically integrated retail chain that could be utilised as a base for a new entrant;
- The merged entity would be in a position to increase prices or decrease service levels for the supply of packaged groceries to independent retailers in a sustainable manner as a result of the proposed acquisition; and
- The degree to which indirect competition from vertically-integrated chains would act to constrain Metcash from increasing prices to independent retailers post-acquisition.

Issues that may raise concerns

Market for the distribution of grocery products via vertically integrated chains and independent wholesalers supplying independent retailers in NSW

103. The ACCC's preliminary view is that the proposed acquisition may raise competition concerns in the market for the distribution of grocery products (which includes both distribution via vertically integrated chains and by independent wholesalers supplying independent retailers), when compared with the likely situation without the proposed acquisition.
104. While Metcash is to an extent constrained by vertically integrated supermarket chains, including Coles and Woolworths, the ACCC is concerned that the constraint imposed by the vertically integrated chains does not appear sufficiently strong to provide Metcash with the incentive to set its wholesale pricing at a level that enables independent retailers to compete strongly on price at a retail level with the vertically integrated chains.
105. In the Grocery Inquiry, the ACCC found that:
- competition with the major supermarket chains does constrain Metcash. If Metcash raised its prices too far it would clearly damage the large independent retailers, who would stand to lose substantial amounts of business. This would in turn damage Metcash as its revenue would fall.
- However, the constraint of retail competition on Metcash's wholesale pricing is not as strong a constraint as it would be on a vertically integrated company equivalent to the Metcash-independent retailers network.⁶
106. In relation to Franklins, the ACCC found that:
- the local presence of a Franklins store has a strong impact on the pricing of Coles, particularly for dry groceries. Franklins has only recently moved to a vertically integrated model of grocery wholesaling and retailing.⁷
107. The ACCC has received information that Franklins, as a vertically integrated retailer, has in the past and could in the future, provide a stronger constraint on the vertically integrated chains via price and promotional competition than Metcash-supplied independent stores.
108. The ACCC has also received information, and notes information provided during the Grocery Inquiry, that suggests that while Franklins is able to compete strongly at the retail level, in contrast due to the pricing of products by Metcash, Metcash supplied independents are not able to compete on price with the vertically integrated retailers across all products.
109. The ACCC found in the Grocery Inquiry that Franklins was better able to compete with Woolworths and Coles because it is vertically integrated. By comparison, as set out at paragraph 91 above, Metcash-supplied retailers

⁶ ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p.154

⁷ ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p.171

indicated that the prices they paid for dry groceries prevented them from being price competitive with the vertically integrated retailers on these products.

110. The ACCC notes that Metcash has incentives to maximise its profits at the wholesale level, rather than seeking to maximise joint profits across the retail and wholesale levels. This focus on profits at the wholesale level may limit the ability of Metcash supplied independent retailers to aggressively pursue market share from Coles and Woolworths through retail price discounting.
111. Further, unlike vertically integrated chains which set their own retail prices, Metcash is limited in its ability to ensure that any wholesale price reduction it provides would be passed on to consumers by Metcash-supplied retailers. This further reduces the incentive for Metcash to lower the wholesale prices it charges retailers.
112. The ACCC notes that Woolworths, Coles, ALDI, Franklins and Metcash-supplied retailers currently compete in this market. Post-acquisition, the number of competitors in this market would be reduced from five to four.
113. Market participants have indicated that Metcash supplied independents in NSW have historically been viewed as convenience-based outlets rather than full line supermarkets, and are seen by consumers as expensive with a limited range of products.
114. The ACCC notes evidence from market participants has also indicated that Franklins supermarkets, unlike Metcash supplied independents, are generally regarded as full line supermarkets operating with a comparable range to other vertically integrated chains.
115. The ACCC has received conflicting evidence as to Franklins' competitiveness as a retailer. Certain market participants have submitted that Franklins has been, and remains, a vigorous competitor at the retail level. In addition, certain market participants have indicated that while Franklins is an aggressive retail competitor in terms of promotions and marketing, Metcash supplied independent retailers are not viewed in the same way. As part of Franklins' marketing and promotions, the ACCC understands that the Franklins loyalty club is widely subscribed to and is used as a means of competing with other supermarket retailers.
116. Conversely, the ACCC has also received information that suggests that due to financial difficulties, Franklins has struggled to compete with other retailers recently, and has become a weak competitor.
117. Market participants have also expressed concern that Metcash may seek to sell the Franklins stores only to retailers willing to tie their stores to Metcash by allowing Metcash to hold the head lease for the retail store and/or signing a supply agreement or some other contractual agreement which has the effect of requiring the retailer to buy from Metcash.

118. The ACCC notes that Metcash is intending in the first instance to acquire the retail stores of Franklins, and would then on-sell them to independent retailers.
119. Concerns have been raised that Metcash's incentive and ability to sell the stores only to retailers who enter into contractual arrangements with Metcash, paired with the relatively less competitive pricing of Metcash supplied products, would have the effect of limiting the ability of these stores to compete aggressively.
120. While competition with the vertically integrated chains does, to some extent, constrain Metcash, the ACCC is concerned that Metcash-supplied independent retailers are in many cases unable to compete on price with vertically integrated chains, and instead seek to rely on convenience of their location to attract local customers for 'top-up' shopping rather than full weekly 'trolley' shopping due to their relatively high prices. Market participants have indicated that this arises in part due to Metcash's incentives as a non-integrated wholesaler to maximise profits at the wholesale level.
121. The ACCC considers that the combination of the reduction in competitors from five to four and the weak competitive position of Metcash supplied independent retailers may raise competition concerns.
122. The ACCC notes evidence that vertically integrated chains compete strongly against other vertically integrated chains. The ACCC is concerned that the loss of Franklins as a vertically integrated chain may also dampen competition between the remaining vertically integrated retailers in NSW.
123. Nevertheless, the ACCC is continuing to explore the extent to which Franklins provides competitive tension, the ability of Franklins to provide the necessary base for any new entrant and other relevant factors prior to forming a concluded view on this issue.

Barriers to entry and expansion

124. The ACCC notes that the all of the barriers to entry outlined in relation to the previous market (at paragraphs 80-88) also apply in this market. In addition, the ACCC notes the scarcity of suitable sites and that the level of scale necessary to spread the sunk costs associated with establishing and operating a retail chain, such as branding, advertising and promotion; means that entry in this market is unlikely.

The ACCC invites views on the analysis outlined above, and in particular further information and specific examples in relation to whether you consider:

- Metcash supplied independent retailers are able to compete on price with vertically integrated supermarket chains;
- The remaining vertically integrated chains would provide a sufficient competitive constraint on Metcash post-acquisition;

- Franklins provides a difference in range, service levels or price when compared to Metcash supplied independents;
- Franklins is a particularly aggressive competitor at the retail level either on price, service, range or promotions;
- The removal of the Franklins loyalty club program would have an impact on local competition;
- Vertically integrated supermarkets compete strongly against other vertically integrated chains, and do not compete as strongly with non-vertically integrated chains; and
- There are attributes other than price, such as service, that enable independent retailers to compete effectively with the vertically integrated supermarket chains.

Wholesale market for the supply of fresh produce to independent supermarket operators in NSW

125. The ACCC's preliminary view is that the proposed acquisition is unlikely to raise horizontal competition concerns in the market for the wholesale supply of fresh produce (that is, the horizontal aggregation of the fresh produce wholesaling operations of Franklins and Metcash is unlikely to raise concerns in its own right).
126. The ACCC notes that there would remain a number of fresh produce wholesalers and suppliers post-acquisition.
127. However, some concerns have been raised by market participants in relation to possible conglomerate effects arising from Metcash's increased presence in the wholesale packaged grocery market.
128. Conglomerate effects occur across separate markets and affect the supply of products that are typically in some way related to each other, such as products that are in neighbouring markets or products that are complementary in either demand or supply.
129. Conglomerate effects may raise concerns where the merged entity alters its operations or product offerings in a way that forecloses the merged entity's rivals and ultimately reduces the competitive constraint they provide in related (or unrelated) markets. For example, the merged entity's rivals may be foreclosed if the merged entity chooses to bundle or tie complementary products, such that customers receive additional benefits when they purchase or use the merged entity's products together (e.g. due to discounts or rebates).
130. Market participants have expressed some concern that, post-acquisition, Metcash's dominant position as a wholesaler of packaged groceries would enable it to provide strong incentives for retailers to purchase their fresh produce requirements from IGA>F rather than competing fresh wholesalers.

131. The ACCC's preliminary view is that the proposed acquisition may raise competition concerns by enabling Metcash to leverage its increased market power in the market for the wholesale supply of packaged grocery items to independent retail supermarkets into the wholesale market for the supply of fresh produce to independent retailers. Metcash may do this by tying the sale of fresh produce to packaged goods contractually or by offering the products in a bundle at a discount.
132. To this end, the ACCC notes that Metcash already has a rebate system in place that rewards stores for purchasing over a certain percentage of their total purchases from IGA>D and IGA>F.
133. The ACCC is concerned that post-acquisition Metcash may be in a position to require and/or incentivise independent retailers to purchase both fresh and packaged grocery items from Metcash and in turn lessen competition in the wholesale supply of fresh items to independent retailers by reducing the ability of retailers to choose the best available wholesale offer without risking losing rebates, paying higher prices or facing uncertainty of supply for packaged grocery items if they switch to a non-Metcash supplier for their fresh produce.
134. Nevertheless, the ACCC is still exploring to what extent Metcash may be able to act in this manner, and is seeking further information prior to reaching a view.

The ACCC invites views on the analysis outlined above, and in particular further information and specific examples in relation to whether you consider:

- Metcash, post-acquisition, is likely to have any greater ability or incentive to bundle fresh grocery products with packaged grocery products, and if so, whether it is likely to achieve any sustainable competitive advantage from doing so;
- Alternative fresh produce wholesalers would be limited in their ability to supply Metcash supplied independent retailers post-acquisition due to Metcash's ability to link supply terms and rebates for packaged groceries to the acquisition of fresh produce from Metcash; and
- Independent retailers currently purchase their fresh produce requirements from sources other than Metcash and Franklins, and if so, to what extent.

Local retail markets

135. Market inquiries have indicated that in certain local markets, Franklins and IGA are close competitors, and are unlikely to be closely constrained by other competitors post-acquisition. While the ACCC notes that Metcash intends to sell the Franklins stores to independent retailers, the existing Metcash supplied supermarkets and the ex-Franklins stores would then be supplied by a single wholesaler and would likely all be branded IGA, reducing the

differentiation between them and reducing the incentives for competition between the stores.

136. The ACCC is concerned that in certain local markets, this may result in a substantial lessening of competition by reducing the competitive tension between Franklins retailers and Metcash supplied independent retailers.
137. Barriers to entry to supermarket retailing are generally high. Market participants indicated that there are significant difficulties associated with obtaining suitable sites and planning permission, particularly in many metropolitan and suburban areas. In this regard, the ACCC considers that the key source of competitive constraint in each local market, post-merger, is likely to be the existing competitors in each area, although potential new entry provides some further constraint in areas where suitable sites are available.
138. Therefore, the analysis of areas of concern focuses on existing local market structures. In assessing each local market on a preliminary basis, the ACCC has investigated the make-up of the market within a 5km radius⁸ of each Franklins supermarket. The ACCC then took into consideration:
- the size of the supermarkets in each local market;
 - the number of remaining competitors to the supermarkets supplied by the merged entity;
 - the geographic make-up of particular local areas, including road networks; and
 - information received from market participants.
139. The ACCC is of the preliminary view that competition concerns are likely to arise in the local market where the Springwood Franklins is located. The only supermarket within 5km of this Franklins store is a Supa IGA store, supplied by Metcash. These stores are each other's closest competitors and there is no other nearby store imposing a strong competitive constraint on these stores.
140. The ACCC is of the preliminary view that competition concerns may arise in the local markets relevant to the Marketland SC and Leeton Franklins supermarkets. In both cases there is a nearby Supa IGA store competing with the Franklins store. However, the ACCC notes that unlike Springwood, there are other competing supermarkets in these local markets which may prevent a substantial lessening of competition in these markets. The ACCC is therefore seeking further information about these and other local markets prior to forming a concluded view.

⁸ The ACCC has generally considered the geographic scope of local supermarket markets to be the area within a 3-5km radius surrounding the supermarket to be acquired. However, in assessing the relevant market in any supermarket acquisition the ACCC will consider geographic factors, such as the layout of roads in the area or the rural location of stores, which are potentially important when defining the geographic scope of a local market.

The ACCC invites market participants to comment on local retail markets

Please provide comments on the following issues and preferably provide further information and specific examples in relation to whether specific Franklins retail stores currently compete closely with Metcash supplied independent stores and are unlikely to be constrained by other supermarket operators post-acquisition.

The ACCC also invites comments from market participants in regard to the ACCC's preliminary views on competition issues that may arise from the proposed acquisition of particular sites by Metcash. The ACCC invites market participants to comment on any other particular sites where they consider competition concerns are likely to arise as a result of the proposed acquisition.

If you are providing comments about particular supermarket sites, please be as specific as possible in regards to the location of each site you are addressing. Please provide reasons for your view that the proposed acquisition of a particular site does/does not raise competition concerns.

Issues unlikely to pose concerns

Procurement market

141. The ACCC has conducted a preliminary assessment to determine whether the proposed acquisition would lessen competition in the market for the procurement of products for sale in supermarkets.
142. Supermarket chains compete with each other and with independent supermarket wholesalers to acquire products from growers and other producers for subsequent retail sale. The proposed acquisition would lead to an increase in the volume of supermarket products acquired by Metcash.
143. The ACCC conducted market inquiries with a number of suppliers. However no significant competition concerns were raised in relation to the proposed acquisition's likely effects on competition in this market.
144. Given the size of the transaction relative to the participants in the procurement market, the ACCC's preliminary view is that the proposed acquisition is unlikely to result in a substantial lessening of competition for the procurement of products sold in supermarkets.

ACCC's future steps

145. The ACCC will finalise its view on this matter after it considers market responses invited by this Statement of Issues.
146. The ACCC now seeks submissions from market participants on each of the issues identified in this Statement of Issues and on any other issue that may be relevant to the ACCC's assessment of this matter.

147. Submissions are to be received by the ACCC no later than 15 October 2010. The ACCC will consider the submissions received from the market and the merger parties in light of the issues identified above and will, in conjunction with information and submissions already provided by the parties, come to a final view in light of the issues raised above.
148. The ACCC intends to publicly announce its final view by 11 November 2010. However the anticipated timeline may change in line with the *Merger Review Process Guidelines*. A Public Competition Assessment for the purpose of explaining the ACCC's final view may be published following the ACCC's public announcement.