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## CREEPING ACQUISITIONS

### SUBMISSION TO COMMONWEALTH TREASURY BY METCASH LIMITED

OCTOBER 2008

#### 1. Summary

- 1.1 Metcash welcomes the opportunity to make a public submission on the Australian Government's discussion paper relating to creeping acquisitions.
- 1.2 Metcash is of the view that creeping acquisitions are a serious threat to effective competition in the Australian supermarket sector. While the ACCC recognised this as a *potential* issue, Metcash believes that creeping acquisitions are already damaging competition in grocery markets. Metcash submits that the Australian grocery industry is at a tipping point, beyond which creeping acquisitions will have an increasingly harmful effect on competition. This is due to:

- (a) the trend towards increasing concentration of market share in the hands of the major supermarket chains (**MSCs**);
- (b) the difficulty faced by independent supermarkets in gaining access to prime sites, especially in shopping centre developments;
- (c) the relationship between the independent retail sector and independent wholesalers such as Metcash, and the downward spiral that is likely to result from the further decline of the independent retail sector;
- (d) foreshadowed changes to planning laws; and
- (e) other barriers to entry, including those identified by the ACCC in its grocery inquiry report.

1.3 One of the reasons that creeping acquisitions pose such a threat to competition is that a single transaction, by itself, may not be seen as causing substantial harm to competition. The risk facing Australia's grocery industry is that, by the time the harm caused by creeping acquisitions is widely recognised it will be difficult, if not impossible, to undo the damage they will have caused. Legislative change is needed now in order to preserve competitive conditions in Australian grocery markets into the future.

1.4 Metcash submits that the most appropriate and effective measure to protect competition in grocery markets is to enact legislation to give effect to the substantial market power model described in the Treasury discussion paper. In Metcash's view, the *Trade Practices Act 1974 (TPA)* should not permit a firm which already has a substantial degree of market power from increasing or entrenching its market power through the acquisition of shares

or assets. It should not be necessary to show that such an acquisition would result in a *substantial* lessening of competition in order to stop the transaction occurring. The substantial market power model builds on existing concepts and principles to rectify this deficiency in Australia's competition laws in a clear and balanced way.

## **2. About Metcash**

- 2.1 Metcash is a marketing and distribution company in the food, liquor and fast moving consumer goods sectors, servicing predominantly the independent grocery retail and liquor market in Australia. The company has been listed on the Australian Securities Exchange since 1995 and has a market capitalisation of \$3.22 billion (as at 9 October 2008).
- 2.2 Building a strong independent retail grocery and liquor industry is the core focus of Metcash. For Metcash to be successful, it is critical that its customers (the independent grocery and liquor retailers) are successful. Metcash continues to focus on building a differentiated competitive product offering for its independent retailers.
- 2.3 Metcash's vision to be "the Champion of the Independent Retailer" and complementary "Local Heroes" promotional grocery campaign underscores its commitment to operating a unique business model which leverages the pooled volume and the entrepreneurial spirit of its independent grocery retailers.
- 2.4 There are over 500 million customer visits to IGA stores per annum. In comparison with the MSCs, a large proportion of the independent grocery retailers serviced by Metcash operate in the rural and regional areas of

Australia. Metcash's service to those retailers has contributed to the availability of groceries in rural and regional areas at competitive prices.

- 2.5 Metcash is not generally a retailer, although it provides pricing advice to its retail customers by undertaking price checks and assisting retailers to choose a pricing strategy appropriate for their store. Metcash's pricing advice is a guide only and independent retailers are free to set their own prices.<sup>1</sup>
- 2.6 Metcash does have an interest in a number of retail stores. However, these interests typically arise in cases where a retailer has difficulty in acquiring a retail site. In such cases, Metcash, which has a strong balance sheet, takes a head lease over the site for 15 to 20 years, and sublets the site to the retailer. In those circumstances, Metcash typically asks the retailer to sign a supply agreement and to buy from Metcash for the term of the lease.
- 2.7 There is clearly a strong degree of interdependence between the independent retail sector and independent wholesalers such as Metcash. The on-going viability of independent supermarkets depends on their ability to acquire products at wholesale prices that allow them to compete effectively with the MSCs. Similarly, the viability of independent wholesalers such as Metcash depends on having a sufficiently large and diverse customer base to allow it to achieve economies of scale, scope and density and to enable them to compete with the MSCs at the wholesale level. While the ACCC made several observations about Metcash's position in the wholesale market in its grocery inquiry report, Metcash believes that greater weight needs to be given to the fact that the independent wholesale and retail sectors of the grocery industry together constitute the "third force" that

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<sup>1</sup> The only restrictions imposed by Metcash is that retailers may not *exceed* advertised promotional prices.

is essential to maintaining effective competition in Australia's grocery markets into the future. In the absence of this third force, Australia's retail grocery markets will be dominated by a cosy duopoly constituted by the MSCs.

2.8 Metcash's role in the grocery industry and its views on the current state of competition are explained in detail in its April 2008 submission to the ACCC's grocery inquiry. A copy of that submission is attached to this paper.

### **3. Creeping acquisitions pose a serious threat to competition in Australia's grocery markets**

3.1 The acquisition of an independent supermarket by a MSC has the potential to be extremely harmful to competition in the relevant retail market and, over time, the relevant wholesale markets. Not only do these acquisitions result in the elimination of a rival and a reduction in the level of choice available to consumers in the area, but there is also a reduction in the economies of scale, scope and density that are available to an independent wholesaler such as Metcash. This in turn undermines the cost base of the entire independent sector.

3.2 A viable independent supermarket sector is critical to the maintenance of competition at the retail level of the market. Independent retailers are the "third force" in a market dominated by the two MSCs. They provide the competitive tension through:

(a) promotional pricing;

- (b) competitive shelf pricing; and
- (c) non-price competition, including convenience, personal service and an ability to cater to local demand.

3.3 In the absence of this third force, Australia's retail grocery markets will be dominated by a cosy duopoly constituted by the MSCs. The importance of the independent sector is explained in detail in Chapter 6 of Metcash's submission to the ACCC's grocery inquiry.

#### *ACCC Grocery Inquiry*

3.4 The ACCC concluded that grocery retailing is workably competitive, but found that there are still a number of factors that limit the level of price competition, including:

- (a) high barriers to entry and expansion, particularly in relation to difficulties in finding new sites for development;
- (b) limited incentives for the MSCs to compete aggressively on price; and
- (c) limited price competition that MSCs face from the independent sector, with independent supermarkets tending to focus on convenience and service.<sup>2</sup>

3.5 The ACCC recognised that the independent supermarket sector provides a competitive force in grocery retailing.<sup>3</sup> The ACCC considered that the potential for strong price competition is more likely to originate with other competitors disrupting the prevailing price behaviour of the MSCs.

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<sup>2</sup> *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries* (July 2008) (ACCC Grocery Report), page 2.

<sup>3</sup> ACCC Grocery Report, page 127.

Competitors with smaller market shares are, in general, more likely to undertake price competition as a way to win market share.

- 3.6 However the ACCC also found that cost constraints often limit the extent of price cutting that is possible.<sup>4</sup> In the ACCC's view, small independent supermarkets rarely compete on price, choosing to compete on other elements such as convenience, range and service.<sup>5</sup>
- 3.7 Metcash acknowledges that it is harder for independent supermarkets to compete with the MSCs on everyday prices. This reflects, in part, the challenges faced by Metcash in competing with the MSCs on price at the wholesale level. However, the ability of the independent retailers to constrain the pricing behaviour of the MSCs should not be discounted. Independent retailers engage in price competition with the major chains on a regular basis through their promotional activities. The activities of Metcash as a wholesaler are heavily constrained by the need to maintain the price competitiveness of independent retailers. If independent grocery retailers do not achieve a competitive cost of supplies, their viability will be threatened, resulting in the revenue stream for Metcash as a wholesaler also being threatened.
- 3.8 The ACCC report found that creeping acquisitions by MSCs have not been a significant contributor to competition issues in the supermarket sector in recent years.<sup>6</sup> This is on the basis that most MSC growth in the supermarket sector has come from the development of new sites rather than acquisitions.<sup>7</sup>

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<sup>4</sup> ACCC Grocery Report, page 103.

<sup>5</sup> ACCC Grocery Report, page 127.

<sup>6</sup> ACCC Grocery Report, page 427.

<sup>7</sup> ACCC Grocery Report, page 428.

- 3.9 Rather, the ACCC stated that creeping acquisitions in the supermarket sector could *potentially* become a concern due to:
- (a) difficulties in obtaining prime sites;
  - (b) other barriers to entry, including the need for scale and efficient wholesaling;
  - (c) the duopoly constituted by the MSCs; and
  - (d) a market where individual retail stores can be picked off one by one.<sup>8</sup>
- 3.10 Metcash submits that the ACCC has understated the seriousness of the creeping acquisition issue in the supermarket sector. What the ACCC describes as a *potential* concern is already harming competition in Australia's grocery markets, and is about to become an increasingly serious threat to competition due to:
- (a) the trend towards increasing concentration of market share in the hands of the MSCs at the retail level;
  - (b) the difficulty faced by independent supermarkets in gaining access to prime sites, especially in shopping centre developments;
  - (c) the relationship between the independent retail sector and independent wholesalers such as Metcash, and the downward spiral that is likely to result from the further decline of the independent retail sector;
  - (d) foreshadowed changes to planning laws; and

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<sup>8</sup> ACCC Grocery Report, page 428.

- (e) other barriers to entry identified by the ACCC in its grocery inquiry report.

*Increasing concentration at the retail level*

- 3.11 While estimates of market share differ (as do the methods by which they are determined) it is clear that, over the last 30 years, there has been a steady trend towards an increase in the market share of the MSCs.
- 3.12 It has been estimated that, between 1975 and 1994, the national retail market share of the major brands (Woolworths, Coles and Franklins) increased from 40% to 69.8%.<sup>9</sup> The market share of the MSCs has now been estimated to be in the order of 74% to 80%.<sup>10</sup> The ACCC's estimate of the market share of the MSCs is lower (in the order of 55% to 60%).<sup>11</sup> However, in addition to expenditure on groceries in supermarkets, this estimate includes expenditure in convenience stores, butchers, bakers, seafood stores, etc. In relation to packed groceries, the market share of the MSCs is now estimated to be in the order of 70% to 78%,<sup>12</sup> compared with 66% in 1998.<sup>13</sup>
- 3.13 While the ACCC notes that most of the growth by MSCs (especially in recent years) is due to the development of new sites rather than the acquisition of existing stores, the trend towards increasing concentration of market share in the hands of the MSCs remains relevant, as it demonstrates that the share of the retail sector served by the independent supermarkets has been

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<sup>9</sup> *Re Queensland Independent Wholesalers Limited* (1995) ATPR 41-438 (at page 40,938).

<sup>10</sup> The figure of 74% is estimated by IBISWorld in *Supermarkets and Other Grocery (except Convenience) Stores in Australia, 2008*, while the figure of 80% is estimated by NARGA's report on *The economic contribution of small to medium-sized grocery retailers to the Australian economy, 2008*.

<sup>11</sup> ACCC Grocery Report, page 48.

<sup>12</sup> ACCC Grocery Report, page 51.

<sup>13</sup> *Fair Markets or Market Failure?*, Report of the Joint Select Committee on the Retailing Sector, August 1999, Table 4.1.

declining. In the absence of measures to address creeping acquisitions, this decline in market share is likely to continue (with a corresponding increase in the market power of the MSCs).

3.14 The ACCC's own analysis suggests that, at the national level, market concentration in the retail sector has reached a critical point. The ACCC found that the CR4 ratio is at least 70% and the Herfindahl-Hirschman Index (**HHI**) is between 1800 and 2200.<sup>14</sup> This suggests that the market is at a 'tipping point', beyond which concentration will become an increasingly serious problem. Further acquisitions of independent supermarkets by the MSCs can only add to market concentration in the retail sector. Consequently, any further acquisitions (including creeping acquisitions) are likely to have a more serious impact on competition than they have had in the past.

3.15 The most widely used and accepted tool to measure the impact of an acquisition on competition in a market is the HHI.<sup>15</sup> Using this methodology, it is possible to demonstrate why creeping acquisitions pose such a threat to competition in a market that is already concentrated.

Consider the example of two hypothetical markets:

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<sup>14</sup> ACCC Grocery Report, page 49.

<sup>15</sup> The HHI is calculated by adding the sum of the squares of the market share of each firm in the relevant market.

(a) In market A, there are seven firms, with market shares as follows:

Firm A = 20%

Firm B = 20%

Firm C = 20%

Firm D = 20%

Firm E = 10%

Firm F = 5%

Firm G = 5%

If Firm A acquires Firm G, the HHI will be as follows:

Pre acquisition = 1750

Post acquisition = 1950

$\Delta = 200$

(b) In Market B there are five firms with market shares as follows:

Firm A = 40%

Firm B = 40%

Firm C = 10%

Firm D = 5%

Firm E = 5%

If Firm A acquires Firm E, the HHI will be as follows:

Pre acquisition = 3350

Post acquisition = 3750

$\Delta = 400$

3.16 In both hypothetical markets, there is an acquisition of a firm with a market share of only 5%. However, in the market that is concentrated, the acquisition has a much greater effect on competition ( $\Delta = 400$ ) than in the market that is workably competitive ( $\Delta = 200$ ). This clearly demonstrates that creeping acquisitions pose a much more serious threat to competition in

markets where incumbents already possess a substantial degree of market power.

*Access to sites*

3.17 The ACCC has noted that MSCs are highly sought after as anchor tenants in major shopping centres, with the effect that access to these prime sites by independent retailers is effectively foreclosed.<sup>16</sup> This means that, when an independent supermarket is acquired by a MSC, it is very difficult for the independent supermarket to return to the market. In addition to losing its existing site, the independent supermarket will find it difficult to establish a new site in a viable location, since it is effectively shut out of the major shopping centres.

3.18 This problem is exacerbated by the use of planning laws to hinder the entry of new supermarkets into an area. For example, in evidence to the ACCC's grocery inquiry, Woolworths acknowledged that it had lodged planning objections to new supermarket developments in order to promote its commercial objectives.<sup>17</sup>

3.19 Because of this, the detrimental impact on competition in a retail market when an independent supermarket is acquired by a MSC is disproportionately high. The issue is not simply one of increased concentration of market share in the hands of the MSCs, but the permanent loss of a serious independent rival.

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<sup>16</sup> ACCC Grocery Report, page 183.

<sup>17</sup> ACCC Grocery Inquiry, Melbourne, 19 May 2008, public transcript, pages 64-66; also see the ACCC Grocery Report, page 192.

*Relationship between the retail sector and wholesale sector*

- 3.20 There is a direct relationship between the success of an independent wholesaler such as Metcash and the independent retail supermarket sector. The loss of each independent supermarket reduces the addressable market for an independent wholesaler such as Metcash, thereby reducing its opportunities to realise economies of scale, scope and density.
- 3.21 The loss of each independent supermarket makes it harder for an independent wholesaler such as Metcash to be competitive on price, which in turn undermines the competitiveness of the independent supermarkets, which in turn makes it harder for an independent wholesaler such as Metcash to be competitive on price, and so on. This downward spiral has the potential to threaten the long term viability of any independent rivalry to the MSCs at both the wholesale and retail levels of the market.
- 3.22 Mr John Cummings (then the Vice-President of the Western Australian Independent Grocers Association) explained to the Baird Committee that when volume falls below the critical mass, warehouse efficiencies fall, economies of scale fall and, ultimately, the costs that wholesalers charge the independents rise:

*"If they rise, we then must put these costs on to our customers, which means that some of our customers will go to Coles or Woolworths, our competitors, and which means that the mass will fall again, the warehouse withdrawals will fall, the economies will fall, the prices will go up and it will be a self-accelerating circle down which we go. Through absolutely no fault of any individual who owns a supermarket today, he will go broke without a chance of even having a look-in. It will not be because of his inefficiencies, it will not*

*be because he cannot run a business: it will be simply because he cannot source his product at the right price.”*<sup>18</sup>

- 3.23 In its submission to the ACCC's grocery inquiry, the National Association of Retail Grocers of Australia (**NARGA**) provided a report by PriceWaterhouseCoopers (**PWC**) which referred to the "critical mass" argument. The PWC report stated that, in WA, if independent grocery sales were to reduce by as little as 20%, it may no longer be viable to keep open the WA warehouse of IGA-Distribution.<sup>19</sup> While PWC referred to the impact this would have on the WA economy (and employment levels in particular), Metcash believes it is also important to consider the effect that the loss of an independent wholesaler would have on the on-going viability of the remaining independent retail supermarkets in a region.
- 3.24 The consequences of a loss of sales volumes at the wholesale level was also acknowledged by Mr Samuel in 2003, when he stated "that detriment to independent operators could result from creeping acquisitions".<sup>20</sup> Mr Samuel also acknowledged that there "is the potential for a loss of sales volume at the wholesale level to give rise to a loss of economies of scale. This, in turn, could generate cost pressures on the entire independent grocer sector."

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<sup>18</sup> *Fair Markets or Market Failure?*, Report of the Joint Select Committee on the Retailing Sector, August 1999, para 5.56.

<sup>19</sup> *The economic contribution of small to medium-sized grocery retailers to the Australian economy, with a particular focus on Western Australia*, Price Waterhouse Coopers, June 2007, page 44; annexed to the public submission to the ACCC Grocery Inquiry by the National Association of Retail Grocers of Australia dated 22 February 2008.

<sup>20</sup> Graeme Samuel, 'Competition and the nation's supermarket trolley: a perspective of the Australian Competition and Consumer Commission', Speech to the Food and Grocery Council of Australia, 16 September 2003, page 7.

### *Foreshadowed changes to planning laws*

- 3.25 One of the ACCC's recommendations is that State and local government planning decisions should have specific regard to competition issues, particularly where a proposed development would facilitate the entry of a new supermarket operator into an area.<sup>21</sup>
- 3.26 Effective measures to guard against creeping acquisitions will be essential in an environment where planning laws are designed to facilitate the entry of supermarket operators into new markets. Under such planning laws it may, for example, become easier for a MSC to enter into an area where it is not currently operating. In such an environment, it is vital that the TPA guards against the gradual elimination of independent supermarkets in the area by way of creeping acquisitions. The objective is not the protection of the independent supermarkets themselves (a MSC can still enter a market by developing a new site) but the preservation of competition in the market by prohibiting the further acquisition of existing independent retailers by a supermarket that already has a substantial degree of market power.

### *Other barriers to entry*

- 3.27 Other barriers to entry faced by independent supermarkets are already very high. These include:
- (a) the use of restrictive covenants by MSCs in lease agreements (thus ensuring that the MSCs maintain access in exclusive and prime sites);
  - (b) difficulties faced by new supermarkets in their ability to match MSC retail offerings into areas such as petrol, liquor, banking and credit cards;

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<sup>21</sup> ACCC Grocery Report, page 177.

- (c) the horizontal integration of MSCs into areas such as petrol retailing and the use of shopper dockets; and
- (d) an inability of independent supermarkets to match the substantial financial commitment required for the long term leases entered into by MSCs.<sup>22</sup>

*Previous findings on competition in the supermarket sector*

3.28 According to NARGA, the rise to market dominance by the major chains, even as early as 1999, had been built on an aggressive program of acquisitions of successful independent stores and chain operations, with little or no intervention by the ACCC. Between 1995 and 1999 around 85 stores had been bought by the MSCs, comprising over \$1 billion of retail turnover.<sup>23</sup> NARGA submitted that independent stores would normally change hands at 3 times EBIT or 5 to 8 times average weekly turnover. For acquisitions deemed strategic, the chains have been known to pay up to 16 times turnover. In WA, it was submitted that Woolworths had once offered 28 times EBIT for a leading independent.

3.29 The Baird Committee noted that anecdotal evidence suggested that the major chains do seek to acquire successful independent stores.<sup>24</sup> It is also worth noting that, while the ACCC stated in its grocery inquiry report that the supermarket sector is workably competitive, its submission to the Baird Committee suggested that the market is characterised by substantial market

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<sup>22</sup> ACCC Grocery Report, page 182.

<sup>23</sup> *Fair Markets or Market Failure?*, Report of the Joint Select Committee on the Retailing Sector, August 1999, para 5.34.

<sup>24</sup> *Id*, para 5.35.

power.<sup>25</sup> Why this situation has changed, and why competition would be thought to have *improved* since 1999, is not clear.

*The need for intervention now*

3.30 It is important to recognise that the damage caused by creeping acquisitions cannot be rectified *ex post*. One of the reasons that creeping acquisitions pose such a threat to competition is that a single transaction, by itself, may not be seen as causing substantial harm to competition. The risk facing Australia's grocery industry is that, by the time the harm caused by creeping acquisitions is widely recognised it will be difficult, if not impossible, to undo the damage they will have caused. This is because:

- (a) independent supermarkets will find it difficult to establish sites to compete with the MSCs, even if further acquisitions by MSCs are curtailed;
- (b) independent supermarkets will not have access to wholesale supplies at prices that will permit them to be competitive with the MSCs; and
- (c) other barriers to entry (referred to in paragraph 3.27 above) will only increase in their significance in the future.

3.31 Legislative change is needed now in order to preserve competitive conditions in Australian grocery markets into the future.

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<sup>25</sup> *Id.*, para 5.1.

#### 4. Section 50 is not an effective tool to combat creeping acquisitions

- 4.1 Even the ACCC, while concluding that creeping acquisitions have not been a major issue to date, supports the introduction of laws to combat the effect of creeping acquisitions. While Metcash submits that the ACCC has understated the impact of creeping acquisitions, it agrees that there is a pressing need for legislative change.
- 4.2 The problem with s 50, in its current form, is that it requires a *substantial* lessening of competition. In the case of a firm with a substantial degree of market power, this sets the bar too high.
- 4.3 "Substantial" is not a precise, quantifiable measure of market power. In *Stirling Harbour Services Pty Ltd v Bunbury Port Authority*<sup>26</sup> French J stated that "'substantially' can be equated with a purpose, effect or likely effect of the impugned conduct on competition that is 'meaningful or relevant to the competitive process'".
- 4.4 In *Rural Press Limited v ACCC*<sup>27</sup> Gummow, Hayne and Heydon JJ stated that the word "substantial" is used "... in the sense of being meaningful or relevant to the competitive process...".
- 4.5 Substantial market power has also been defined as "... the ability of a firm to raise prices above the supply cost without rivals taking away customers in due time, supply cost being the minimum cost an efficient firm would incur in producing the product."<sup>28</sup>

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<sup>26</sup> [2000] FCA 38

<sup>27</sup> (2003) 216 CLR 53

<sup>28</sup> *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177.

- 4.6 The Explanatory Memorandum to the *Trade Practices Legislation Amendment Bill 1992* stated that the word "substantial", in the context of s 50, was intended to refer to an effect on competition which is real or of substance, rather than large or weighty.<sup>29</sup>
- 4.7 The issue is not that s 50 requires evidence of a large or weighty impact on competition, but rather that there must be clear evidence (which would support a case by the ACCC in the Federal Court) that an acquisition would be likely to have a real or substantial effect. In the absence of such evidence, the ACCC cannot oppose a transaction under s 50, even if it believes the transaction would be likely to *lessen* competition.
- 4.8 The ACCC has noted that it can address local markets in considering the effect of an acquisition, citing the example of its decision relating to the Karabar supermarket to support the proposition that a local market (in this case Queanbeyan) can be a substantial market for the purposes of s 50. However, this deals only with the issue of single acquisitions, not creeping acquisitions. If a local market could not be considered for the purposes of s 50 then issues would arise in the scrutiny of any acquisition, not just creeping acquisitions, since the ACCC's ability to assess an acquisition would fall at the first hurdle.
- 4.9 The challenge posed by *creeping* acquisitions is not that they cannot be examined at a local level, but that there will be circumstances in which a single acquisition may not result in a substantial lessening of competition, even though it may entrench or enhance the market power of an existing firm.

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<sup>29</sup> see *Miller's Annotated Trade Practices Act*, 29th ed (2008), para [1.50.21].

## 5. International positions on creeping acquisitions

5.1 Competition authorities throughout the world tend to apply one of two tests when considering the competitive effects of a merger:

(a) a substantial lessening of competition test (or similar) (eg. Australia, US); or

(b) a dominance test (or similar) (eg. EU).

5.2 In October 2002, an OECD Competition Committee debated the substantive criteria used for merger assessment.<sup>30</sup> Nearly half of the submissions made by member states indicated that creeping acquisitions could be difficult to address under each country's test, regardless of whether the country applied a substantial lessening of competition test or a dominance test.<sup>31</sup>

5.3 Australia's submission stated that:

*"a series of small mergers or 'creeping acquisitions' can be difficult to address under the substantial lessening of competition test. This is because creeping acquisitions are only ever likely to increase the market power on an incremental basis and therefore it becomes difficult to observe and quantify which incremental acquisition resulted in the substantial lessening of competition"*<sup>32</sup>

5.4 Of the countries that provided comments, Lithuania indicated small mergers that are analysed in isolation would not be caught by either a substantial

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<sup>30</sup> OECD, *Substantive Criteria used for Merger Assessment*, DAFNE/COMP (2003)5, a copy of which can be found at: <http://www.oecd.org/dataoecd/54/3/2500227.pdf>.

<sup>31</sup> Of the 19 submissions received by the OECD, 9 members indicated that their current tests would not, or would be unlikely to be able to block, a 'creeping acquisition'; 3 indicated that their current tests would be sufficient to block a creeping acquisition; 2 indicated that their tests *might* be sufficient to block, and 5 did not give a clear view.

<sup>32</sup> OECD, *op cit*, page 145.

lessening of competition test, or a dominance test.<sup>33</sup> New Zealand submitted that the difficulty was in determining at what point to intervene, or at what point the substantial lessening of competition threshold should be triggered.<sup>34</sup> The UK considered that mergers that lead to an immaterial increase in market power are unlikely to be viewed as reinforcing or creating a dominant position or as a substantial lessening of competition.<sup>35</sup>

5.5 The following countries outlined the special considerations in their jurisdictions for creeping acquisitions:

- (a) Finland indicated that it applied a separate rule to cover a series of small mergers. Those mergers are covered by a so-called 2 year rule. Under the rule, where business operations are acquired through two or more successive transactions, the turnover of the target of the acquisition is taken to include the combined turnover related to the business operations acquired from the same entity or foundation, and the turnovers of the entities or foundations acquired within the same industry in Finland during two years preceding;
- (b) in Hungary, where a series of small mergers appears to be leading to the creation of a firm having significant market power, the turnover thresholds can also be met by including subsequent acquisitions from anywhere within a two-year period. In those circumstances the Hungarian Office of Economic Competition can block a transaction once a series of mergers puts the acquiring group into an economic position where it can act to a large extent independently of the market;

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<sup>33</sup> *Id*, page 228.

<sup>34</sup> *Id*, page 256.

<sup>35</sup> *Id*, page 286.

(c) in Mexico, although there is no specific test for creeping acquisitions, the Mexican Federal Competition Commission can block a series of mergers before an economic agent can obtain substantial market power; and

(d) in the US, each individual transaction is generally evaluated independently on its own merits. However the US authorities (through a court order) can require a corporation that has acquired a number of entities, to divest and reduce its market share.

5.6 Consideration of the challenges posed by creeping acquisitions is not confined to Australia. While relatively few countries have adopted measures to deal with creeping acquisitions, there is a reasonably high level of recognition that they are not easily addressed under either of the commonly used tests for the assessment of mergers and acquisitions. This supports the view that legislative change is required if Australia is to respond effectively to threat to competition posed by creeping acquisitions.

## **6. Legislative change is required to deal with creeping acquisitions**

### **A. The aggregation model**

6.1 The aggregation model would involve a corporation being prohibited from making an acquisition if, when combined with acquisitions made by the corporation within a specified period, the acquisition would be likely to substantially lessen competition in a market. The *Trade Practices Amendment (Creeping Acquisitions) Bill 2007*, proposes a period of 6 years.

- 6.2 For the reasons set out below, Metcash does not consider that the aggregation model would be a workable or effective measure to combat creeping acquisitions.
- 6.3 Creeping acquisitions are typically described in two ways:
- (a) a series of acquisitions over time, none of which, by themselves, cause a substantial lessening of competition, but which do have this effect when considered together;
  - (b) a single acquisition by a firm that already has market power but which, by itself, does not substantially lessen competition.
- 6.4 A substantial lessening of competition is typically assessed using a 'future with and without' test. That is, the future state of competition in the market with the impugned conduct is compared to the future state of competition in the market without the impugned conduct. This is, by definition, a forward looking test. It is difficult to see how an aggregation model is compatible with this mode of analysis. It would be necessary to begin the assessment from an earlier point in time, considering whether the series of transactions has had, and will have, the effect of substantially lessening competition.
- 6.5 The problem is that market conditions change over time. The conditions that prevailed in a market at the time of the first transaction will not necessarily be the same as those that prevailed at the time of the last transaction. The definition of the market itself can change. Something as simple as a new road can change the geographic boundaries of a retail grocery market. How much weight can be given to earlier transactions in light of the potential for changing market conditions? There is an element of retrospectivity about the aggregation model. It has the potential to cast

doubt over the validity of an earlier transaction which may have been lawful at the time.

6.6 Further, the aggregation model assumes that, in local retail markets, there will be a series of transactions that can be considered in combination with the acquisition under review. However, the ACCC's approach to market definition (see paragraph 4.8 above) may result in quite small local retail markets, especially in rural and regional areas. In such markets there may be few, if any, transactions that can be considered in the context of a creeping acquisition. This does not mean that a creeping acquisition cannot occur. As noted in paragraph 6.3 above, a creeping acquisition can occur where a firm which already has a substantial degree of market power seeks to acquire a small market participant. It simply means that the aggregation model will not be effective in guarding against such an acquisition.

6.7 The aggregation model is only capable of logical application if it is seen this way – because of the effect of the firm's earlier transactions, its next transaction must be prohibited. Put another way, because a firm is already large, it cannot be allowed to become any larger. This is, in effect, a less clearly defined version of the substantial market power model. This is discussed below.

## **B. The substantial market power model**

6.8 Under the substantial market power model, a firm would be prohibited from making an acquisition if it already has a substantial degree of power in a market, and the acquisition would result in *any* lessening (as opposed to a substantial lessening) of competition in that market.

## *Key principles*

- 6.9 At its heart, the substantial market power model can be reduced to the following proposition – a firm which has a substantial degree of market power should not be permitted to increase or entrench that market power through the acquisition of shares or assets. Surely it cannot be suggested that it is acceptable for a firm with a substantial degree of market power to increase its market power, provided it does so in small steps? This should be uncontroversial, yet it is an issue that is not currently addressed by the TPA. Section 46 only proscribes the taking advantage of market power for a specific purpose, while s 50 only prohibits acquisitions which will substantially lessen competition. A firm which already has market power can make further acquisitions provided that the resulting lessening of competition is not substantial.
- 6.10 The TPA has, in the past, prohibited a dominant firm from making an acquisition that would further increase its dominance. Prior to 1992, s 50(1)(b) prohibited a dominant corporation from acquiring shares or assets of a body corporate if the acquisition "*would, or would be likely to, substantially strengthen the power of the corporation to dominate the market*".
- 6.11 Metcash does not believe that the former provision should be reinstated as:
- (a) "dominance" is too high a threshold; and
  - (b) this provision still has the "substantiality" element which is the challenge posed by s 50 as currently drafted.
- 6.12 However, it should be recognised that the basic principle underpinning the substantial market power model is not novel or unknown in Australian

competition law. It is an incremental change that would address an omission in the current legislation.

*Barriers to entry and incentives to invest*

- 6.13 In considering the merits of the substantial market power model, it is important to note that it is not a "cap" or a ban on future acquisitions by a firm with a substantial degree of market power. It is not, for example, triggered by a fixed or arbitrary market share. Nor is it an absolute prohibition on further acquisitions. It prohibits only acquisitions that will lessen competition. A transaction which is not likely to lessen competition can proceed.
- 6.14 This is relevant to arguments about failing firms. If, for example, there is an independent supermarket which is keen to sell, but who genuinely cannot find a buyer other than a MSC, there will be grounds to argue that the acquisition of the supermarket by a MSC will not lessen competition.
- 6.15 Metcash acknowledges the importance of incentives to invest and recognises that a perceived barrier to *exit* could have the potential to discourage entry into the market by an independent. However, Metcash considers that this threat should not be overstated. More importantly, any perceived barrier to exit must be balanced against the improved incentives to invest that would result from measures that ensure competitive conditions will continue to exist in markets.

*The application of the substantial market power model in local retail markets*

- 6.16 It is important to recognise that market power is not merely a function of market share. This is especially true in retail grocery markets. Consider, for example, a local market where each MSC owns a supermarket and there are

two independents. Based solely on market share, it might be argued that neither MSC has a substantial degree of market power in that local market. However, the market power of the MSCs is not attributable simply to the number of stores that they have, but also to:

- (a) their vertical integration at all levels of the supply chain;
- (b) their horizontal integration into areas such as petrol retailing and banking;
- (c) their economies of scale and scope;
- (d) their attractiveness as anchor tenants in shopping centre developments; and
- (e) their financial strength and ability to establish very large sites and engage in deep price discounting compared to an independent retailer.

6.17 When these factors are considered, it is apparent that a MSC can have a substantial degree of market power in a local retail market where it is only one of several stores. It is even possible for a MSC to project this market power into a retail market where it is yet to establish a site.

6.18 Over the last 15 years there have been 22 instances, in NSW alone, where an independent supermarket has exited a local retail market shortly after the entry of a MSC:

<b>Town</b>	<b>Store Closed</b>	<b>Date (Approximate)</b>	<b>Competitor</b>
Eden	Foodtown	10 years ago	Bi Lo
Coonabarabran	Payless	13 years ago	Coles
Wellington	Payless	9 years ago	Coles
Wellington	Clancys	9 years ago	Coles
Narrabri	Payless	15 years ago	Coles
Moree	Payless	15 years ago	Woolworths
Young	Payless	12 years ago	Woolworths
Kiama	Foodtown	10 years ago	Woolworths
Helensburg	Clancys	7 years ago	Coles
Corrimal	Payless	12 years ago	Coles
Cowra	Payless	14 years ago	Woolworths
Cooma	Payless	13 years ago	Woolworths
Moruya	Payless	10 years ago	Woolworths
Bowral	Payless	12 years ago	Coles
Coffs Harbour	Payless	12 years ago	Woolworths
Goulburn	Payless	12 years ago	Coles
Mudgee	Foodtown	15 years ago	Woolworths
Lithgow	Riteway	8 years ago	Woolworths
Armidale	Payless	12 years ago	Woolworths
Temora	Foodland	15 years ago	Woolworths
Batemans Bay	Foodland	15 years ago	Woolworths
Concord	Jewel	8 years ago	Coles

6.19 Numerous submissions to the ACCC grocery inquiry alleged that MSCs had engaged in predatory pricing against independent supermarkets.<sup>36</sup> While the ACCC did not find evidence of contraventions of s 46 of the TPA, there is evidence that the entry of a MSC into a local retail market can have a significant detrimental effect on competition. When this entry occurs at the expense of an existing independent retailer, the effect on competition is likely to be more pronounced. MSCs have had particular success where they have been able to acquire the last independent supermarket in a local

<sup>36</sup> ACCC Grocery Report, pages 430-433.

retail market. As discussed earlier in this submission, once an independent supermarket exits a local retail market it is difficult, if not impossible, for the independent to return.

- 6.20 This is analogous to an observation that has been made about s 46 of the TPA, namely, that it does not prohibit a firm from engaging in conduct for the purpose of *acquiring* a substantial degree of market power. It only applies where a firm takes advantage of its existing market power.<sup>37</sup> Suggestions to address this issue include amending s 46 to apply it to a firm which has, *will have, or is likely to have*, a substantial degree of market power.<sup>38</sup>
- 6.21 In a similar vein, consideration should be given to specifying that, for the purposes of the substantial lessening of market power model:
- (a) a firm does not need to have a substantial market share in order to have a substantial degree of power in a market; and
  - (b) a firm may be taken to have a substantial degree of power in a market if it will have a substantial degree of power immediately following its entry into the market.
- 6.22 These proposals are not intended to prevent the new entry of an existing supermarket chain into a market in any form. There is nothing in the substantial market power model that would prevent a MSC from establishing a supermarket on a new site. However, a supermarket chain with a substantial degree of market power would be prohibited from

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<sup>37</sup> eg. Edwards, G, *The hole in the section 46 net*, (2003) 31 ABLR 151.

<sup>38</sup> *Id*, page 169.

entering the market by acquiring an existing supermarket if such an acquisition was likely to result in any lessening of competition.

## **7. Conclusion**

- 7.1 Creeping acquisitions are not a new issue in the Australian supermarket sector. The ACCC's grocery inquiry is simply the latest study of this behaviour. In responding to this report, the challenge for the Australian Government and the Federal Parliament is to recognise the serious threat that creeping acquisitions pose to competition and to seize what may be its final opportunity to implement effective measures to ensure that Australian consumers continue to enjoy the benefits of vigorous competition in grocery markets well into the future.
- 7.2 Metcash would be pleased to elaborate on this submission or to provide further comments on legislative proposals as they are developed.

A handwritten signature in black ink, appearing to read 'Andrew Reitzer', enclosed within a large, loopy oval scribble.

**Andrew Reitzer**

**METCASH LIMITED**

**10 OCTOBER 2008**