FEDERAL COURT OF AUSTRALIA

Australian Competition and Consumer Commission v Metcash Trading Limited [2011] FCA 967

|  |  |
| --- | --- |
| Citation: | Australian Competition and Consumer Commission v Metcash Trading Limited [2011] FCA 967 |
|  |  |
| Parties: | **AUSTRALIAN COMPETITION AND CONSUMER COMMISSION v METCASH TRADING LIMITED ACN 000 031 569 and PICK N PAY RETAILERS (PTY) LIMITED** |
|  |  |
| File number(s): |  |
|  |  |
| Judge: |  |
|  |  |
| Date of judgment: | 25 August 2011 |
|  |  |
| Catchwords: | **TRADE PRACTICES –** whether share acquisition in the grocery industry would contravene s 50 of the *Competition and Consumer Act 2010* – market definition – whether the market pleaded was a market for goods or a market for services – whether a market exists for the supply of packaged groceries by wholesale to independent supermarket retailers in NSW and the ACT – whether pressure exerted by major supermarket chains downstream at retail level relevantly constrains dedicated wholesaler for purposes of market definition – whether hypothetical monopolist test applies to price charged by wholesaler or margin earned by wholesaler – whether pleaded counterfactuals were required to be established on the balance of probabilities or on the ‘real chance’ test – whether factors in s 50(3) made a substantial lessening of competition in a market likely |
|  |  |
| Legislation: | *Competition and Consumer Act 2010* (Cth) ss 4E, 46, 50, 76 |
|  |  |
| Cases cited: | *Australian Gas Light Company v Australian Competition and Consumer Commission (No 3)* (2003) 137 FCR 317  *Boral Besser Masonry Limited v Australian Competition and Consumer Commission* (2003)215 CLR 374  *Davids Holdings Pty Limited v Attorney-General (Cth)* (1994) 49 FCR 211  *In re Tooth & Co Limited; in re Tooheys Limited* (1979) 39 FLR 1  *Queensland Wire Industries Pty Limited v Broken Hill Proprietary Company Limited* (1989) 167 CLR 177  *Re Queensland Independent Wholesalers Limited* (1995) 132 ALR 225  *Sellars v Adelaide Petroleum NL* (1994) 179 CLR 332  *Seven Network Limited v News Limited* (2009) 182 FCR 160  *Singapore Airlines Limited v Taprobane Tours WA Pty Limited* (1991) 33 FCR 158 |
|  |  |
| Date of hearing: | 14, 15, 16, 17, 18, 21, 22, 23, 24, 25, 28, 29, 30, 31 March, 6, 7, 18, 19, 20, 27 April and 6 May 2011 |
|  |  |
| Place: | Sydney |
|  |  |
| Division: | GENERAL DIVISION |
|  |  |
| Category: | Catchwords |
|  |  |
| Number of paragraphs: | 461 |
|  |  |
| Counsel for the applicant: | NJ O’Bryan SC, JA Halley SC, DP O’Donovan, CG Arnott, D Tynan, TM Glover |
|  |  |
| Solicitor for the applicant: | Australian Government Solicitor |
|  |  |
| Counsel for the first respondent: | JT Gleeson SC, PJ Brereton SC, D Roche |
|  |  |
| Solicitor for the first respondent: | Freehills |
|  |  |
| Counsel for the second respondent: | JE Griffiths SC, CA Moore, RA Yezerski |
|  |  |
| Solicitor for the second respondent: | Blake Dawson |

|  |  |
| --- | --- |
| IN THE FEDERAL COURT OF AUSTRALIA |  |
| NEW SOUTH WALES DISTRICT REGISTRY |  |
| GENERAL DIVISION | NSD 1714 of 2010 |

|  |  |
| --- | --- |
| BETWEEN: | AUSTRALIAN COMPETITION AND CONSUMER COMMISSION  Applicant |
| AND: | METCASH TRADING LIMITED ACN 000 031 569  First Respondent  PICK N PAY RETAILERS (PTY) LIMITED  Second Respondent |

|  |  |
| --- | --- |
| JUDGE: | EMMETT J |
| DATE OF ORDER: | 25 AUGUST 2011 |
| WHERE MADE: | SYDNEY |

THE COURT ORDERS THAT:

1. The proceeding be dismissed.
2. The applicant pay the respondents’ costs of the proceeding.

Note: Entry of orders is dealt with in Rule 39.32 of the *Federal Court Rules 2011*.

|  |  |
| --- | --- |
| IN THE FEDERAL COURT OF AUSTRALIA |  |
| DISTRICT REGISTRY |  |
|  |  |

|  |  |
| --- | --- |
| BETWEEN: | AUSTRALIAN COMPETITION AND CONSUMER COMMISSION  Applicant |
| AND: | METCASH TRADING LIMITED ACN 000 031 569  First Respondent  PICK N PAY RETAILERS (PTY) LIMITED  Second Respondent |

|  |  |
| --- | --- |
| : |  |
| DATE: | 25 AUGUST 2011 |
| PLACE: |  |

**REASONS FOR JUDGMENT**

|  |  |
| --- | --- |
| INTRODUCTION | [1] |
| SOME BACKGROUND | [3] |
| The Grocery Industry | [4] |
| Franklins | [13] |
| Metcash | [21] |
| Private Brands | [31] |
| Services Provided by Metcash | [35] |
| The Price Charged by Metcash for Packaged Groceries | [42] |
| The Barons Strategy | [47] |
| Five Cents per Carton Increase in Service Fee | [49] |
| The PwC Report | [66] |
| Arrangements between Metcash and Franklins | [72] |
| Spar Australia Limited | [75] |
| Four Retailers | [81] |
| Koundouris | [82] |
| Karellas | [93] |
| Krnc | [94] |
| Lionis | [102] |
| THE COMMISSION’S PLEADED CASE | [110] |
| THE ISSUES | [127] |
| RELEVANT ECONOMIC PRINCIPLES | [147] |
| Object of Market Definition | [150] |
| Hypothetical Monopolist Test | [153] |
| Market Dimensions | [156] |
| Counterfactuals | [166] |
| MARKET DEFINITION | [174] |
| Geographic Dimension | [176] |
| Product Dimension | [181] |
| The Relevant Product | [184] |
| The Relevant Price | [188] |
| Conclusion as to Product | [203] |
| Functional Dimension | [204] |
| Perception of Competitive Constraints | [209] |
| Metcash’s Executive Management Committee Minutes | [216] |
| The Jardim Analysis | [231] |
| The Major Supermarket Chains as a Constraint | [239] |
| Threat of Sale as a Constraint | [272] |
| Threat of a Constraint by Woolworths as a Wholesaler | [280] |
| Franklins as a Constraint | [297] |
| Project Energise | [300] |
| Ling Chi | [326] |
| Conclusion as to Constraints | [329] |
| Conclusion as to Market | [337] |
| THE COUNTERFACTUALS | [343] |
| The Store Sale Process | [352] |
| The Consortium’s Offer | [362] |
| The Consortium’s Prospects | [385] |
| Conclusion as to the Counterfactuals | [424] |
| EFFECT ON COMPETITION | [427] |
| Section 50(3) Factors | [432] |
| Import Competition | [433] |
| Barriers to Entry | [434] |
| Level of Concentration | [436] |
| Countervailing Power | [438] |
| Ability to Increase Prices or Profit Margins | [441] |
| Availability of Substitutes | [448] |
| Dynamic Characteristics of the Market | [450] |
| Removal of a Vigorous and Effective Competitor | [452] |
| Vertical Integration | [454] |
| Conclusion as to Effect of the Acquisition on Competition | [456] |
| CONCLUSION | [461] |

# INTRODUCTION

The question raised by this proceeding is whether the proposed acquisition by the first respondent, Metcash Trading Limited (**Metcash**), from the second respondent, Pick n Pay Retailers (Pty) Limited (**Pick n Pay**), of all of the shares in the capital of Interfrank Group Holdings Pty Limited (**Franklins**) would result in a contravention of s 50 of the *Competition and Consumer Act 2010* (Cth) (**the Competition Act**). Section 50 provides, relevantly, that a corporation must not acquire shares in the capital of a body corporate if the acquisition would have the effect, or be likely to have the effect, of **substantially lessening competition** **in a market**. Under s 4E of the Competition Act, the meaning of the term **market** includes, when used in relation to any goods and services, a market for those goods or services and other goods or services that are **substitutable for**, or otherwise **competitive with**, the first-mentioned goods or services. The applicant, the Australian Competition and Consumer Commission (**the Commission**), contends that the acquisition by Metcash of Franklins would be likely to have the effect of substantially lessening competition in a market for the wholesale supply of packaged groceries to independent supermarket retailers in New South Wales (**NSW**) and the Australian Capital Territory (**the ACT**).

On 1 July 2010, Metcash entered into an agreement with Pick n Pay to acquire all of the issued shares in the capital of Franklins for $215 million. The agreement was subject to certain conditions precedent. On 17 November 2010, the Commission informed Metcash that it opposed the proposed acquisition. On 26 November 2010, the Commission undertook to commence a proceeding seeking to restrain the proposed acquisition, and the parties undertook to take all reasonable steps for securing an urgent final hearing of the proceeding on an expedited basis. Metcash also undertook not to waive any condition precedent and not to acquire any interest in shares in Franklins without giving the Commission five clear business days’ notice. Metcash and Pick n Pay have agreed that their agreement will remain on foot pending resolution of this proceeding.

# SOME BACKGROUND

It is desirable to say something about various aspects of the grocery industry and some of the participants in that industry, including Franklins and Metcash. There is no real dispute as to much of the factual background. However, there are significant disputes as to the inferences that should be drawn and the conclusions that should be reached in the light of that factual background.

## The Grocery Industry

There are four main categories of participants in the grocery industry in Australia. First, there is the **consuming public**, members of which are the ultimate acquirers of grocery products that are supplied by retailers. Secondly, there are **retailers** of grocery products, who fall into two different groups. The first group of retailers consists of self-supplying supermarket chains, such as Woolworths, Coles, Aldi and Franklins, while the second group of retailers consists of independent retailers. The third category of participants in the grocery industry consists of **wholesalers**, such as Metcash, and numerous other specialist wholesalers. The wholesalers supply grocery products to independent retailers. Finally, there are **manufacturers and primary suppliers**, who supply grocery products to the self-supplying supermarket chains, to wholesalers and directly to independent retailers. There are two different groups of manufacturers and primary suppliers. One group consists of large national manufacturers and primary suppliers of numerous types of fast-moving consumer goods, such as Coca Cola Amatil, Nestlé, Unilever and Procter & Gamble. There are also smaller, state-based manufacturers and primary suppliers, such as Saxbys Soft Drinks, McDonnell’s Fruit Supply and fresh produce farms.

The self-supplying supermarket chains undertake several stages of the process of the supply of grocery products to consumers. Those stages range from negotiating with and acquiring products from manufacturers and primary suppliers, including fresh produce from farms, to delivering the products to their retail stores, pricing the products on the shelves of the retail stores and selling the products to the consuming public. On the other hand, independent retailers acquire their products from wholesalers, or, less often, directly from manufacturers and primary suppliers.

Wholesalers negotiate with, and acquire grocery products from, manufacturers and primary suppliers, including fresh produce from farms, and supply those products to independent retailers. Some independent retailers make their own arrangements for the delivery of grocery products from the wholesalers to their retail stores. Others rely on the wholesalers for their deliveries.

Independent retailers are generally responsible for pricing the products on the shelves in their retail stores and selling the products to the consuming public. However, when products are sold as part of a promotion, a ceiling price for the retail sale of products to the consuming public may be fixed by the wholesalers in consultation with the retailers.

Independent retailers whose stores are of a similar size and character and are supplied by the same wholesaler usually operate under a common **banner**. Each member of a banner group adopts a common public brand, which is represented in the painting of store fronts and interiors. A retail store’s banner affects its trading name, get-up and appearance. Members of a banner group are offered a range of retail services by their wholesaler, are encouraged to follow common stocking and discounting policies and have access to shared funds for promotions. Such an approach to grocery retailing simulates, to a degree, the pattern of business employed successfully by the self-supplying supermarket chains, while retaining some independence of action for the individual retailers, particularly in pricing policies.

Stores with a floor space in excess of 1,200 square metres are commonly described as **supermarkets**, although many self-service stores smaller than that are also sometimes referred to as supermarkets. Such smaller stores are necessarily restricted in the product range that they offer, and they are often described as **top-up stores**. Smaller retail stores, which do not offer a large or diverse product range, counter the large supermarkets by offering personal services directed to convenience. Stores that sell a narrow range of popular items in a trading area of less than 350 square metresare commonly described as **convenience stores**.

The existence of banner groups that are tied to a wholesaler, in the sense that the wholesaler controls the banner name and the group members have some obligation to conform to certain styles and standards, is central to a wholesaler’s commercial performance and prospects. Operating a successful banner group requires that retailers accept a degree of subordination of their own commercial independence to a larger commercial strategy. Under such a strategy, the wholesaler and banner groups of similar retailers present a common face to the consuming public and adopt similar stocking policies, similar pricing and common promotions. There will be a loss of competitiveness if banner discipline is poor.

There is considerable diversity in what is offered to consumers by retailers. Thus, each of the following may be of significance, and the subject of competition:

location;

range of merchandise;

store layout and presentation;

checkout facilities;

hours of trading;

personal service; and

price.

The grocery industry in Australia is a highly competitive industry characterised by high volumes and low margins. The operators of self-supplying supermarket chains are extremely disciplined and endeavour to standardise their offerings at any one time. Nevertheless, those offerings are not static, but shift as the chain operators explore market opportunities and develop new strategies. On the other hand, the products offered by independent retailers exhibit greater diversity than those of the chains in areas such as, for instance, size and location. Independent retailers may choose, or be forced, to rely upon factors other than price to attract customers.

## Franklins

Franklins operates a grocery business in NSW involving both wholesale and retail activities. The assets of that business (**the Franklins assets**) include:

the brand and trademark **Franklins**;

the brand and trademark **No Frills**;

leasehold interests in respect of 79 retail premises in which Franklins operates stores;

a management agreement in respect of one further retail store which Franklins operates;

franchise agreements with the operators of ten retail stores;

agreements with various information technology licensors, logistics providers, manufacturers and other suppliers, under which Franklins acquires groceries and supplies the groceries to the 90 stores referred to above; and

various intangible assets owned or controlled by Franklins, including pricing systems and expertise in promotions and advice, which assist in acquiring groceries and supplying them to retail stores.

The 80 retail stores operated by Franklins (**the Franklins Corporate Stores**) and the ten retail supermarket stores operated under franchise (**the Franklins Franchise Stores**), to which I have referred above, all operate under the Franklins banner. All of those stores are located in NSW. Franklins supplies grocery products to all of the stores. The grocery products include packaged groceries, health, beauty and cosmetic products, general merchandise and fresh produce.

Franklins is a wholly owned subsidiary of Pick n Pay, which is incorporated in the Republic of South Africa. Pick n Pay is a wholly owned subsidiary of Pick n Pay Stores Limited (**Pick n Pay Stores**), a company which is incorporated in the Republic of South Africa and listed on the Johannesburg Stock Exchange. The business of Pick n Pay Stores and its subsidiaries (**the Pick n Pay Group**) consists of a network of 888 retail stores, which operate under various brands in South Africa, a number of other countries in southern Africa, and Australia. Most of the stores are owned by the Pick n Pay Group, although several are franchised. Although the franchised stores are independently owned, they have similar get-up to the stores corporately owned by the Pick n Pay Group, and are marketed and promoted together with the Pick n Pay Group’s own stores. The Pick n Pay Group employs over 49,000 people.

Mr Gareth Ackerman has been the chairman of Pick n Pay Stores since March 2010. He succeeded his father, Mr Raymond Ackerman. Mr Nick Badminton is the chief executive officer of the Pick n Pay Group.

Mr Aubrey Zelinsky was the managing director of Franklins from June 2001 to 30 June 2010. His responsibilities included reporting on the performance of the Franklins business by preparing and presenting reports to the supervisory board of Pick n Pay every six months. Those reports were largely drafted by Mr Ronald Perlov, but were ultimately approved by Mr Zelinsky. All of the members of the executive team of Franklins reported directly to Mr Zelinsky in his role as managing director.

Mr Perlov commenced employment with Franklins in July 2001. Since that time, he has held the following positions:

general manager, finance and administration;

company secretary; and

finance director.

He has been the acting managing director of Franklins since 30 June 2010, when Mr Zelinsky announced his retirement. Mr Perlov is a director of Franklins. As acting managing director of Franklins, Mr Perlov is responsible for all operations of the Franklins business, in accordance with the authority delegated to him by the directors of Pick n Pay Stores and the chief executive officer of the Pick n Pay Group. In particular, Mr Perlov is responsible for the overall profitability, development and growth of the Franklins business, and for planning and directing, subject to approval by the directors of Pick n Pay Stores, all negotiations relating to mergers, the acquisition of new business, or the sale of major assets. In his capacity as finance director of Franklins, Mr Perlov is responsible for the management of financial aspects of the Franklins business, including managing the funding requirements of the business, reporting on the trading operations of the business, budgeting and business planning, and risk management functions.

Mr Dennis Cope is the chief financial officer of the Pick n Pay Group, and is a director of Pick n Pay and of Franklins. Mr Cope is responsible for the financial performance reporting and other internal financial reporting of the Pick n Pay Group to Mr Badminton and to the directors of Pick n Pay Stores. He is also responsible for the preparation and publication of the Pick n Pay Group’s financial accounts in accordance with its regulatory obligations. On a monthly basis, Mr Cope receives from Mr Perlov management accounts that detail the performance of the Franklins business over the relevant month and the cumulative performance of the business for the financial year.

In 2001, Pick n Pay made an initial investment in Australia of 567.9 million rand, equivalent to approximately $133.7 million. Since the initial investment, Pick n Pay has made a total investment of approximately $289.4 million. The Franklins business has made losses in seven of the ten years that it has been owned by Pick n Pay. Its accumulated losses from the original investment to 31 August 2010 are $105.1 million.

## Metcash

Metcash operates several business units or divisions, including the **IGA-Distribution** division and the **IGA-Fresh** division. IGA-Distribution is Metcash’s largest division, and is Australia’s largest grocery wholesale distribution and marketing company, with seven distribution centres located in NSW. Through its business divisions, Metcash supplies, by wholesale, various grocery products to independent retailers of various sizes throughout Australia, ranging from convenience stores to large format supermarket stores. These retailers are independent of the self-supplying supermarket chains such as Coles, Woolworths, Aldi and Franklins. As well as supplying grocery products, Metcash provides branding and other support services to independent grocery retailers, who operate under the **IGA** banner, which is owned by Metcash. Not all independent retailers are supplied by Metcash, and some of the independent retailers supplied by Metcash do not obtain all of their grocery products from Metcash.

The IGA banner is Metcash’s public face. The terms **IGA** and **Metcash** are sometimes used interchangeably in relevant documents.

Metcash has an **executive management committee** chaired by Mr Andrew Reitzer, its chief executive officer. As at February 2010, the executive management committee included Mr Mick Jablonski, the Metcash merchandise director, Mr Edwin Jankelowitz, the chief financial officer of Metcash, and Mr John Randall, the company secretary, as well as others. The committee meets on a weekly basis to discuss all aspects of Metcash’s business. If Mr Reitzer is not available, the meeting does not take place.

Mr Joao Jardim, who is known as Lou Jardim or Lou Jardin, was the chief executive officer of the IGA-Distribution division of Metcash from 2000 until February 2010. In that role, Mr Jardim attended the Metcash executive management committee meetings. Reports were made at the meetings in relation to each division of Metcash, including the IGA-Distribution division.

During the 1990s, G & L Warehouse Pty Limited (**G & L**), located in Fyshwick, ACT, was a wholesale supplier. G & L was owned and operated by a group of independent supermarket operators in Canberra, most of whom traded under the banner **Shop Rite**. G & L set up a warehouse to supply groceries to retailers, effectively at cost price, so that profits could be earned at the retail level. The warehouse was originally operated as a cost centre, rather than as a profit centre, although retailers paid a service fee to G & L. G & L did not take any share of rebates offered by manufacturers or primary suppliers, which enabled independent retailers to compete directly on price with chains such as Coles and Woolworths. G & L also passed on to retailers a portion of the **warehouse rebate** it received from manufacturers and primary suppliers as a result of those suppliers not needing to deliver to individual stores.

In the late 1990s, G & L was acquired by Davids Limited (**Davids**). Metcash took over Davids in about 1998, when Davids was in significant financial trouble. Following the takeover, Metcash streamlined several independent store banners under a single banner, namely IGA, removing numerous independent banners that were then in the market.

In 2005, Metcash acquired a business known as Foodland Associated Limited (**Foodland**), as a result of which it was able to achieve synergies and economies of scale across all of its divisions, with cost savings and efficiency gains being delivered through the integration of personnel, systems and warehouse operations. Metcash benefited from volume gains of approximately $900 million. Following the Foodland acquisition, Metcash moved from its Loganlea warehouse in Queensland to a new warehouse location at Crestmead in Queensland, and was able to spread its fixed costs, overheads and expenses over increased volumes. Compared to the performance of the old Foodland warehouse, Metcash enjoyed a significant increase in productivity in terms of the cost of picking grocery products in fulfilment of retailers’ orders.

Metcash has three tiered store brands or channels under the IGA banner, namely **Supa** **IGA**, **IGA** and **IGA X-press**. Stores operating under those brands service different target groups. Supa IGA stores, which are supermarket stores and range in size from about 1,200 square metres upwards, account for about 40 per cent of sales by the IGA-Distribution division. IGA stores, which are top-up stores and range in size between about 350 square metres and about 1,200 square metres, account for around 30 per cent of sales. IGA X-press stores, which are convenience stores and range in size up to around 350 square metres, account for around 2 to 3 per cent of sales. Other independent stores supplied by Metcash account for the balance of sales by the IGA-Distribution division.

The IGA-Distribution division consults with retailers by means of its national board and state boards. Each **state board** consists of elected IGA retailers, representing each of the three tiered store brands from the relevant state. Those retailers are joined on the board by a number of state-based executives of the IGA-Distribution division, including the state general manager for IGA-Distribution. The precise composition of each state board otherwise varies from state to state. The **national board** consists of IGA retailers from the state boards, representing each of the three tiered store brands. Those retailers are joined by four appointed directors of the IGA-Distribution division and Metcash, who have the same voting rights as the retailers. The state boards meet approximately monthly, while the national board meets five or six times a year. The boards are advisory only.

As chief executive officer of the IGA-Distribution division, Mr Jardim attended all meetings of the national board. He occasionally attended meetings of state boards.

### Private Brands

To compete with the broad range of private label products offered by the **major supermarket chains**, a term I shall use to refer to Coles and Woolworths, and, to a lesser extent, Aldi, Metcash supplies three tiers of private label products to IGA retailers. They are:

**Black & Gold** – a range of low price private label products;

**IGA Signature** – a range of premium private label products supplied only to IGA retailers; and

**IGA Pure Organics –** a range of organically grown products supplied only to IGA retailers.

Black & Gold products are available to any independent retailer who wishes to purchase them. Metcash, through the IGA-Distribution division, supplies Black & Gold products for the same price and on the same terms to all independent retailers, regardless of the banner under which they operate. Metcash sources its Black & Gold products through Metfood Pty Limited (**Metfood**). Metfood was established in May 2006 and is jointly owned by Metcash and Foodstuffs (NZ) Limited (**Foodstuffs**), a New Zealand-based entity. Metfood was established to enable Metcash and Foodstuffs to improve their joint buying power in order to obtain private label products more cheaply and to provide those products to their retailers at lower prices.

Metfood conducts a tender process in relation to each private label product. There are around 900 to 1,000 products in the Black & Gold range. Through the tender process, Metfood is able to ensure that Metcash and Foodstuffs obtain the best possible price for their private label products. In turn, Metcash and Foodstuffs are then able to supply private label products to their retailers at lower wholesale prices. That has the consequence that Metcash’s independent retailers are able to compete with the major supermarket chains and with Aldi in relation to the supply of private label products to the consuming public. Since June 2009, Metcash has reduced the standard wholesale prices of approximately 300 Black & Gold products to assist IGA retailers to compete with the major supermarket chains.

The major supermarket chains also offer private brands. Woolworths’ private brand is known as **Home Brand**, while Coles’ private brand is **Smart Buy.**

### Services Provided by Metcash

Independent retailers supplied by Metcash are free to set their own retail prices, and Metcash has no control over the prices that independent retailers charge consumers for grocery products, except in relation to promotions. However, because independent retailers must compete with Woolworths or Coles stores in their vicinities, Metcash encourages them to benchmark their standard shelf prices against Woolworths’ or Coles’ standard shelf prices. Of particular interest are items known as **key value items**, which are supermarket products whose prices are often known to consumers and used by them to assess the value on offer from a store. Milk and bread are examples of key value items. For many independent retailers, gathering and monitoring Woolworths’ and Coles’ standard shelf prices would be a practical impossibility. However, because competing with Woolworths and Coles at the retail level is essential for the success of the independent grocery network as a whole, Metcash has established a retail pricing service for independent retailers. In NSW, the retail pricing service is known as the Mix & Match Retail Pricing System (**the Mix & Match System**).

The Mix & Match System involves several steps. Metcash staff check standard shelf prices in Woolworths and Coles stores every week on a rotational basis. That entails prices for between 1,200 and 1,500 items being checked weekly, and prices for other products being checked on an eight-week rolling cycle. The prices are entered into the retail pricing service, which is usually divided into categories of grocery products, such as breakfast cereal, canned vegetables and baby products. Metcash uses the price check data to generate different **pricing zones**, which enable independent retailers to select how far above or below the standard Woolworths shelf price they price their grocery products. Pricing zones have nothing to do with geography. Woolworths has traditionally been the price leader in the grocery market, and therefore Woolworths’ prices generally provide the benchmark for independent grocery pricing. However, there are some signs that Coles is becoming a price leader, at least in relation to certain products. Accordingly, Metcash double-checks against Coles’ prices as well.

Of the pricing zones generated by Metcash, the zone corresponding with standard shelf prices at the relevant Coles or Woolworths store is regarded as a base zone. Independent retailers select different pricing zones for different categories of goods, and communicate their selections to Metcash. In the Mix & Match System, **zone 60** is generally equivalent to Woolworths’ standard shelf prices, subject to minimum gross profit requirements. Therefore, if an independent retailer wants to charge the same as Woolworths for a particular category of products, it selects zone 60 for that category. If an independent retailer wants to set its prices above or below Woolworths for a particular category of products, it selects a zone other than zone 60. For example, zone 76 is equal to zone 60 plus one per cent, so a retailer using zone 76 pricing will achieve an additional one per cent gross profit compared to a retailer using zone 60. The retailer can choose pricing zones across its entire range of grocery products, or for a particular category of grocery products. Once the retailer’s price selections are communicated, Metcash generates a unique price file for the retailer, according to the retailer’s selection, and provides that price file to the retailer electronically each week. The price file can be entered directly into the retailer’s pricing system.

Of the various available pricing zones, there are five zones with gross profit percentage below zone 60 and seventeen zones with gross profit percentage above zone 60. Thus, there are altogether 23 zones from which to choose. Each individual retailer decides which zone or zones it will operate on, whether that be zone 60, a zone above or below zone 60, or some combination of zones. The zone chosen might depend upon the competition faced by the store, the banner under which the store operates, where the store sits in the marketplace, and the gross profit that the retailer seeks to achieve.

Metcash has published a distribution operations and standards manual (**the** **Metcash Manual**), which is designed to outline the services, procedures and standards for retailers operating under the IGA banner. The Metcash Manual is designed to explain to IGA retailers all the steps required so to operate, from opening an account and making necessary financial arrangements, to meeting branding, warehousing and operational requirements. It covers all services offered and supplied by Metcash through the IGA-Distribution division.

The Metcash Manual includes a catalogue of items for use in stores, such as check-out bags, cash register ribbons, carton cutters and blades, cutting boards, cleaners, clothing and the like. The Metcash Manual also describes Metcash’s centralised warehouse, which came into operation in July 2000 to supply general merchandise and slow moving products to all customers nationally. The Metcash Manual asserts that the warehouse enables more efficiency in the distribution of such products, which are, by their nature, normally “small order size”. The warehouse allows Metcash to maintain distribution of slow moving items, whose sales would not normally warrant inclusion in a state-wide distribution centre.

The Metcash Manual provides that all customers are to be on a pre-set ordering schedule. While orders can be transmitted at any time, they will not be processed except in accordance with that pre-set schedule. Orders can, however, be processed outside the pre-set time by contacting Metcash’s customer service team in advance. The Metcash Manual states that grocery orders of fewer than 100 cartons will only be processed by prior arrangement. It describes a grocery and general merchandise warehouse assembly system for orders, consisting of voice recognition technology, which is said to deliver an extremely high level of accuracy in assembly. Metcash, through IGA-Distribution, hires pallets on behalf of retailers so that deliveries can be made as efficiently as possible. The Metcash Manual describes procedures for the control of pallets, as well as procedures for dealing with such matters as hand loading, damaged stock, ordering errors, returns of goods, statements and payments, and the handling of perishable and seasonal products.

### The Price Charged by Metcash for Packaged Groceries

The price that an independent retailer pays for packaged groceries supplied by Metcash is made up of **the price shown on the Metcash invoice** for the groceries, less any **rebates or other discounts for which the retailer is eligible**. Rebates or other discounts for which a retailer is eligible are not shown on the Metcash invoice. Such rebates and discounts are typically paid by direct credit to the retailer’s trading account. The price shown on the Metcash invoice is made up of:

the supplier list price;

**minus** the published discounts that Metcash obtains from the manufacturer or primary supplier;

**minus** any promotional case deal discount;

**plus** a service fee;

**plus** a fee for any freight required by the retailer.

It is appropriate to say something further about each of those components.

The **supplier** **list price** is the starting point in determining the prices at which Metcash purchases grocery products from its manufacturers and primary suppliers. It is a standard wholesale list price that is the same for any purchaser. It is a non-promotional fixed price that is generally set on a national basis for the supply of the majority of products by manufacturers and primary suppliers. It tends to remain relatively consistent, although it is varied from time to time on the basis of changes in input costs and other market-driven factors, such as exchange rates. There is usually no negotiation between Metcash and the manufacturers and primary suppliers about supplier list prices.

**Published discounts** are discounts on the supplier list price offered by most manufacturers and primary suppliers to all customers that meet qualifying criteria. The published discounts are listed on the invoices received by Metcash from the manufacturer or primary supplier. Metcash pays to manufacturers and primary suppliers the supplier list price, reduced to the extent of any published discounts that it is able to obtain. The published discounts are:

trade discounts given by manufacturers and primary suppliers to any purchaser;

warehouse allowances, being discounts for any orders where grocery products are delivered to a warehouse, as distinct from being delivered direct to a retail store;

quantity buy allowances, being volumetric discounts given for purchasing certain quantities of the manufacturer’s or primary supplier’s product; and

settlement discounts, being discounts given in recognition of prompt payment of the account of the manufacturer or primary supplier.

**Promotional case deal** **discounts** are provided by manufacturers and primary suppliers on particular products that are on promotion. The discount attaches to cases or **cartons** of the product being promoted. Once the promotional price is set, retailers are required to sell the relevant product at no more than the promotional price. Metcash does not normally impose either a minimum or a maximum limitation on the volume or quantity of a product that a retailer can buy while the product is on promotion. Some retailers purchase volumes or quantities of a product on promotion that are in excess of what they expect to sell during the promotion period. Such purchases are said to be made by way of investment in that, while the retailers purchase the product at the promotional wholesale price, they may sell any excess after completion of the promotional period at the usual price, thereby increasing their margin on the product. This practice is known as **investment buying**.

The **service fee** charged to a retailer is calculated as a proportion of the total value of the grocery products purchased by the retailer from Metcash. The service fee proportion varies by volume and also varies from state to state.

### The Barons Strategy

Metcash considers that two of the factors that inhibit growth in the independent grocery network are difficulties in opening new stores and the creeping acquisition of stores by the major supermarket chains. Thus, in the last ten years, Woolworths, and to a lesser degree Coles, have adopted a strategy of targeting particular independent retailers, including IGA bannered retailers, offering to buy their stores, often at a premium, and converting them into Woolworths or Coles branded stores.

Metcash perceived that practice as eroding the volume and value of its independent grocery network, and therefore implemented what it calls the **Barons Strategy**. Under the Barons Strategy, Metcash approaches large, successful independent retailers, who own multiple stores, and offers to buy 26 per cent of their business. When such offers are accepted, Metcash almost always acquires its interest by subscribing fresh capital for the businesses. Ritchies Stores Pty Limited (**Ritchies**) is one of the retailers in which Metcash has acquired such an interest.

### Five Cents per Carton Increase in Service Fee

Notes from a meeting on 23 August 2006 that was attended by Mr Jardim record that Mr Jardim suggested, on that date, that an approach should be made to Mr Fred Harrison, the chief executive officer of Ritchies, and to the IGA-Distribution national board, about an increase of ten cents per carton in Metcash’s service fee. The proposed increase was discussed at the Metcash executive management committee meeting held on 25 August 2006, in the context of providing a fund for rental subsidies to enable IGA to access major shopping centres and provide what were described as “price into product” subsidies to meet competition. On 25 August 2006, Mr Jardim and Mr Reitzer received an email from Mr Mark Laidlaw, the general manager of the IGA-Distribution division in Victoria, concerning a discussion he had had with Mr Harrison. The email recorded that Mr Harrison understood Metcash’s predicament concerning rental subsidies and the burden that the matter placed upon Metcash’s cost of doing business. Mr Harrison had expressed the view that, if certain trading terms could be restructured, Ritchies would be prepared to support the increase. Mr Laidlaw said that, while the increase would create a huge amount of dissent amongst the retailers, the time may have been right to realign the imbalance in trading terms between Metcash and individual operators, on the one hand, and Metcash and multi-store operators, such as Ritchies, on the other hand. Following a further exchange, Mr Reitzer said in a later email to Mr Laidlaw on 25 August 2006 that he thought some of the increase was “for our profit”. He said that the ten cents was to fund the rental subsidies that Metcash was giving “everywhere” and to provide money for what was described as the “category killer strategy”.

At a meeting of the national board held on 29 August 2006 and attended by Mr Jardim, the national board retailers advised that they could not endorse the proposed increase. The meeting noted that Metcash would need to make a presentation to each state board and that the national board retailers would establish a working party to examine alternatives.

On 30 August 2006, Mr Jardim reported to Mr Reitzer by email that the proposed increase had been presented to the national board on 29 August 2006. He attached a draft letter that he proposed to send to all retailers. The draft letter began by referring to “relentless domination by Coles and Woolworths” of the grocery environment in Australia. The draft letter said that Metcash had borne the burden of this, and recognised the need to continue to take a leadership role by providing opportunities for all independent retailers to maintain successful and sustainable businesses. It also said that Metcash would be increasing service fees to allow for an investment in retailing and merchandising strategies, that this would benefit all independent retailers, regardless of size, and that opportunities would be created for everyone to grow and remain sustainable. The draft letter said that, with effect from 1  November 2006, the current service fee would be increased by ten cents per carton, and that information would be circulated regarding the investment of those funds and the plans being implemented that would allow independent retailers to compete.

At the Metcash executive management committee meeting held on 1 September 2006, at which Messrs Reitzer and Jardim were present, the proposed ten cents per carton cost increase was discussed. The draft letter from Mr Jardim to retailers appears to have been tabled.

On the same day, 1 September 2006, Mr Con Sciacca, general manager of the IGA-Distribution division in South Australia, sent an email to Mr Jardim concerning a meeting with Mr Roger Drake, a “baron” retailer operating under various banners in Queensland and South Australia. Mr Sciacca said that Mr Drake was not comfortable with “the concept” of the increase, as he and many other multi-store operators saw themselves as taking all the risk, with the small stores coming along for the ride. Mr Sciacca said that Mr Drake was extremely critical of the lack of detail, and had indicated that he wanted more information about how the funds raised by the service fee increase would be used. He had asked what would stop Metcash from simply applying another increase next time Metcash had a problem. Mr Sciacca reported that Mr Drake said that it was important to him that there be some certainty that Metcash would not seek to increase costs in such a manner in future.

On 5 September 2006, Mr Jardim sent an email to Mr Reitzer reporting that he had presented the proposed fee increases to the Victorian state board. He said that his assessment was that they had accepted a five cent increase, but that Metcash would need to fight hard for the other five cents.

On 8 September 2006, Mr Reitzer told Mr Jardim that he was concerned about managing any damage associated with the “ten cents exercise”. Mr Jardim responded that most of the heat would occur over the next few weeks and that, thereafter, the state general managers would be “facing the customer”.

On 11 September 2006, Mr Laidlaw sent Mr Jardim a proposed paper for a discussion with Mr Peter Noble, the chief executive officer of the operator of **Foodworks** stores, and Mr Leo Blake, a director of the operator of two chains of stores in Victoria. The paper stated that it was becoming increasingly difficult to absorb cost increases, and that some would need to be passed on.

On 15 September 2006, Mr Jardim told Mr Reitzer in an email that he would like to hold firm on the full ten cents “until we ride the storm”. He said that any concession he made would only make the retailers look for others, as they went further into the following week. On 18 September 2006, Mr Jardim reported to Mr Reitzer that the fee increase had been rejected at the Western Australia meeting “as expected”. He said that retailers were requesting transparency as to how the funds would be spent. Mr Jardim rejected the request for transparency on the basis of confidentiality issues.

On 24 September 2006, Mr Jardim sent an email to Mr Ian Ashcroft, a member of the IGA-Distribution national board, saying that he understood that Mr Ashcroft was looking for a total abandonment of the fee strategy, and that Mr Ashcroft would resign if the fees went ahead. Mr Jardim invited Mr Ashcroft to reconsider his approach. He said that the last 12 to 18 months had been extremely tough, that he had been trying to find an alternative to increasing fees, and that Metcash could not hold the increase back any further. He said that, originally, he had made the decision to lift the service fee by ten cents per carton, but that, after representation from the national board, he had agreed to implement only five cents from 1 November 2006, and to refer the other increase to the national board for further discussion. He said that the reason he needed the income was to shore up growth opportunities and recover cost increases.

On 26 September 2006, Mr Jardim reported to Mr Reitzer that a national board phone hook-up had not gone as expected. He said that he had thought he had convinced Mr Ashcroft to take a softer line, but that that must have changed. Mr Jardim said that there were, at that time, twelve members contemplating resignation and eight that wanted to work with Metcash. Mr Jardim said that the board members were maintaining their current position of taking action against Metcash, and would meet on the following Tuesday to formalise their position. He said that it appeared that Queensland and Victoria did not want to take action but that they were being overruled by NSW and South Australia, with Western Australia supporting resignation. Mr Jardim said that he thought Metcash could work through the situation in NSW and Western Australia, and that South Australia remained the issue.

On 28 September 2006, Mr Jardim sent to Mr Reitzer two draft letters to retailers concerning the proposed service fee increase. One version was for IGA retailers and the other was for non-IGA retailers. The draft letters notified their prospective receipients of a five cents per carton increase in service fees, effective from 1 November 2006, and said that that would be the first increase since 2001. The letters asserted that, over the last 18 months, Metcash had incurred significant cost increases and that, in the face of such continued increases in direct costs, it had been looking to find alternatives to increasing fees. The letters said that a fee increase could not be held back any further. The letters said that Metcash had considered various options and had elected to implement the increase across all products, representing an impost of approximately 0.1 per cent of the average turnover of an independent retail operation. The letters were sent to retailers on 29 September 2006.

On 29 September 2006, Mr Jardim sent to Mr Reitzer a copy of a speech that he proposed to deliver to the national board, seeking to justify the five cents per carton increase. In the speech, Mr Jardim justified the fee increase by reference to operational cost increases and the substantial costs directly related to ensuring that Metcash kept its independent retailers in business. Mr Reitzer responded that the proposed speech looked good to him. The speech was apparently delivered by Mr Jardim.

On 9 October 2006, Mr Jardim received a report concerning retailers’ reactions to notification of the fee increase. The report said that things were “smooth” in relation to NSW. Later on the same day, Mr Reitzer said in an email that the most important thing was to show the retailers ways to recover the 0.1 per cent impact through “lower costs” and “clever pricing”. A further report of 10 October 2006 concerning feedback indicated that “all the noise” was coming from Victoria, with some more expected from NSW and South Australia that day. Mr Reitzer responded that the only negative had come from the proprietor of the **Supabarn** stores in Canberra. I shall refer to Supabarn below.

On 11 October 2006, Mr Reitzer received a report that the mood at a meeting of the Victorian state board had been somewhat confrontational. The retailers had indicated that they were going to hold a meeting on the evening of 23 October 2006 to discuss the increase. The report said that retailers were very unhappy and would take every opportunity to destabilise the current relationship. On 18 October 2006, Mr Jardim and Mr Reitzer received a report concerning a Foodland board meeting, indicating that there had been no real aggression concerning the increase. Mr Drake referred to his disappointment concerning the increase.

On 26 October 2006, Messrs Jardim and Reitzer received an email from Mr Harrison concerning a meeting that he had had with representatives of another organisation. He said that he had been asked question after question, including questions about Ritchies’ relationship with Metcash, and about how the IGA network was performing across the country. He said that there was much talk about Woolworths and Coles, and that the question of the “ten cents per carton price increase” was raised. Mr Harrison said that he explained that it was a five cents per carton increase, representing 0.1 per cent of “our gross profits”, and that Ritchies was not going to lose the money, as it had already worked out how it would recoup the price increase from consumers without impact upon the prices of key lines. Mr Harrison explained, he reported, that there were hundreds of items on the shelves that were not stocked by the major supermarket chains and therefore could not be price checked against the chains. He said that those products, which were the slower 20 per cent of the product range, could easily “substantiate” a five cents per carton service fee increase.

Metcash implemented the five cents per carton fee increase on 1 November 2006. Having regard to the low margins typically earned by independent retailers, a price increase of 0.1 per cent of average turnover represented, in some cases, a substantial proportion of total profits.

### The PwC Report

In 2007, Metcash engaged PricewaterhouseCoopers (**PwC**) to review the IGA network, to identify the value generated annually by the network, and to say whether or not the value generated by the network was equitably split between Metcash, on the one hand, and independent IGA retailers, on the other hand. PwC presented a report dated 26 November 2007 containing its findings and conclusions (**the PwC Report**) to a meeting of the IGA national board, senior management and senior executives of Metcash, which took place in Sydney.

The PwC Report determined that, in the 2007 financial year, the IGA network earned $450 million. The IGA-Distribution division accounted for 41 per cent of that figure, with earnings before interest and taxes (**EBIT**) of $185 million, and IGA retailers accounted for 59 per cent of the figure, with combined EBIT of $265 million. The EBIT of the IGA network, as a percentage of sales, was 5.81 per cent. That was higher than the EBIT of Coles for the same period, which was 3.9 per cent, and slightly lower than the EBIT of Woolworths in the same period, which was 5.9 per cent. The PwC Report stated that, of the three tiered IGA store brands, the IGA and IGA X-press stores generated significantly higher margins on EBIT than the Supa IGA stores. However, the Supa IGA stores generated the majority, some 63 per cent, of retailers’ sales volume.

The PwC Report also recommended that developing a succession plan for stores that did not currently have a “solid lock-in” with Metcash should be a key focus to prevent independent store owners from selling their businesses to the major chains or other competitors. It reported that for 598 stores no Metcash lock-in was in place, and that a further 41 stores were locked in only through the standard Metcash supply agreement. The stores with no or very limited lock-in represented 34.3 per cent of the total IGA sales revenue.

The PwC Report stated that the IGA network generated strong profitability at both wholesale and retail levels, but also identified key opportunities for potential growth. Further, it identified some key material risks to the network: increased price competition, competitor store openings, acquisitions and refurbishments, loss of supplier income, and trading hour deregulation.

The PwC Report then suggested five **key strategic priorities** for the IGA network to address, as follows:

establishing what was described as a “competitive fresh offer” by investing in Metcash’s capabilities;

capturing market growth by opening a further 75 new Supa IGA stores and 250 IGA and IGA X-press stores by the 2012 financial year;

identifying and executing opportunities to reduce costs of doing business, both at retail level and in the supply chain;

investing in retail analytics capabilities to drive improved ranging and pricing decisions; and

strengthening the network by increasing purchase volumes through Metcash to drive sourcing efficiency.

The PwC Report stated that responsibility for the delivery and success of the recommended transformation programme would rest jointly with Metcash and IGA retailers. That responsibility, it said, must be shared and embraced by all retailers within the network, regardless of whether the retailer operated a Supa IGA store, an IGA store or an IGA X-press store, and irrespective of ownership. The key to the transformation programme was said to be the understanding by both Metcash and IGA retailers of the interdependencies and sequences proposed in the programme.

## Arrangements between Metcash and Franklins

On 14 September 2001, Franklins entered into an agreement with Metcash for the wholesale supply of groceries to Franklins supermarkets (**the Metcash Supply Agreement**). The Metcash Supply Agreement was for two years, with an option to extend for one year. Under the Metcash Supply Agreement, Metcash agreed to provide warehouse services to Franklins for a price, to pass on to Franklins all discounts, rebates and allowances associated with the products purchased by Franklins, and to maintain specified levels of service.

In late 2002, Franklins became aware that Metcash was not passing on to Franklins certain discounts, allowances and rebates in accordance with the terms of the Metcash Supply Agreement. After a complaint was made, Metcash reimbursed Franklins over $2 million for discounts and allowances that had been improperly withheld. In the light of that experience, Franklins formed the view that wholesale supply by Metcash to Franklins did not leave Franklins with sufficient margin. Accordingly, in April 2003, Franklins began exploring alternatives to the wholesale supply of groceries by Metcash, including renegotiating more favourable terms and self-supply.

In late 2003 or early 2004 Mr Zelinsky recommended to the supervisory board of Pick n Pay that it should invest in wholesale operations for the establishment of a self-supply function for Franklins. That recommendation was accepted, and, in January 2004, Franklins gave Metcash 12 months’ notice of termination of the Metcash Supply Agreement and commenced establishing self-supply operations for its supermarkets. Those operations commenced in early 2005.

## Spar Australia Limited

In 2003, Australian Retail Logistix Limited (**ARL**) was a subsidiary of United Star Supermarkets Limited (**United Star**). The shareholders of United Star were independent supermarket retailers in NSW, the ACT, the Northern Territory and Queensland, who traded under the **SPAR** and **5 Star** banners. United Star provided retail and marketing support to these retailers. ARL operated a distribution centre in Acacia Ridge, Brisbane, and supplied packaged grocery products to retailers, not all of whom were shareholders of United Star.

In December 2005, United Star and ARL merged, and, in October 2006, the name of the merged company was changed to SPAR Australia Limited (**SPAR**). SPAR is an unlisted public company. Mr Leigh Carson, who had been chief executive officer of ARL, was the chief executive officer of SPAR until December 2010. SPAR Licensing Pty Limited (**SPAR Licensing**) is a subsidiary of SPAR. SPAR Licensing is the franchisor of **SPAR**, **SPAR Express** and **5 Star** branded franchisee stores. There are approximately 139 such stores. SPAR’s wholesale sales for each of the years ended 30 June 2009 and 30 June 2010 were approximately $150 million.

On 1 December 2010, Mr Jardim, who had left Metcash in February 2010, became managing director of SPAR. Mr Jardim gave evidence in the present proceeding, including evidence concerning discussions that he had with Woolworths in December 2010, to which I shall refer later.

SPAR’s principal activities are the procurement, storage and distribution of fast moving consumer goods, liquor warehousing on behalf of a group known as the Liquor Marketing Group, the provision of marketing and retail support services for the SPAR bannered franchisee stores, retailer training programmes, and retail property development. SPAR does not own any of the franchisee stores, although it holds the head lease on two supermarket sites in Queensland. As at December 2010, SPAR supplied 153 stores in Queensland, 65 stores in NSW, 14 stores in the ACT and 6 stores in the Northern Territory. SPAR’s retail operations include store planning and design, recruitment of retailers, and training.

SPAR’s distribution centre in Acacia Ridge supplies around 13,000 lines of fast moving consumer goods. SPAR has a contract with a third party to warehouse, manage and pack customers’ orders for about 2,000 further perishable products, including freezer and chilled products. SPAR does not have the infrastructure or the facilities necessary to operate a distribution centre for perishable products such as fruit and vegetables.

Some of the 79 stores SPAR supplies in NSW and the ACT only buy from SPAR on an *ad hoc* basis every two or three weeks. Stores north of Port Macquarie are supplied by SPAR directly out of the Acacia Ridge distribution centre. Retailers operating those stores organise for the pickup and delivery of goods from the distribution centre to their stores. They also pay for the cost of freight to those stores. Stores located south of Port Macquarie are supplied by SPAR from either the Sydney or Canberra cross-docking depot. The cross-docking depots are facilities operated by a third party transport provider, which allow for the unloading and reloading of goods. The depots allow for a large delivery truck to unload goods transported from Brisbane. The SPAR delivery trucks travel from the Acacia Ridge distribution centre to those depots and unpack the products. Retailers obtaining supply through a cross-docking depot are required to organise the delivery and bear the cost of freight between the cross-docking depot and their stores.

## Four Retailers

It is desirable to say something about four independent retailers, whose relevance primarily arises from the prospect of their mounting an offer to acquire the Franklins assets if Metcash is prevented from completing its proposed acquisition of Franklins. The four retailers are controlled by members of the Koundouris, Karellas, Krnc and Lionis families.

### Koundouris

Supabarn Supermarkets Pty Limited (**Supabarn**) is part of the **Koundouris Group**, which is a family business specialising in property development, construction and property management in Canberra and Sydney. The Koundouris Group was established in 1965, and has extensive interests in Canberra and Sydney and a wealth of experience in retailing and property. The current total group debt to asset property backing ratio is less than 40 per cent. Mr Theo Koundouris is a director of Supabarn. He has worked in the retail supermarket industry since 1991, when the Koundouris family business acquired its first supermarket in the Canberra Centre in Civic, ACT. The Koundouris Group owns and operates a supermarket chain under the **Supabarn** banner.

The first Supabarn supermarket, acquired in 1991, was in significant financial difficulty, and it took around two years under Supabarn management for the supermarket to become profitable. In around March 1999, Supabarn began operating another supermarket in Kaleen, ACT. In October 1999, Supabarn commenced operating a supermarket in Five Dock, NSW. When that supermarket was acquired, the Koundouris Group purchased the surrounding freehold land for approximately $10 million and built a library for the local council, an apartment block and a car park. In around 2003 or 2004, Supabarn commenced operating a supermarket in Wanniassa, ACT. That supermarket was originally a small IGA store. The Koundouris Group purchased the store and the surrounding leasehold land and rebuilt the premises into a large supermarket. In 2008, Supabarn commenced operating, at Gymea, NSW, a supermarket with an area of approximately 1,200 square metres. In 2010 Supabarn also commenced trading at Sutherland, NSW, with a supermarket having an area of approximately 1,850 square metres. In May 2010, Supabarn commenced trading from a warehouse in Majura Park, near Canberra airport. The warehouse has an area of approximately 4,200 square metres and caters for wholesale customers and customers who require a limited range of lines in bulk, such as restaurants. The warehouse does not supply retail supermarkets. Each of the Supabarn supermarkets, apart from the Supabarn Express at Gymea, offers customers a full range of grocery products.

Since 1999, Supabarn has been unable to implement fully its business strategy of increasing the number of supermarkets it operates, because of the difficulty in acquiring appropriate sites in the ACT and NSW. Supabarn endeavours to compete with the major supermarket chains on price, quality, range and service. It is thus critical that Supabarn is able to obtain packaged groceries at a wholesale price that enables it to compete in that way.

Supabarn presently obtains many of its packaged groceries by wholesale from Metcash. The retail pricing of goods sold in Supabarn stores is the same across all stores, except at Express outlets, where the prices are generally higher, and at the warehouse, where the prices are generally lower. Supabarn generally matches the price of its packaged groceries, including freezer items, to Woolworths’ prices. Supabarn checks a list of staple items weekly. It also checks prices as posted to Supabarn by Metcash.

However, Supabarn does not sell packaged groceries below the wholesale price it has paid. As there are many items acquired from Metcash at prices above Woolworths’ retail prices, the retail price at Supabarn stores is higher than the retail price at Woolworths for those items. Consequently, Supabarn does not meet every Woolworths price on every product. It has a particular problem with Black & Goldproducts, as it acquires Black & Gold items such as flour, sugar, tissues and cheese at wholesale prices higher than Woolworths’ Home Brandshelf prices.

Supabarn obtains supply of products from sources other than Metcash where it is possible and cost effective to do so. That includes the acquisition directly from manufacturers or primary suppliers of products that are not stocked by Metcash or by the major supermarket chains. Such specialty items are priced with regard to the items in the same category offered by Woolworths, and to the relative quality of the products. Items obtained from sources other than Metcash give the Supabarn business superior margins.

Supabarn stocks Metcash’s Black & Gold generic brand and seeks to price its Black & Gold products to compete with Woolworths’ Home Brand, Coles’ Smart Buybrand and Aldi’s private brands. There are about 800 different products in the Black & Gold range. However, Supabarn does not stock the full range. mainly because of the high prices of Black & Gold products.

Since 1991, the majority of Supabarn’s packaged grocery product range has been supplied by a single wholesaler. From 1991 to 1999, the Civic supermarket received wholesale supply of packaged groceries and perishables from G & L. Following the acquisition of G & L by Davids, Supabarn’s packaged groceries were supplied by Davids. Supabarn’s arrangements for wholesale supply changed significantly within a couple of years of that acquisition. Davids implemented a strategy to manage all retailer rebates and manage promotional programmes. Rebates were negotiated and collected by Davids on Supabarn’s behalf. Supabarn therefore lost its ability to negotiate all terms directly with suppliers, and to control the use of funds provided by suppliers in the form of rebates and promotional programmes. Davids paid a fixed loyalty rebate to Supabarn of 2.5 per cent. Supabarn also paid a service fee of 2.95 per cent to Davids for warehousing services provided to Supabarn.

Between about 1998 and 2000, Metcash took over Davids. After that takeover, the 2.5 per cent rebate that Davids had paid was raised to 4.5 per cent by Metcash. The increase reflected the fact that Metcash did no marketing on behalf of Supabarn.

From 2001 until 2004, Metcash endeavoured to persuade Supabarn to operate under the IGA banner. Supabarn did not agree to do so. From 2005, after Franklins stopped being supplied by Metcash and opened its own warehouse, Metcash, through the IGA-Distribution division, endeavoured to persuade Supabarn to enter into a supply agreement. On 16 March 2006, Supabarn entered into an agreement with Metcash for the wholesale supply of packaged groceries. The main effect of entry into that supply agreement was that, in addition to the 4.5 per cent rebate on total grocery, dairy and freezer products purchased, Supabarn obtained a further 1.5 per cent rebate. After the supply agreement expired, Metcash continued to supply Supabarn supermarkets, giving the same rebate. Under the supply agreement, service and delivery fees were payable by Supabarn to Metcash. When those fees are factored in, after rebates, the net price paid by Supabarn for a product is about 1.5 per cent below the supplier list price for the product.

In about August 2007, Mr Koundouris attended a meeting with Mr Zelinsky to discuss an offer made by Supabarn to acquire the Franklins business for $120 million. The offer was rejected. However, Mr Zelinsky said that, if Supabarn brought its supermarket assets into the Franklins business, Supabarn would be offered a half interest in the Franklins business for $80 million on the basis that the Franklins business, with the Supabarn supermarkets, would be run as a joint venture. Ultimately, nothing came of the proposal.

### Karellas

Karellas Investments Pty Limited (**Karellas Investments**) owns and operates supermarkets at Cremorne, Blaxland and Pyrmont in NSW. All of the stores operated by Karellas Investments are Supa IGA supermarkets. Karellas Investments has spent a lot of time and money renovating the supermarkets and attempting to make them competitive with Coles and Woolworths. Mr Vasilli Karellas, his brother, Mr Andrew Karellas, and their parents are the directors of Karellas Investments.

### Krnc

Mr John Krnc has been involved in the supermarket business in the ACT for about 27 years. During that time, he has owned and operated several supermarkets with his brothers Steven, Tony and Robert. The first supermarket business was acquired in 1983 at Griffith. That supermarket was operated until 1985. During that time it operated under the **Food Masters** banner and was supplied by Davids. In 1986, a further supermarket business at Kambah was bought and was operated until 1995. That supermarket also operated under the Food Masters banner and was also supplied by Davids.

A supermarket business was operated by the Krnc family from 1988 at Monash, also under the Food Masters banner and also supplied by Davids. In 1989 a supermarket business at Lyneham was acquired. When that store was acquired, it operated under the Shop Rite banner and was supplied by G & L. After Davids acquired G & L, the banner was changed to **Festival** in November 1991. After Metcash acquired Davids in 1998, the store operated under the IGA banner. In 2004, the store commenced taking supply from ARL, and the banner was changed back to Shop Rite. The Lyneham store is currently supplied by Metcash and operates under the IGA banner.

In 1991, a supermarket business at Hawker was acquired by the Krnc family. When acquired, it was operated under the Shop Rite banner and was supplied by G  & L. Subsequently, the banner was changed to Festival, and supply was taken from Davids. After Metcash acquired Davids, the store operated under the IGA banner, but the banner changed back to Shop Rite in 2004. The Hawker store is currently supplied by Metcash under the IGA banner.

In 2003, a new supermarket was constructed at Nicholls by the Krnc family. This supermarket initially operated under the IGA banner. The Nicholls store was supplied by Metcash until 2004, when the banner changed to Shop Rite and supply was obtained from ARL. The Nicholls store was a top-up store. The store was sold in 2007.

In 2006, a supermarket business and land was acquired by the Krnc family at Hackett. The Hackett store is supplied by Metcash and operates under the IGA banner. Finally, in July 2008, the Krnc family acquired a supermarket business in Karabar, Queanbeyan, NSW. The Karabar store is a full-line supermarket. It is supplied by Metcash and is branded Supa IGA.

The Karabar, Hawker and Lyneham stores are owned and operated by Dealore Pty Limited (**Dealore**). The directors of Dealore are Mr John Krnc and his brothers. Mr John Krnc also owns and operates the Hackett store with his brothers.

Of the supermarkets that are currently owned and operated by the Krnc family, the Karabar store has the highest turnover, followed by the Hawker store, the Lyneham store and the Hackett store. The Lyneham store has about twice the annual turnover of the larger Hackett store, because of its location in a more central area with popular surrounding shops. The four Krnc brothers also operate stand-alone liquor stores in the ACT, through Supergrocer Pty Limited. The four Krnc brothers are directors of Supergrocer Pty Limited.

Mr John Krnc is on the state board of IGA-Distribution for NSW and the ACT. Mr John Krnc is also a director of Independent Liquor Retailers Pty Limited, which operates stores under the **Local Liquor** banner, and is also a director of Direct Fruit Distribution Pty Limited, which operates a warehouse in Fyshwick, ACT, that supplies fresh produce to local retailers.

### Lionis

Benzat Holdings Pty Limited (**Benzat**) is the franchisee of four Franklins supermarkets located at Springwood, Newtown, South Hurstville and Cronulla, NSW. Mr Peter Lionis and his father, Mr Michael Lionis, are directors of Benzat. Peter Lionis has been involved in grocery retailing for approximately 19 years, dealing with suppliers, wholesalers and other retailers. Michael Lionis has been involved in the grocery industry for over 30 years, originally operating a supermarket in Canberra before moving to NSW. Peter Lionis manages the four Franklins supermarkets with his father.

In the early 1990s, Benzat operated supermarkets under the IGA and Supa IGA banners. Benzat initially obtained packaged groceries from Davids, and subsequently took supply from Metcash. Peter Lionis was for some years a member of the IGA-Distribution state board for NSW. In 2006, he was awarded the title of IGA retailer of the year, and the Newtown supermarket was awarded the title of IGA supermarket of the year. Such awards are made by Metcash to high performing retailers and supermarkets promoting the IGA banner. Recipients are selected by representatives of Metcash.

The Newtown supermarket had previously been operated by Woolworths. Following the acquisition by Woolworths of a number of Franklins supermarkets in 2001, Woolworths was required to divest itself of certain supermarkets, and Benzat acquired the Newtown supermarket as part of that process. Benzat kept the prices at Woolworths’ levels initially, but soon realised that, because of the wholesale prices charged by Metcash, the supermarket could not operate profitably.

Benzat operated the Springwood supermarket under the Supa IGA banner and the Newtown supermarket under the IGA banner until 2007, when the stores became franchises of Franklins. Benzat did not sign a Metcash wholesale supply agreement. The Springwood and Newtown supermarkets both offer a full range of grocery products. Metcash supplied the Springwood and Newtown supermarkets until they became Franklins franchises in 2007.

At the end of January 2007, Peter and Michael Lionis travelled to South Africa to observe the operations of Pick n Pay Stores, including Pick n Pay Stores’ operation of a successful franchise system for supermarkets. Ultimately, in early 2007, Benzat decided to switch from Metcash to Franklins, because it was difficult to acquire additional supermarkets under Metcash, and Franklins was willing to assist Benzat to acquire additional supermarkets. Benzat signed franchise agreements with Franklins for the Newtown and Springwood supermarkets in April and May 2007. As part of the arrangements with Franklins, Benzat acquired two existing Franklins supermarkets, at South Hurstville, NSW in May 2007, and Cronulla, NSW in June 2007. Franchise agreements for those stores were entered into in May and June 2007 respectively.

The South Hurstville supermarket offers a full range of grocery items and operates as a full-line supermarket. After acquiring the South Hurstville store, Benzat renovated the supermarket at a cost of around $2 million. The supermarket at Cronulla also offers a range of different grocery items. Benzat renovated the Cronulla supermarket in October 2008 at a cost of around $1 million.

The fresh produce supplied by Franklins is not of a sufficiently high quality for Benzat’s operations, and Benzat therefore obtains fresh produce from manufacturers and primary suppliers directly. Benzat also acquires certain specialist grocery items from small manufacturers and primary suppliers who do not supply their products through the Franklins distribution centres. Benzat is occasionally able to obtain a special deal from certain manufacturers and primary suppliers who would normally supply their products through the Franklins distribution centres. It would not be possible, either from a logistics or profitability perspective, for Benzat to acquire every grocery product required to service its customers directly from individual manufacturers and primary suppliers.

Goods are acquired by Benzat at prices that include the wholesale list price and the warehouse fees, less various applicable rebates. In the case of Franklins, Benzat pays the wholesale price plus a flat fee per carton. When Benzat was supplied by Metcash, Metcash charged its service fee in the manner I have set out above. Thus, any price increase by a supplier in the cost of a carton would have meant a more significant increase to the overall price paid by the retailer by way of service fee to Metcash, compared to the situation with Franklins.

# THE COMMISSION’S PLEADED CASE

In its amended statement of claim of 28 February 2011 (**the Statement of Claim**), the Commission alleges that there is a market for the wholesale supply of packaged groceries to independent supermarkets in which:

the acquirers are independent supermarket retailers located in NSW and the ACT, who require packaged groceries to operate their businesses;

the suppliers are Metcash, Franklins and, to a lesser extent, SPAR; and

the product supplied is a range of packaged groceries, which are distinct from, and not substitutable with, any other goods, including fresh produce and pre-prepared food.

The Commission refers in the Statement of Claim to a market for “the supply of wholesale packaged groceries”. In these reasons, I shall refer, where relevant, to “the wholesale supply of packaged groceries”. I do not understand anything to turn on that distinction.

The Commission also alleges that there are high barriers to entry into the pleaded independent wholesale grocery market, by reason of the following matters:

Capital investment of approximately $30 million, a significant proportion of which is sunk cost, is likely to be required to set up the necessary physical assets to supply the pleaded market, including warehousing, stock, and information technology and logistics infrastructure.

Relationships would need to be established with manufacturers and primary suppliers to allow buying at competitive prices.

The volume of wholesale sales to independent supermarket retailers would need to be at a sufficient level to achieve a return on the capital investment required.

Securing such a volume of sales would require a significant number of independent supermarket retailers to commit to acquiring packaged groceries from any new entrant in the pleaded market.

Most independent supermarket retailers would be unlikely to commit to a new entrant in the pleaded market that did not offer retail support services, including store branding, promotions and a pricing system, in addition to the supply of groceries.

Many independent supermarket retailers would be unlikely to be able to commit to a new entrant in the pleaded market because a significant number of them have exclusive supply arrangements with Metcash, which holds equity in a number of the companies operating stores under the IGA banner, and which is the landlord in respect of a number of stores operated under the IGA banner.

Many independent supermarket retailers would be likely to be unwilling to commit to a new entrant in the pleaded market unless they were satisfied that the new entrant would have long term viability, that the quality of the store branding and retail support would be adequate, that the range offered by the new entrant would be sufficient to meet requirements, that deliveries would be sufficiently reliable and frequent to meet their requirements, and that they would be able to secure suitable generic branded products from the new entrant.

The Commission then alleges that the acquisition of Franklins by Metcash would have, or be likely to have, the following effects:

Franklins would cease to operate under the agreements by which it acquires and supplies packaged groceries by wholesale, and would cease operating its retail support assets and its associated assets that assist it in acquiring and supplying packaged groceries.

Franklins would cease to offer wholesale supply to franchisees.

Most, if not all, of the 80 Franklins Corporate Stores would be sold to persons who would operate them as stores under the IGA banner, supplied by Metcash through its IGA-Distribution division.

The operators of those stores would then acquire packaged groceries from Metcash.

The number of wholesalers capable of supplying large format independent supermarkets would be reduced to one.

Franklins, which is Metcash’s closest competitor for the wholesale supply of packaged groceries to independent supermarket retailers operating large supermarket stores, would be shut down.

New entry into, or expansion by an existing competitor within, the alleged wholesale grocery market would be unlikely, because barriers to entry would remain high.

The Commission alleges that, if the acquisition of Franklins by Metcash does **not** proceed, it is likely that the 80 Franklins Corporate Stores will be acquired by a third party or third parties, who would procure the wholesale supply of packaged groceries by acquiring and continuing to operate the Franklins assets, by establishing their own wholesale operations in NSW and the ACT, or by using the volume of sales generated by the 80 Franklins Corporate Stores to sponsor the establishment of a third party wholesaling operation for the purpose of supplying those stores and other independent supermarkets not committed to taking supply from Metcash.

Alternatively, the Commission alleges that, if the acquisition of Franklins by Metcash does not proceed, a **significant majority** of the 80 Franklins Corporate Stores is likely to be acquired by a third party or third parties, who would be likely to procure the wholesale supply of packaged groceries by acquiring and continuing to operate the Franklins assets, by establishing their own wholesale operations, or by using the volume of sales generated by the stores acquired to sponsor the establishment of a third party wholesaling operation for the purpose of supplying those stores and other independent supermarket stores not committed to taking supply from Metcash.

The Commission originally contended that SPAR was a viable third party acquirer of the Franklins business. The Commission has now abandoned that contention. Accordingly, the only third party put forward by the Commission as an acquirer of all or a significant majority of the Franklins Corporate Stores is a consortium of independent retailers based in NSW and the ACT. I shall say more about the proposed consortium below.

The Commission alleges that it follows that, if the acquisition of Franklins by Metcash does not proceed, competition in the alleged market is not likely to be substantially lessened, and the likelihood of new entry or expansion by an existing competitor will be increased, because:

the number of suppliers in the pleaded market would not be reduced;

Metcash would not be in a position to shut down its closest competitor for the wholesale supply of packaged groceries to independent supermarket retailers operating large-scale supermarket stores; and

barriers to entry into the alleged market would be lowered as a consequence of the wholesale volumes presently generated by Franklins not being tied to Metcash.

During the preparation of the proceeding for hearing, and, subsequently, during the course of the hearing, Metcash raised a question concerning the way in which the Commission puts its case. In the Statement of Claim, the Commission pleads a market in which the product supplied is described as a range of wholesale packaged groceries. The term **wholesale packaged groceries** is defined, in the Statement of Claim, as comprising a significant proportion of the **goods** sold in supermarkets, including branded and generic items such as breakfast cereal, canned food, biscuits, flour, tea, coffee, soft drinks, nappies, cleaning products, personal hygiene products and frozen goods, but not including fresh items such as fresh fruit and vegetables, meat, delicatessen or bakery items. Thus, the term is defined to comprise **goods** of a particular description, although the scope of the relevant goods is not exhaustively defined.

The Statement of Claim also asserts that the pleaded independent wholesale grocery market is a substantial market. That assertion is particularised by reference to the supply of wholesale packaged groceries. Clearly enough, wholesale packaged groceries, as defined, are goods.

The term **independent supermarket retailers** is defined in the Statement of Claim as including the ten Franklins Franchise Stores, but excluding the 80 Franklins Corporate Stores. Thus, Franklins is alleged to participate as a supplier in the pleaded market, but only insofar as it is a supplier to the stores operated under franchise, and not insofar as it engages in self-supply.

Against that background, Metcash drew attention to the terms of a report by Dr Christopher Pleatsikas served by the Commission in February 2011 (**the Pleatsikas Report**), and which was tendered by the Commission. Much of the Pleatsikas Report was rejected as evidence but was admitted as submission. Part of the Pleatsikas Report that was admitted as submission asserted that Metcash supplies **wholesale services in connection with dry grocery items**, and suggested that the relevant market was **the supply of wholesale services for dry groceries**. The Pleatsikas Report identified the question of whether the proposed acquisition of Franklins by Metcash would affect competition in a possible market for **the supply of wholesale services for dry grocery items**, and suggested that close substitutes for **the supply of wholesale services for dry groceries to retailers** did not exist. Thus, the Pleatsikas Report quite clearly expressed opinions on the basis that the relevant market was a market for the supply of services.

By letter of 2 March 2011, Metcash complained to the Commission that there was a discrepancy between the Commission’s pleaded case in the Statement of Claim and the market identified in the Pleatsikas Report. Metcash drew attention specifically to the language of that part of the Statement of Claim that refers to “a range of wholesale packaged groceries”. Metcash pointed out three differences between the market as pleaded by the Commission and the market identified by Dr Pleatsikas, the most significant of which was the discrepancy in the relevant product, being said to be, on the one hand, wholesale packaged groceries, and, on the other, wholesale services for dry groceries. Metcash stated that it intended to proceed on the basis that it was to meet the pleaded case, namely, the case asserting a market for goods. Metcash invited the Commission to formulate an amendment. The Commission declined to do so. Pick n Pay was not a party to the Commission’s response to Metcash’s complaint.

On the ninth day of the hearing, the Commission applied for leave to make a further amendment to the Statement of Claim. Significantly, the proposed amendment was to assert that the product that was the subject of the alleged independent grocery market was as follows:

**The service** of supplying a range of Wholesale Packaged Groceries (WPG) to Independent Supermarket Retailers (ISRs). The range of WPGs is distinct from, and not substitutable for, any other range of goods, including fresh produce and pre-prepared food.

Particulars

**The service comprises**:

(a) the procurement of a range of WPG from suppliers and manufacturers;

(b) the warehousing of WPG;

(c) accepting orders for particular items from the range of WPG from ISRs;

(d) gathering the WPG items ordered and preparing them for delivery or collection;

(e) arranging delivery or collection of the WPG items ordered;

(f) invoicing and accounting services as between the wholesaler and the retailers associated with each order for WPG.

[Emphasis added]

Having regard to the earlier express refusal by the Commission to seek leave to amend, and the fact that the hearing had reached its ninth day, the application for leave to amend was refused. Nevertheless, the Commission contended that, where the Statement of Claim refers to the product supplied in the alleged market as “a range of wholesale packaged groceries”, which are distinct from, and not substitutable with, supply of any other products, including fresh produce and pre-prepared foods, it should have been understood as defining the product as **the service of supply of a range of wholesale packaged groceries** to independent supermarket retailers.

Further, the Commission contended that the Statement of Claim should have been understood as saying that the service product identified consisted of the procurement of a range of wholesale packaged groceries from suppliers and manufacturers, the warehousing of wholesale packaged groceries, the acceptance of orders for particular items from the range of wholesale packaged groceries from independent supermarket retailers, the gathering of the wholesale packaged groceries ordered and the preparation of them for delivery or collection, the arrangement of delivery or collection of the wholesale packaged groceries ordered, and the invoicing and accounting services as between the wholesaler and the retailers associated with each order for wholesale packaged groceries.

Such a construction of the relevant paragraph of the Statement of Claim is insupportable. The Statement of Claim pleads a market involving the supply of goods and not the supply of services. Although it is not wholly clear what position the Commission ultimately took on the point, the Commission in its final submissions appeared to accept that it contended only for a market for the wholesale supply of goods consisting of packaged groceries, as defined, albeit not exhaustively and only inclusively. The Commission also said, however, that nothing ultimately turns, as a matter of substance, on whether the pleaded market is characterised as a market for goods or for services. The Commission said that the supply of a range of wholesale packaged groceries, as defined, was the economic activity pleaded as the *sine qua non* of the market, and that, accordingly, no question of notice to Metcash and Pick n Pay of a differently pleaded case could arise.

# THE ISSUES

Three broad issues are raised for determination in the proceeding, although the three issues are interdependent and interrelated. The first issue is **the definition of the relevant market**. The critical elements that determine the characteristics and, therefore, the boundaries, of a market are:

a **product** for which there is a demand;

a source of **supply** for the product; and

strong **substitution** between the actual and the potential sources of supply for buyers or sellers, if they are given a sufficient price incentive.

Each of those elements requires consideration.

I have referred already to the controversy concerning the Commission’s formulation of the pleaded market, and I have set out the main characteristics of the market contended for by the Commission. The Commission says that the actual and potential supply in that market by Franklins to retailers provides close competition for the existing supply by Metcash, and that there would be no credible **supply-side substitute**, a term to which reference is made later, if Metcash were to acquire Franklins. An entity may be included within a relevant market even if it does not presently supply that market, if it is such a close supply-side substitute as to be able readily to supply the market, and to do so quickly and without the need for significant new investment. The Commission says that there is no such firm capable of being included in the market for the wholesale supply of packaged groceries in NSW and the ACT.

Metcash contends, on the other hand, that there is a national market for the supply of packaged groceries, fresh products, general merchandise and health, beauty and cosmetic products to the consuming public by way of integrated retail chains and independent wholesalers supplying independent grocery retailers. Metcash says that the suppliers in that market include Woolworths, Coles and Aldi, as well as Franklins, Metcash and SPAR. Metcash says, in the alternative, that there is a market approximately within the geographical region comprising NSW and the ACT for the supply of such grocery products to the consuming public by way of integrated retail chains and independent wholesalers supplying independent grocery retailers. Pick n Pay postulates a market in terms substantially similar to the terms of the market postulated by Metcash.

The second issue concerns a comparison between the circumstances that will prevail in the future if the acquisition by Metcash does not proceed with the circumstances that will prevail if the acquisition does proceed. Such scenarios are often referred to as the “future without” and “future with” scenarios, and the exercise to be conducted by the Court is often referred to as the **counterfactual analysis.** In these reasons, I use the term **counterfactual** to mean a pleaded scenario that will come to pass in the future without the proposed acquisition. I have already set out the alternative counterfactuals pleaded by the Commission. Metcash and Pick n Pay, on the other hand, say that, if the acquisition of Franklins by Metcash does not proceed, each of the 80 Franklins Corporate Stores will be sold to one of the major supermarket chains, or sold to an independent grocery retailer, or closed. They say that Metcash will supply grocery products to the independent grocery retailers who acquire the stores.

The third issue concerns **the likely effect of the acquisition** **on competition** in the relevant market. That issue is the ultimate issue, and is dependent upon the first two issues, in that it can only be determined having regard to both market definition and the counterfactual analysis. The Commission contends that the acquisition of Franklins by Metcash is likely to have the effect of substantially lessening competition in the relevant market, and so contravene s 50 of the Competition Act. Metcash and Pick n Pay contend, on the other hand, that the acquisition is likely to have little effect on competition in the relevant market.

Before considering the three broad issues in greater detail, it is desirable to say something further about the terms in which s 50 of the Competition Act is framed. Section 50 requires the Court to determine whether a proposed acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a relevant market. The section thus has two limbs. On the one hand, the Court might be satisfied that an acquisition **would** **have** the necessary effect. On the other hand, the Court might not be able to reach that conclusion but, nevertheless, might be able to conclude that the acquisition in question **would be likely to have** the necessary effect.

In a sense, it may be otiose to enquire as to whether a particular acquisition **would** have the necessary effect, since it is difficult, if not impossible, to conceive of circumstances where an acquisition would have a particular effect but would not be likely to have that effect. Even if it be impossible to establish that an acquisition would have a particular effect, it may be established that the acquisition would be likely to have the effect. Thus, it seems that the only enquiry that needs to be made is as to whether an impugned acquisition would be likely to have the necessary effect.

A further question then arises as to the content of the concept that an acquisition would be likely to have a particular effect. The phrase **would be likely to have** may be capable of bearing two meanings. One is that it is **more probable than not** that the acquisition will have the necessary effect. The other is that there is **a sufficiently high finite probability** that the acquisition will have the necessary effect. The latter meaning may be expressed by saying that there is a **real chance** of the relevant effect eventuating (see *Australian Gas Light Company v Australian Competition and Consumer Commission (No 3)* (2003) 137 FCR 317 (***AGL***) at [342]).

The better view is that **likely** signifies a real chance rather than a greater probability than not (see *AGL* at [343]). If **likely** simply meant **more probable than not**, it would be difficult to distinguish the application of the second limb of s 50 from the application of the first limb, which, having regard to the onus of proof applicable in proceedings under Part IV, could be established on the balance of probabilities (see *AGL* at[347]).

However, a real chance or possibility does not encompass **mere** possibility. The provision in s 76 of the Competition Act for substantial pecuniary penalties for contravention of s 50 of the Competition Act suggests that the phrase **would be likely to** refers to a relatively higher degree of probability than **may**. The phrase offers no quantitative guidance, but requires a qualitative judgment about the effect of an acquisition or proposed acquisition. The bar must not be set so high as effectively to expose an acquiring corporation to a finding of contravention simply on the basis of possibilities, however plausible they may seem, generated by economic theory alone. On the other hand, the bar must not be set so low as effectively to allow all acquisitions to proceed, save those with the most obvious, direct and dramatic effect upon competition. Section 50 gives effect to a kind of competition risk management policy that must be applied in the real world. The assessment of the risk, or real chance, of a substantial lessening of competition cannot rest upon speculation or theory. The Court is concerned with commercial likelihoods relevant to the proposed acquisition. The application of the word **likely**, and the assessment of the substantial lessening of competition, must both be carried out at a level that is commercially relevant or meaningful (see *AGL* at [348]).

Section 50 also calls for an enquiry as to whether there would, or would likely, be a **substantial** lessening of competition, were the proposed acquisition to proceed. That enquiry also requires a qualitative judgment to be made. It applies to a lessening that encompasses the hindrance or prevention of competition. In order to meet the threshold, the effect of the acquisition must be meaningful or relevant to the competitive process. Little weight should be given to short-term effects readily corrected by market processes (see *AGL* at [351]). As I have indicated above, in determining whether there is likely to be a substantial lessening of competition, it is necessary to consider the counterfactuals (see *AGL* at [352]).

Further questions arise in the present case when considering precisely how the real chance test is to be applied to the future state of the relevant market, both with and without the proposed acquisition. The issue is whether the real chance test applies in relation to the identification of counterfactuals, or only in relation to the consequences of counterfactuals that are proved on the balance of probabilities. For instance, the Commission may be required to show that:

there is a real chance that a particular counterfactual will come to pass, and that, compared to the scenario in which that counterfactual comes to pass, there is a real chance that the proposed acquisition would result in a substantial lessening of competition;

there is a real chance that a particular counterfactual will come to pass, and that, compared to the scenario in which that counterfactual comes to pass, it is more probable than not that the proposed acquisition would result in a substantial lessening of competition; or

it is more probable than not that a particular counterfactual will come to pass, and that, compared to the scenario in which that counterfactual comes to pass, there is a real chance that the proposed acquisition would result in a substantial lessening of competition.

The existence of multiple or alternative counterfactuals adds a further complication.

The Commission contends that the proper approach is to ask whether or not the counterfactual propounded by it is sufficiently credible to be more than a mere possibility, and to assess the likelihood of a substantial lessening of competition on the basis of that counterfactual. The Commission says that, because there is a credible counterfactual in which the Franklins assets will continue to be operated in the relevant market, there is a real chance of a substantial lessening of competition if the proposed acquisition proceeds. The Commission says that, if the counterfactual were to be determined on the balance of probabilities, it would replace the real chance test for a substantial lessening of competition, because it would require what will happen in the future to be established on the balance of probabilities.

There is a realistic possibility, the Commissions says, that, if the acquisition does not proceed, the Franklins assets will provide the only potential alternative source of supply in the relevant market. Accordingly, there is a real chance that the acquisition would lead to a substantial lessening of competition, as it would preclude the possibility of the Franklins assets being used in competition in the relevant market for the foreseeable future. The Commission says that the alternatives to be weighed up are the certain absence of competition if the acquisition proceeds, and the real chance of competition if the acquisition does not proceed. The presence of even one small but potentially significant competitor will tend to dilute the impact of a monopoly. The removal of the beneficial effects of such a competitive constraint as is constituted by Franklins is, the Commission says, a substantial lessening of competition.

A distinction may be drawn between proof of historical facts, on the one hand, and proof of future possibilities and past hypothetical situations, on the other hand. The civil standard of proof applies to the first category but not to the second, particularly when it is necessary to determine future possibilities and past hypothetical situations for the purpose of assessing damages. If the law is to take account of future or hypothetical events in assessing damages, it can only do so in terms of the degree of probability of those events occurring. However, if the chance is so low as to be regarded as speculative or so high as to be practically certain, the Court will take that chance into account in assessing the damages. Where proof is necessarily unattainable, it would be unfair to treat as certain a prediction that has a 51 per cent probability of occurring but to ignore altogether a prediction that has a 49 per cent probability of occurring. The Court assesses the degree of probability that an event would have occurred, or might occur, and adjusts its award of damages to reflect the degree of probability (see *Sellars v Adelaide Petroleum NL* (1994) 179 CLR 332 at 350).

If those principles are analogous to those that apply to the assessment, for the purposes of s 50 of the Competition Act, of future events that are part of the counterfactual analysis for the purposes of deciding whether a substantial lessening of competition is likely, then there is no need for an adjustment of the outcome to reflect the degree of probability, because the whole test for the purposes of s 50 is circumscribed by the expression **real chance**. On the other hand, that conclusion may itself be a justification for rejecting the analogy of assessment of damages. In that exercise, the quantum of damages is first determined on the assumption that there is a certainty that the hypothetical event occurred or will occur. That quantum is then discounted by reference to the degree of likelihood as to whether the hypothetical event occurred or will in fact occur.

The Commission also contends that, if there were a further balance of probabilities test, in addition to the real chance test, acquisitions that the Court was satisfied would have a real chance of resulting in a substantial lessening of competition would nevertheless not be prohibited unless the actual chance could be proved on the balance of probabilities. That, the Commission says, would be directly contrary to s 50, in that, once the Court identifies a real chance of a substantial lessening of competition, that is to say, a likely substantial lessening of competition, there should be no further element to be established to demonstrate contravention. The Commission says that it only needs to establish a real chance of a substantial lessening of competition. It is not required to exclude all realistic possibilities that there will not be a substantial lessening of competition, which would be a fundamentally different exercise.

The Commission contends that the effect of the contentions advanced on behalf of Metcash and Pick n Pay as to the counterfactuals is that the Commission would need to establish, on the balance of probabilities, the following:

which entity would bid for which assets, both together and on a **breakup basis** (that is, on the basis that the Franklins assets were broken up and sold separately, as distinct from the proposed Metcash acquisition of share capital);

how much would be paid for the Franklins assets, both together and on a breakup basis;

how the bid would be funded;

whether Pick n Pay would accept the bid; and

how the Court would decide the matter, if the Commission opposed the counterfactual acquisition under s 50.

The Commission says that adopting such an approach would impose a standard that could seldom, if ever, be met by any moving party under s 50 of the Competition Act, in circumstances where, as in the present case, the counterfactual scenario does not involve mere maintenance of the *status quo*.

Although I do not consider that the Commission is required to show that, if the proposed acquisition proceeds, a substantial lessening of competition is more probable than not, I consider that the Commission must establish, on the balance of probabilities, what the future state of the market will be, both with and without the proposed acquisition. That is, the Commission must satisfy the Court that its counterfactual is more probable than any competing hypothesis advanced to suggest that there is no real chance of competition being substantially lessened as a result of the acquisition (see for example *AGL* at [356]).

In the present case, multiple counterfactuals are contended for by the Commission. Accordingly, the Commission is not entitled to succeed unless the Court concludes:

that it is more probable than not that one of the Commission’s counterfactuals will come to pass if the proposed acquisition does not proceed; and

that there is a real chance that, if the proposed acquisition does proceed, that would result in a substantial lessening of competition compared to the scenario in which one of those counterfactuals comes to pass.

# RELEVANT ECONOMIC PRINCIPLES

Both the Commission and Metcash adduced evidence from economists who have expertise in relation to competition. I have referred above to the Pleatsikas Report, on which the Commission places reliance. Dr Pleatsikas is a director at the Berkeley Research Group, an economic, litigation support services and business strategy consulting firm, which has its headquarters in California. Dr Pleatsikas has a B.A. from the University of Pennsylvania, an M.S. in natural resources from the University of Vermont, and an M.A. and Ph.D. in regional economic analysis from the University of Pennsylvania. He has taught economics and quantitative methods at both the University of Pennsylvania and the University of Maryland. Dr Pleatsikas’ particular areas of expertise are industrial organisation, competition policy, damages analysis, regulation and microeconomics.

Metcash relies on a report by Professor George Hay. Professor Hay is the Edward Cornell Professor of Law and Professor of Economics at Cornell University. He has a B.S. in mathematics, an M.A. in economics, and a Ph.D. in economics from Le Moyne College, Northwestern University. He has held teaching positions at Yale University and visiting professorships at the Universities of Virginia, Oxford, Melbourne, New South Wales and Sydney. The subjects he has taught include Anti-Trust Law, Comparative Anti-Trust Law, Competition Law and Policy, Economic Analysis Law, Economics for Lawyers, Industrial Organisation and Principles of Economics.

Both Dr Pleatsikas and Professor Hay are clearly well qualified to express opinions as to economic principles. In substance, as might be expected, there was little difference between the contents of their respective reports as to the relevant economic principles. However, I did not find helpful the application by the witnesses of those principles to the specific circumstances of the present case. Accordingly, I rejected those parts of their reports in which they purported to express opinions about the application of the relevant principles to those circumstances. Nevertheless, I admitted that material as submissions from the parties tendering the respective reports. I have attempted below to distil from the reports the economic principles relevant to the three issues to be determined in the proceeding, which, as I have said, are the issues involving market definition, the counterfactuals, and the substantial lessening of competition.

## Object of Market Definition

When considering an acquisition, the concept of market definition is useful in the economic analysis because it assists in throwing light on the potential for competitive harm resulting from the acquisition. In the present proceeding, defining the market is necessary to identify the field of economic rivalry in which the acquisition of Franklins by Metcash will have a potential impact.

Defining a market delineates an area of close competition relevant to a firm’s products and conduct, and involves identifying the relevant competitive constraints on firms, so that the competitive implications of the conduct in question can be assessed. **Substitution**, either in demand or in supply, defines that area of competition. If two products are substitutes, an increase in the price of one relative to the price of the other, all other things being equal, results in a decrease in the sales of the first product and an increase in sales of the second product. It is necessary to identify close substitutes, since close substitutes will impose competitive discipline on a firm and its prices. Substitution can be inferred from quantitative or qualitative information. In quantitative terms, “substitutability” is captured by measuring **elasticity** of demand and **cross-elasticity** of demand. The former provides a measure of overall constraint on prices. The latter provides a measure of substitutability between or among different products. The scenario in which a large number of consumers of a product would switch to a similar product in response to even a small increase in the price of the first product, meaning that any effort to increase the price of the first product would be doomed to failure, is an example of high cross-elasticity of demand between the two products.

The Commission’s merger guidelines define **supply-side substitution**. The merger guidelines state that a product, or a group of products, may be a supply-side substitute for a product of one of the parties to a merger if, in response to an increase in the price of the product:

the production facilities and marketing efforts used for that product can be switched quickly, and without significant investment, to supply a demand-side substitute for the product of the party to the merger;

the distribution network used by the product can be modified quickly, and without significant investment, to supply the party to the merger’s customers at their present location or within a distance they would likely travel; and

it would be profitable for the current suppliers of the product to make such changes, in that the profits earned on the assets in their current use would be less than if the assets were switched to supply a demand-side substitute for the product of the party to the merger.

## Hypothetical Monopolist Test

A critical market definition test is the **hypothetical monopolist test**. That test involves determining whether a hypothetical monopolist supplier in a market could profitably impose a **small but significant non-transitory increase in price**, most commonly between five and ten per cent, for the supply of relevant products, or whether substitution by buyers or suppliers would make such an increase unprofitable. If the hypothetical monopolist supplier could profitably impose such an increase, to which I will refer as a **relevant increase in price**, the market is correctly defined.

However, if the hypothetical monopolist supplier could not impose a relevant increase in price, a smaller and smaller market must be postulated until a positive answer can be given to the question of whether it could impose the increase profitably. The relevant market is identified as the smallest area, in terms of either product or geographic space, over which a hypothetical monopolist could profitably impose a relevant increase in price. If there are several products that compete within the same market, it is the cumulative switching to all those alternative products by consumers that determines whether close demand-side substitutes exist. If the cumulative effect is sufficient to make the relevant increase in price unprofitable, all close substitutes would be included in the market, even if the consumer switching to each individual product in isolation might be insufficient to make the relevant increase in price unprofitable.

The merger of two of several producers of a particular product might result in the market for that product being more concentrated and more susceptible to cartel activity or other forms of oligopolistic conduct, such that the unilateral exercise of significant market power could lead to higher prices. However, in circumstances where cross-elasticity of demand between two products is high, the first product would not constitute a relevant market for the purpose of assessing such a proposed merger because, even if all the producers of that product were to merge into one, the merged producer would still not have the ability to increase and maintain prices above the competitive level and remain profitable. The smallest relevant market would require the inclusion of the producers of both products.

## Market Dimensions

Markets can be defined in terms of product, function and geography (see *AGL* at [378]). I shall say something below about the application of each of those dimensions to the present case. Occasionally, time and consumer dimensions are used, but they are not of any significance to the present case.

Definition in terms of function refers to the link in the chain of production for a specific product. Different functional levels, such as manufacturing, wholesaling and retailing, for a specific product, are often complements rather than substitutes. Accordingly, care must be taken to ensure that different functional levels are not combined into a single product market in cases where hypothetical monopolists at separate functional levels could each profitably impose a relevant increase in price. If they could do so, combining the functional levels into a single relevant market may violate the principle of identifying the smallest market under the hypothetical monopolist test.

The identification of a relevant market by functional dimension requires consideration of the differences between **horizontal** economic relationships and **vertical** economic relationships. Horizontal economic relationships generally involve rivalry, whereas vertical economic relationships are generally co-operative. Generally, horizontal interactions are characterised by rivalry among entities selling the same or similar products to the same or similar customers. Such entities attempt to win custom from their competitors. In contrast, vertical interactions are generally characterised by co-operation among entities engaged in a supply and acquisition relationship. That is to say, such entities are engaged in different functions along a supply chain and would ordinarily work collaboratively to win sales at each level in that chain. In the Australian grocery industry, the self-supplying major supermarket chains, such as Woolworths and Coles, are often described as **vertically integrated**. Further, there are vertical relationships between Metcash, on the one hand, and the IGA retailers, on the other hand.

Because the different functional markets in any distribution chain for a given product are generally considered to be economic complements, rather than substitutes, in the supply of the product, whether goods or services, the functional market concept is quite different in nature from the product market concept and the geographic market concept.

Competitive rivalry involves aggressive behaviour: competitors in a market do not provide assistance to one another. Further, larger competitors do not step aside so that smaller competitors may gain a foothold in the market. Rather, competitors, as rivals, continuously seek to gain advantage in the market place. Such behaviour generally enhances efficiency and, ultimately, consumers benefit from unrestricted and vigorous competition. The separation of aggressive but efficient behaviour from behaviour that is inefficient because it undermines competition is an important object of competition analysis.

In a perfectly competitive market, there will be many sellers, each lacking the ability to influence price through its own actions. Each seller will, in such circumstances, lack **market power**. Participants in such a market must sell their products at marginal cost, being the cost associated with producing additional units of a good or service. On the other hand, in a classic monopoly market, there is only one seller, usually with significant discretion over price. A firm that has no significant competitive constraints on its pricing discretion will be regarded as having monopoly power or significant or substantial market power.

Between the extremes of a perfectly competitive market and a classic monopoly market, there are various kinds of imperfectly competitive markets. In an **oligopolistic** market, there are a few sellers of identical or similar products. Participants in such markets are generally aware of their influence over price, are cognisant of their interdependence and can often earn rates of return that exceed normal levels. Some markets can be described as being **monopolistically competitive**, in that they contain many sellers of similar products. Because monopolistically competitive firms sell similar products, they have some degree of market power and can charge prices exceeding marginal costs.

In a workably competitive market, some or even all participants may have some market power, in the sense that they all have some discretion over price, but no participant will have a substantial degree of market power. In such a workably competitive market, at any given time, prices might deviate from underlying costs and the deployed technologies might deviate from the most efficient ones currently available. Economic forces drive such a market towards efficient prices, outputs and costs, but not instantly.

Realistically, almost every participant in a market has some economic market power in the sense that the participant has some discretion over its prices and its level of product quality. However, the degree of market power that is of concern in relation to competition policy is higher than economic market power in that sense. Thus, for example, s 46 of the Competition Act employs the concept of **substantial degree of market power** as the threshold of concern. Substantial market power is the ability to earn returns substantially in excess of the opportunity cost of capital, without attracting the entry of participants who would be likely to impose significant competitive constraints.

Market power is not necessarily correlated with **market share**, although participants with relatively high market share often exercise substantial market power and participants with relatively low market share seldom exercise substantial market power. Participants are generally able to exercise substantial market power not only as a consequence of having a high market share, but also because the relevant market is protected by barriers to entry and expansion. Markets that are easy to enter are generally characterised by intense competition. On the other hand, where barriers to entry into a market are high, incumbents can more easily exercise market power because the threat of entry is more remote.

## Counterfactuals

I have already said something about counterfactuals in the context of the language of s 50 of the Competition Act. It is desirable to say something further about them from an economic perspective. Counterfactual assessments are necessarily prospective, in that assessments of the state of competition as it would be with the proposed acquisition, and without the proposed acquisition, both involve a prediction of the future.

Ordinarily, the state of competition expected to prevail if an acquisition does not occur will be a continuation of the state of affairs existing prior to the implementation of the proposed acquisition, which is, in the present case, the acquisition of Franklins by Metcash. Thus, ordinarily, one would endeavour to define the relevant product and geographic market and to measure the existing level of concentration. That level of concentration would then be compared with the level of concentration expected to prevail if the acquisition proceeds. If the market would be relatively unconcentrated both before and after a proposed acquisition, there is a presumption that the proposed acquisition would not adversely affect competition. Even if the market is relatively concentrated, but the proposed acquisition will have only a small impact on the level of concentration, a conclusion may be drawn that there would be no adverse effect on competition.

However, even where the level of existing concentration is already high, and will become appreciably higher if the proposed acquisition proceeds, and if there is the possibility of the creation of a firm with a higher market share, further analysis may be necessary, although its precise nature will depend upon the circumstances. For example, it may be necessary to ascertain whether the entity being acquired has been a significant constraining influence on the market, such that its disappearance will cause the market to function less competitively. If the proposed acquisition has the potential to create significant economies of scale or scope for the merged firm, it may be desirable to assess whether the potential reduction in competition from the reduced number of participants in the relevant market might be offset by the fact that the merged entity will be a more efficient and aggressive competitor. That consideration is more likely to be relevant when the merging firms are not currently among the largest competitors in the market.

An important consideration in evaluating whether a substantial lessening of competition is likely to result from an acquisition is the proposed purchase price, together with the prices implied by other offers, including those associated with counterfactuals. However, low offers from other parties might represent an opportunistic attempt to acquire assets with the intention of merely extracting cash from the target over the short to medium term, without making the investment that would be necessary to maintain the competitive position of the target over the long term. Thus, careful analysis of the offers is desirable in order to identify their competitive implications.

**Minimum efficient scale** is also an important consideration. In order to compete successfully over the long term, participants in the market must achieve such a scale. Failure to do so will result in costs that are too high to enable successful competition with other participants that have achieved that scale. The minimum efficient scale will vary depending on the circumstances of the participant and the market. For a wholesale supplier of products, the prices at which the wholesaler can procure products from manufacturers and primary suppliers, compared with the prices at which competitors can procure such products, may provide a good indication as to whether minimum efficient scale has been achieved. In the grocery industry, given the relatively thin margins that characterise that industry at the wholesale and retail level, quite small differences between the acquisition costs of different wholesalers can be indicative that the higher-cost wholesaler has not achieved the minimum efficient scale.

The resources available to acquirers in counterfactual circumstances are also a relevant consideration for the purposes of determining how competition might be affected by a proposed acquisition. The existence of complementary assets is a relevant factor. Complementary assets may be tangible assets, such as warehouses, or intangible assets, such as proprietary logistical procedures or contractual arrangements. The relevant extent and impact of such assets can have a significant effect on the ability of an acquirer to operate the acquired assets effectively and efficiently. If one of the potential counterfactual acquirers possesses significant complementary assets, it may be able to assure the continued long term viability of the assets to be acquired. Complementary assets can enable a participant in a market to achieve economies of scale that would otherwise be more difficult and costly to attain.

The skills of the acquirer in the industry will also be relevant, whether or not the skills were acquired in exactly the same industry. Skills from another industry may be useful if they can be applied in the industry in question.

It is also necessary to consider the resources available to a counterfactual acquirer, including the acquirer’s financial resources. To the extent that the acquirer’s plans require restructuring, upgrading, integration with other assets or other costly investments, the acquirer must demonstrate the financial means to achieve those objectives. It will also be necessary to evaluate the plans and forecasts of a potential counterfactual acquirer to determine whether those plans are feasible for the purposes of maintaining, or perhaps enhancing, the ability of the target’s assets to compete in the relevant market. Beyond an assessment of the ability of the counterfactual acquirer to deploy complementary assets, desirable entrepreneurial and technical skills and sufficient financial resources, it will be necessary to assess the plans and strategies of the prospective acquirer, as well as to make an evaluation of the acquirer’s capability of competing successfully in the marketplace.

# MARKET DEFINITION

The analysis of a claim concerning competition in a market necessarily begins with a description of the market. Under s 50(3)(d) of the Competition Act, one of the factors to be considered is the degree of countervailing power in the market. Defining the market and evaluating the degree of power in that market are part of the same process. Analysis of the two is separated only for the sake of simplicity. If a firm is vertically integrated, the relevant market for determining degree of market power will be in respect of the product that is the source of that power. After identifying the appropriate product, it is necessary to describe accurately the parameters of the market in which the relevant firm’s product competes. Too narrow a description of the market will create the appearance of more market power than in fact exists; too broad a description will create the appearance of less (see *Queensland Wire Industries Pty Limited v Broken Hill Proprietary Company Limited* (1989) 167 CLR 177 at 187-188 (***Queensland Wire***)).

The key economic characteristic that defines the boundaries of a market is substitution, as is recognised by the definition of **market** in s 4E of the Competition Act. A market is an area of potential close competition, requiring an identification of the goods or services that can be substituted for, or are otherwise competitive with, other goods or services (*Queensland Wire* at 195). It is the field of actual and potential transactions between buyers and sellers among whom there can be strong substitution, at least in the long run, if there is a sufficient price incentive. Substitution might be between one product and another, or between one source of supply and another, in response to changing prices. The possibilities of such substitution set the limits upon a market participant’s ability to “give less and charge more”. The question is whether, if a firm were to give less and charge more, there would be much of a reaction and, if so, from whom that reaction would come (see *Seven Network Limited v News Limited* (2009) 182 FCR 160 at [347]).

## Geographic Dimension

In circumstances such as the present, the exact geographic boundaries of the market are not as significant as the functional dimension of the market. The Australian supermarket industry is dominated by Woolworths and Coles, both of whom are large national companies which adopt national strategies. They are run from their head offices, negotiate on a national basis and present a national image. Similarly, Metcash is organised nationally, makes strategic decisions at the national level and presents its own national image, through the IGA brand. When Metcash’s internal documents refer to Metcash’s market share, they regularly do so by reference to its national market share.

However, factors such as the physical remoteness between centres of commercial activity throughout Australia give rise to discontinuities in possibilities for substitution across the entire country. For example, one of the many difficulties SPAR has experienced has been attempting to supply retailers in NSW in circumstances where its only warehouse is in Queensland and it has only cross-docking facilities in NSW. Such discontinuities may give rise to distinct and separate geographic markets, although Metcash contends that they should be characterised as giving rise to geographic sub-markets.

The concept of a **sub-market** has no explicit statutory role. It refers to an area of competition narrower than a market, and intended as a tool of analysis rather than an element of a legal standard of liability. Sub-markets may be used to examine how competition works in the broader market, by identifying its nature and intensity in various segments (see *Singapore Airlines Limited v Taprobane Tours WA Pty Limited* (1991) 33 FCR 158 (***Taprobane Tours***)at 181). The sub-market concept may be a way of overcoming confusion caused by the practice of separating markets according to functional levels that relate to categories of purchaser, such as wholesale and retail levels. Such categories may not be an appropriate basis for defining markets, but may support the identification of sub-markets (see *Taprobane Tours* at 181-182).

The question of market power requires consideration of market power in the relevant market, not market power in some sub-market. However, the delineation of sub-markets can be useful as pointing to a particular characteristic or structural dimension of the market that throws light on how the market works, once the market has been defined. The use of sub-markets as a tool can have a propensity to confuse. Metcash contends that it is important not to confuse an area of close competition with a sub-market, when in fact that area ought to be held to be a market. A market is an area of close competition, a field of rivalry. Both the supply side and the demand side are relevant to an assessment of the market. To speak of sub-markets does not solve the problem, but merely restates it. There may be a wider, or a narrower, area of rivalry. If the narrower area itself constitutes a market, then it is power and conduct in that area that must be examined. However, that is not to say that an evaluation of power and conduct in the narrower area can be undertaken in isolation. The dynamics of rivalry in the narrower area may be influenced by what goes on in the wider area (see *Boral Besser Masonry Limited v Australian Competition and Consumer Commission* (2003)215 CLR 374 (***Boral Besser***) at [133]).

The various wholesaling operations of Metcash are organised and delivered on a state by state basis. Thus, Metcash has state-based distribution centres and its service fees differ from state to state. The wholesaling operations of the major supermarket chains are organised largely on a state by state basis. In addition, Franklins supplies wholesale services only within NSW. Further, transport and infrastructure costs make distribution from outside NSW and the ACT uneconomic. I consider that, for present purposes, the geographic dimension of the relevant market for the wholesale supply of packaged groceries is NSW and the ACT.

## Product Dimension

In order to identify the relevant product for the purpose of defining the market in the present case, a starting point is to determine what Metcash and Franklins sell in the marketplace. The Commission says that the critical economic activity is the wholesale supply, to independent supermarket retailers, of packaged groceries, in accordance with the Commission’s definition of the term **wholesale packaged groceries**. Metcash engages in that activity through its IGA-Distribution division, which is its largest business division both by turnover and by margin. While Metcash undertakes numerous other activities, such as liquor and hardware wholesaling, the Commission says that those activities are not relevant to the present case. Further, while Franklins engages in the provision of packaged groceries to the Franklins Corporate Stores, as well as the wholesale supply of packaged groceries to the Franklins Franchise Stores, the Commission says that its activities in supplying the Franklins Corporate Stores are not relevant for present purposes.

As I have said, the Commission contends that the relevant product for the purpose of market definition is a range of packaged groceries, **including** branded and generic items, such as breakfast cereal, canned food, biscuits, flour, tea, coffee, soft drinks, nappies, cleaning products, personal hygiene products and frozen food, but **not including** fresh items such as fresh fruit and vegetables, meat, delicatessen items and bakery items. It contends that packaged groceries, as so limited, are distinct from, and not substitutable with, any other goods, including fresh produce and pre-prepared food. Metcash contends, on the other hand, that the product dimension of the market should not be confined in the manner suggested by the Commission, so as to exclude fresh produce and pre-prepared food.

The Commission sometimes describes the product thatMetcash supplies to retailers as a **service**. It contends that, for the purpose of applying the hypothetical monopolist test, the relevant price is the **margin** that Metcash makes for providing that service, not the total price that it charges for the packaged groceries that it supplies to the retailers. Metcash, on the other hand, contends that the relevant product for the purposes of market definition is the goods and associated services that it supplies and that the relevant price is the **total** **price** paid by retailers for the goods and associated services, net of all relevant allowances and rebates.

### The Relevant Product

Metcash supplies to its retailers by wholesale a wider range of products than those that fall within the Commission’s definition of packaged groceries. Similarly, retailers and the self-supplying major supermarket chains sell a wider range of products than those that fall within the Commission’s definition. The products supplied by Metcash to retailers include:

dry groceries;

frozen goods;

dairy products;

fresh fruit and vegetables;

delicatessen products; and

general merchandise.

When retailers come to sell those products, they seek to make a profit margin across this bundle of goods, not merely the goods caught by the Commission’s definition. That might involve making a smaller or no profit margin on some goods, such as milk, in order to attract customers into the store in the hope of making a greater profit margin on other goods sold to customers.

The Commission says that it does not follow that, because Metcash supplies products other than those falling within its definition, the relevant product for assessing the competition effects of the proposed acquisition should be more broadly defined. Markets, the Commission says, are defined by reference to products, not firms. Firms can and often do participate in multiple markets simultaneously.

The Commission seeks to justify confining the relevant range of goods for the purposes of market definition by excluding a range of specialty suppliers of fresh products, who provide supply-side substitution in relation to those products. Thus, the Commission appears to contend that there is a separate market for the goods supplied by Metcash by wholesale that are not within the Commission’s definition of packaged groceries. However, while there is evidence that retailers obtain products from sources other than Metcash, the process of substitution is not confined to fresh produce, and extends to packaged groceries. Such a constriction of the market is, accordingly, artificial.

The Commission’s approach would raise questions as to how a relevant increase in price should be applied to the narrower range of products for which it contends, for the purposes of the hypothetical monopolist test. Indeed, the Commission did not attempt to apply the hypothetical monopolist test to the price of the product that it says in the Statement of Claim is the relevant product for the purposes of market definition, namely, to the price of packaged groceries sold by wholesale. Rather, the Commission sought to apply the test to the margin of profit generally achieved by Metcash on its wholesale sales of packaged groceries. I do not accept that there is a separate product market limited in the way contended for by the Commission.

### The Relevant Price

In order to apply the hypothetical monopolist test, the relevant price for the relevant product must be identified. The application of the test requires identification of the product, the increase in the price of which is in question. The Commission formulates the question in the present case as whether a hypothetical monopolist could profitably increase its profit margin on the wholesale supply of packaged groceries to independent supermarket retailers by a small but significant amount for a period that is more than transitory. The Commission says that, if a hypothetical monopoly wholesale supplier of packaged groceries to independent supermarket retailers could profitably increase that profit margin by between five and ten per cent, without inducing sufficient demand-side or supply-side substitution to force prices back, then that would be a powerful indication that the product dimension for which it contends correctly identifies the relevant market.

The Commission places weight on the fact that Metcash does not manufacture goods. Rather, it acquires goods from manufacturers or other primary suppliers and sells the goods and associated services to independent retailers, deriving from these activitiesa margin above its costs of the sales. The Commission says that the wholesale supply of packaged groceries by Metcash is not of generic or bulk goods *simpliciter*, but the assembly and offer of a very large number of separate packaged groceries, which have to be selected, purchased and warehoused in order for the supply to occur. The Commission draws attention to the Metcash Manual as indicating the components of the product that Metcash supplies, which, the Commission says, involves the service of the wholesale supply of packaged groceries.

The Commission contends that, in circumstances where a wholesaler is not the manufacturer of the packaged groceries it supplies, the wholesale supplier is rewarded for its services by adding a margin, or mark-up, to the price paid by the wholesaler to the manufacturer or other primary supplier. The Commission says that that is the way Metcash describes its earnings from the wholesale supply of packaged groceries. The margin earned by Metcash in respect of its wholesale supply of packaged groceries is repeatedly referred to in the internal and public results announcements made by Metcash. Consequently, as I have already indicated, the Commissioner says that the proper application of the hypothetical monopolist test involves determining whether a small but significant non-transitory increase in that **wholesale profit margin or mark-up** would be profitable, or whether it would induce sufficient demand-side or supply-side substitution to force prices back.

The Commission says that, if such an increase in price were applied to the total price charged for packaged groceries to retailers, including the cost of the packaged groceries acquired by Metcash from its suppliers, the bar to showing that such an increase in price was profitable would be raised significantly, thereby potentially resulting in a failure to detect the ability of Metcash to increase its price significantly. The Commission also says that that would allow for a much broader market. The Commission says that, in the case of the wholesale supply of packaged groceries to independent supermarket retailers, an increase of five to ten per cent in the wholesale price of the packaged groceries would involve a doubling, or more, of the wholesaler’s profit margin.

The Commission says that the transactions between supplier and buyer, for which the supplier is directly remunerated, identify the product that is being supplied. The approach for which it contends, the Commission says, identifies the way in which, and the price for which, a wholesaler is remunerated in respect of the economic activity in which it is engaged. It says that that approach implies that a hypothetical monopolist wholesaler supplying packaged groceries to independent supermarket retailers could profitably impose on retailers a relevant increase in the profit margin it receives for that wholesale supply. That is to say, the impact of such an increase on the ability of retailers to compete against the major supermarket chains would not be large enough to make the relevant increase unprofitable for the hypothetical monopolist.

According to the Commission, a five per cent increase in the profit margin achieved by Metcash would be profitable, because it would produce an increase in retail prices of, at most, about 0.26 per cent, which could be passed on without customers noticing. The Commission says that the approach just described is consistent with the market pleaded by it and is appropriate to the analysis of the proposed acquisition of Franklins by Metcash for the purposes of s 50 of the Competition Act.

The Commission says that, whether a five per cent increase in price is applied at the level of the wholesale margin, or a smaller percentage, such as one per cent, is applied to the overall wholesale price, the impact for the purposes of market definition is broadly the same. Within the margin, there exists a pricing freedom that would have a big effect on the profits of the wholesaler, yet bring about minimal, if any, loss of sales to the independent retailer. The Commission suggests that, for the purposes of the hypothetical monopolist test, a relevant increase in price of as little as one per cent may be appropriate in industries characterised by high volumes and low margins. It says that, if a five per cent increase were to be applied at the level of the wholesale price, pricing discretion could be exercised within a very substantial area, and would not be captured by a market definition that encompasses substitutes that are not close. That, it says, would defeat the purposive function of market definition.

That contention, however, appears to beg the question. It relies on the proposition that, unless one adopts the Commission’s contention, the contention will fail. Further, the Commission’s contention would raise the question of how an alternative acquirer of Franklins could restrain Metcash from imposing such an increase. If it is as easy as the Commission implies to impose a relevant increase in price without the consuming public noticing, there is no good reason to suppose that any alternative acquirer of Franklins would ever be able to constrain Metcash from imposing supra-competitive pricing.

The Commission’s approach involves identifying the value that the wholesaler adds at its stage in the supply chain. That value is adopted as the price of the service supplied by the wholesaler. The question is then posed as to whether the wholesaler could profitably impose a relevant increase upon that amount. While Metcash provides associated services, it does not only supply services. The wholesale supply of packaged groceries is not limited to the supply of services, any more than the retail supply of groceries is so limited. Further, the associated services provided by Metcash are not available in the absence of the acquisition by a retailer of packaged groceries from Metcash.

Metcash’s practice of recording its margin in various documents, such as internal records and accounting documents, does no more than reveal that Metcash, like most firms, is interested in what profit or margin it makes. Metcash is not unique in having an interest in those matters.

There is no logical distinction between the wholesale supply of goods and the retail supply of goods in terms of characterising the activity as the supply of services, as the Commission sometimes seeks to do. If Metcash is engaged in the supply of services or a service, one could also say that the retail supply of packaged groceries involves the supply of services, namely the services of sourcing a suitable range of goods, gathering them together in one place, providing convenient access to them with car parks and the like, displaying them in a logical order on the shelves, providing facilities such as shopping trolleys with which to carry them, and so on. However, those are in fact simply aspects or incidents of the actual supply of goods by retail.

There is no logical reason why the relevant increase in price should be applied differently to wholesalers and retailers of packaged groceries, namely, to the margin earned by the former but to the price charged by the latter. Retailers do not manufacture goods any more than wholesalers do. There is no relevant distinction to be drawn between the supply of packaged groceries at the retail level and the supply of packaged groceries at the wholesale level. A conventional retail market involves the sale of goods, and the price that customers pay is the price of the goods, not the retailer’s profit margin. Similarly, a conventional wholesale market involves the supply of goods.

Thus, to draw a distinction between the wholesale market and the retail market, with the former being a services market and the latter a goods market, has no foundation in logic or reality. A wholesaler does not simply provide a service of facilitating the purchase of goods by a retailer from a manufacturer or primary supplier. The wholesaler sells goods to a retailer, and, accordingly, the relevant price for the application of the hypothetical monopolist test is the price of those goods, not the profit margin derived from the sale of the goods by the wholesaler to the retailer.

Having regard to the constraint imposed by the major supermarket chains, to which reference is made below, if Metcash were to increase the price of the range of packaged groceries supplied by it by five per cent, or even something less than five per cent, independent retailers would lose customers to the major supermarket chains. Metcash would suffer and the major supermarket chains would benefit.

The hypothetical monopolist test should be applied to the wholesale price of packaged groceries. The magnitude of the hypothetical increase in price would need, in order to satisfy the test, to be such as to cause an increase in the price of packaged groceries at the retail level by a real or noticeable amount. When applying the hypothetical monopolist test in the present case the major supermarket chains must be taken into account. There is no evidence that a hypothetical monopolist wholesaler of packaged groceries could increase prices profitably, such that the price of groceries at the retail level would increase by a significant amount.

### Conclusion as to Product

The Commission’s case has been propounded on the basis that there is a separate market for the wholesale supply of packaged groceries, as defined by the Commission. The Commission purports to apply the hypothetical monopolist test to the margin that it says Metcash makes, in the geographic market of NSW and the ACT, in supplying the service of providing packaged groceries, so defined. I do not consider that the delineation of the market should be limited by reference to packaged groceries, as the Commission would define that term. Nor do I consider that it is appropriate to apply the hypothetical monopolist test to the margin made by Metcash on the supply of packaged groceries, so defined, rather than to the wholesale price charged by Metcash for the supply of packaged groceries or any other goods supplied by it to retailers.

## Functional Dimension

The Commission relies on the distinction between wholesaling and retailing functions, based on what it says are clearly separate and distinct wholesale and retail transactions relating to packaged groceries (see *Davids Holdings Pty Limited v Attorney-General (Cth)* (1994) 49 FCR 211 (***Davids Holdings***)). It says that market transactions of significance at the wholesale and retail levels indicate separate functional levels. Thus, it says, the existence of Metcash as a discrete wholesaler indicates that wholesaling activities are economically viable and, therefore, represent a relevant economic activity for the purposes of identifying a separate wholesale market. The extent to which the wholesale services of Franklins are provided under contracts by separate firms, and so can be a viable economic activity, is, it says, also consistent with the existence of a separate wholesale functional market. The Commission contrasts the vertically integrated activities of the major supermarket chains with the separate wholesaling activities of Metcash and Franklins. The major supermarket chains operate their own wholesale supply arrangements and do not offer packaged groceries by means of a wholesale supply chain to any independent supermarket retailers on the Australian mainland. Therefore, it says, they are not included in the relevant market.

The extent of vertical integration is a continuous variable, capable of exerting a complex influence on other matters. Certainly, there are important differences between Metcash and Franklins as to their degree of integration with the retail stores. Unlike Franklins, Metcash does not own outright or franchise any of the stores operated under the IGA banner. While it has a 26 per cent ownership interest in several supermarket stores, such as Ritchies, those investments are intended to secure its wholesale supply to the stores, which, in general, are high volume Supa IGA supermarkets.

The Commission contends that it would be to miss the point of market definition to insist that each service offered by Metcash be analysed for the purpose of identifying the market, as though integration were all or nothing. The Commission says that it is necessary to focus on the alternative offers that are available to independent supermarket retailers for the wholesale supply of packaged groceries, and that that is the potential for marginal competition.

The major supermarket chains are vertically integrated for self-supply to their wholly owned retail stores. They do not offer wholesale supply of packaged groceries to independent supermarket retailers, nor do they engage in arm’s length wholesale supply transactions. By contrast, the specific aim of the business of Metcash is not to be vertically integrated with the retail level, but to offer wholesale supply only. Metcash is a focused wholesaler, and, accordingly, does not compete with its customers, who are retailers.

The Commission says that, since the major supermarket chains do not offer, and are not likely to offer, the wholesale supply of packaged groceries to independent supermarket retailers, they are not a credible alternative source of supply. That raises the question of whether it is likely or possible that Woolworths would offer the wholesale supply of packaged groceries to independent supermarket retailers, a matter that constituted a distraction during the hearing, and to which I will refer further below.

### Perception of Competitive Constraints

The Commission contends that Franklins is a close competitive constraint on Metcash, but that the major supermarket chains are not. The views and practices of those within the industry are often instructive when considering the appropriate definition of the market (see *Boral Besser* at [257]), and the Commission contends that Metcash and Franklins perceive each other as fierce competitors. For example, the Commission asserts that the entry of Franklins into wholesaling in 2005 and its wholesaling activities thereafter were the focus of intense scrutiny by Metcash. It points to what it describes as “the relentless reporting” of those activities by Metcash in its internal documents, such as minutes of directors’ meetings, reports prepared for directors and the minutes of weekly executive management committee meetings, and to regular references to Franklins’ competitive position as an actual and potential wholesaler in NSW and the ACT.

The Commission asserts that, on the other hand, there is no suggestion in any internal Metcash document that it considers the major supermarket chains to be a close or even distant constraint **at the wholesale level**. The Commission says that the only references to competition from the major supermarket chains in Metcash’s internal documents and strategy documents are to the competitive behaviour of the major supermarket chains **at the retail level**.

Metcash’s internal documents certainly demonstrate that Metcash regarded the major supermarket chains as competitors at the retail level. Weekly emails summarising the contents of the catalogues of major supermarket chains, internal emails discussing how to respond to initiatives from the major supermarket chains and communications with IGA retailers indicate that Metcash was very much conscious of the significance, for its business, of the major supermarket chains.

Metcash often acts on the basis that the major supermarket chains are major competitors. Since at least 2002, Metcash has carried out weekly price checks on Woolworths and Coles, as well as on Franklins, in relation to both standard shelf prices and promotional prices. When Metcash measures its market share, it does so by reference to a national market that includes Woolworths and Coles. Under the Mix & Match System, retailers are supplied with retail prices set by reference to Woolworths’ regular shelf prices. The IGA-Distribution division has launched several specific programs designed to assist retailers to compete with the major supermarket chains.

Other market participants also regard Woolworths and Coles as their principal competitors in the grocery industry. Franklins, for instance, perceived its principal competitors to be Woolworths, Coles and Aldi. Mr Carson, the former chief executive officer of SPAR, identified the major supermarket chains as major competitors of SPAR, and said that they placed great pressure on the prices that SPAR could charge for wholesale supply. When asked to elaborate on the pressures placed on SPAR’s prices, Mr Carson did not refer to Metcash, notwithstanding that Metcash is a large national wholesaler.

In its board reports, Woolworths identifies IGA, the Metcash brand, as one of its three major competitors. The other two are Coles and Aldi. The references to IGA in the Woolworths board reports appear under the heading “Competitive Review” and refer to advertising activities by Metcash, which form an important part of Metcash’s overall wholesaling activities. That evidence of Woolworths’ perception of its competitors accords with commercial reality.

The Commission placed considerable store on the minutes of Metcash’s executive management committee meetings. I shall therefore say something about those internal documents. A significant internal document evidencing Metcash’s perception of its competition is an analysis prepared by Mr Jardim, about which I shall also say something.

#### Metcash’s Executive Management Committee Minutes

At the Metcash executive management committee meeting held on 16 April 2004, it was noted that a strategy was to be prepared to safeguard “the NSW retail base” from attack by Franklins. At the same meeting, it was noted that NSW and Queensland sales were being affected by the “Coles/Shell arrangements”. The potential purchase of three stores by Woolworths, resulting in a loss of $1 million of annual turnover, was noted. It was also noted that Franklins’ purchases were six per cent “behind” the previous year.

On 18 June 2004, Mr Jardim sent a circular to all IGA retailers concerning the supply of milk. He began by saying “yet again, our chain opposition has cut a super milk deal”. He referred to the recent announcement of a three year milk contract between National Foods and Woolworths as showing that collective buying power “delivers best price”. Mr Jardim urged IGA retailers to respond to a questionnaire designed “to martial (*sic*) our milk buying power”.

Notes taken of a meeting concerning the IGA-Distribution division on 12 August 2004, at which Mr Jardim was present, record a proposed “NSW fighting plan”, the object of which was to block the threat of new wholesale entry by Franklins, by developing a new package that would give retailers one per cent more for signing up to various commitments. The Commission says that the note is a recognition by Metcash that Franklins’ entry into the market for the wholesale supply of packaged groceries was a threat, prompting the development of plans to prevent independent retailers from switching from supply by Metcash. The meeting appears to record the genesis of what became known as **Project Energise**, an attempt made by Metcash to secure its supply agreements with independent retailers, to which I shall refer later.

The minutes of the executive management committee meeting held on 13 August 2004 record that a new package of trading terms was being developed for NSW retailers in exchange for improved security of business continuity. The Commission characterises that both as a recognition by Metcash that Franklins was a threat and as the continued development of plans to prevent independent retailers from switching to supply from Franklins.

At the meeting of the executive management committee on 3 September 2004, it was noted that the “lock in terms” for retailers were likely to be an extra 1.2 per cent rebate in return for a five year supply agreement, a charge over the stores and a first right of refusal. It was also noted that five stores in the ACT had moved their supply arrangements. The prospect of Franklins starting franchising was noted as a threat.

At the meeting of the executive management committee on 10 September 2004, it was noted that the “lock in terms” for retailers had been drafted and were being reviewed. The minutes noted that discussions were continuing with Mr Koundouris and that Woolworths was bidding aggressively. Further reference was made to the Canberra stores being supplied independently, and a further reference was made to Franklins starting franchising.

At the meeting on 24 September 2004, it was reported that “lock in terms” for retailers had been agreed. Further reference was made to Mr Koundouris and to the fact that a competitor was now supplying seven stores in Canberra. Reference was again made to Franklins starting franchising.

The minutes of the executive management meeting held on 1 October 2004 record that meetings were being arranged with NSW stores, offering increased payment terms and rebates in return for higher **teamwork scores**, a fresh five year supply agreement, and rights of first refusal to purchase stores. I shall refer below to teamwork scores. The Commission says that that was responding to the threat from Franklins. Again, the minutes record reference to Mr Koundouris, a competitor’s supply to eight to nine stores in Canberra, and franchising by Franklins. The minutes report that Coles and Woolworths were aggressively bidding for stores, that there had been no progress with Mr Koundouris and that there was likely to be a sale to Woolworths. A proposed PowerPoint presentation regarding Project Energise was apparently presented to the meeting.

At the meeting of the executive management committee of 8 October 2004 references were again made to Franklins starting franchising. There was a report that 15 stores in Canberra were expected to transfer to the competitor, and become Franklins franchise stores at a later stage. The minutes also refer to the new terms having been agreed by the NSW state board, and to enthusiasm from retailers.

Notes of a meeting attended by Mr Jardim on 28 October 2004 refer briefly to “NSW fighting plan”, noting that there was some resistance to signing documents. The notes also record, in relation to competitive pressure, that Coles was “reducing prices across the board”. The notes also refer to a loss of stores in Canberra.

The minutes of the meeting of the executive management committee on 29 October 2004 again referred to Franklins starting franchising. The minutes also referred to new agreements being signed by retailers in relation to Project Energise, and referred to the transfer of ten stores in Canberra to the competitor.

Notes of a meeting attended by Mr Jardim on 10 December 2004, under the heading “NSW Fighting Plan”, record the following:

Done – being sold in

Resistance from the “Greek” connection

The reference to NSW Fighting Plan appears to be a further reference to Project Energise. The reference to the Greek connection appears to be a reference to the Koundouris interests. In addition, with respect to competitive pressure, the notes record that Woolworths had regained the lead, taking market share from Coles.

It is apparent from the minutes of further meetings of the executive management committee, which follow the same pattern as those briefly summarised above, that Metcash very much had Franklins in mind. It is equally apparent, however, that Metcash also had the activities of Coles and Woolworths in mind. As well as regular references to Franklins, the minutes of the executive management committee meetings regularly refer to Coles, Woolworths and relative market shares. For example, there are references to attempts by Coles to buy IGA stores. There are references to Woolworths’ pricing strategy. On 15 December 2006, there is a reference to the fact that Coles and Woolworths had reduced prices in country stores following the announcement of Metcash results. Such topics are mentioned in minutes of meetings of the executive management committee through to 2010.

The conclusion to be drawn from this internal material is that the senior executives of Metcash were clearly concerned with the competitive effect of Franklins as a wholesaler. However, the material also clearly demonstrates that Metcash was very much concerned with the major supermarket chains as having a significant competitive effect on its business activities.

The Commission asserts that Franklins, and in particular its franchise operation, provided a greater constraint on Metcash than the major supermarket chains, such that the major supermarket chains did not provide a close competitive constraint, while Franklins did. Certainly, Franklins was a standing item at the meetings of the Metcash executive management committee. However, the minutes of those meetings do not support the Commission’s assertion. The minutes show that the major supermarket chains were also a standing item at the meetings. Comparison of the minutes suggests that the members of the committee spent more time discussing the major supermarket chains than they did discussing Franklins. Whereas references to Franklins decrease over time, the references to the threats imposed by the major supermarket chains increase.

#### The Jardim Analysis

A significant internal Metcash document is a market activity analysis prepared by Mr Jardim in May 2009 (**the Jardim Analysis**). Mr Jardim described his analysis as a brief marketplace overview of recent activity and a comparative snapshot of Metcash’s major competitors and the pressures on them, with a simple overview of their current strategies. The Jardim Analysis described the Australian supermarket landscape as continually changing, and said that the fight for sales and market share in an industry dominated by two companies was extremely fierce. It said that, aside from the two major chains, being Woolworths and Coles, a third player, presumably Aldi, was fast emerging as a considerable threat. It also said that, apart from those industry pressures, new competitors were about to enter the Australian market.

The Jardim Analysis set out a table showing the strategic focus of each of the key retailers then currently trading in the Australian market. The table of strategies shows a high degree of overlap between the strategies of Woolworths, Coles and the IGA network. The Jardim Analysis stated that, at face value, the table showed the strength of Woolworths and the ability of Woolworths to dominate in many key strategic initiatives. Its cash flow and market dominance allowed Woolworths not only to participate in multiple strategic initiatives, but also to apply significant marketing expenditure, so as to dominate in those areas. At the other end of the scale, the Jardim Analysis said, Aldi took a simple and yet effective approach, involving a focus on private labels and pricing considerably lower than the rest of the market.

The Jardim Analysis then dealt with market share and stated that the most recent results showed a trend that had been current for a few years: Woolworths continued to dominate the market and was growing at a considerable rate, largely at the expense of Coles. It said that Metcash and IGA had again “grown their like for like sales” at a greater rate than any competitor in the market, but that they were a clear and distant third behind Woolworths and Coles. That was attributed to the new store growth of the chains, particularly Woolworths and Aldi, who were increasing their market share by opening new stores.

The Jardim Analysis next dealt with each of Woolworths, Coles and Aldi separately. It stated that, for the last decade, Woolworths had been the clear market leader in the Australian supermarket industry. Rather than acquiring existing businesses, Woolworths continued to expand into any “green-field sites” that it was able to obtain. In particular, Woolworths was identifying small towns where it could establish a presence, either directly in the town or just outside, and could draw business away from the existing retail outlets. Three examples were given where IGA stores were operating.

The Jardim Analysis stated that recent trends suggested that Woolworths was willing to reduce its “store footprint and layout” to venture into smaller size operations, thereby giving it a presence in markets that would have previously been considered too small. That was said to be one of IGA’s largest threats, since that strategy directly affected existing IGA businesses. If there were no existing IGA businesses, the strategy would limit any potential for IGA to venture into those areas, once Woolworths had established a foothold. A recent example in Jindabyne was mentioned, whereby Metcash sought to stop Woolworths taking over an independent store. In that case, Woolworths negated any anti-competitive arguments by closing down an operation in Cooma so that the purchase could proceed.

The Jardim Analysis said that Coles had made significant demands on its relationships with manufacturers and primary suppliers, asking for income and support for little return. It was suggested that, in an effort to claw itself back to a respectable financial situation, Coles was targeting suppliers as one means of obtaining quick income.

The Jardim Analysis said that Aldi’s significantly reduced range and type of offer, as well as its physical size and store footprint, was allowing it to position stores on sites that were considered too small by the large chains and traditional supermarkets. That allowed Aldi to sneak “under the radar”, but its impact on a town, customers and other supermarkets in the area could nevertheless be considerable. The Jardim Analysis said that those smaller sites were “at the heart” of the IGA medium-tier store channel. It observed that the number of consumers trialling the Aldi business was growing, and that Aldi was doing whatever it could to convert such trialists into regular customers.

In summary, it can be said that the Jardim Analysis discloses a focused concern of Metcash, through Mr Jardim, as chief executive officer of the IGA-Distribution division, on the competitive effect of the major supermarket chains on the IGA network. It does not disclose any concern about Franklins’ wholesale activities, insofar as those activities had an impact on the activities of Metcash.

### The Major Supermarket Chains as a Constraint

Woolworths and Coles have approximately 80 per cent of the national grocery market share. Independent retailers regard the major supermarket chains as their competitors, and there is vigorous competition between independent retailers and the major supermarket chains, involving both price and non-price factors. The relevant non-price factors include range, home brand or private label product range, store location, store appearance, standards of service, quality of fresh produce, and trading hours.

Independent retailers must match or be close to the major supermarket chains on price. Price competition is not limited to regular shelf prices. Increasingly, price competition revolves around promotional pricing or specials on key value items, such as coffee, nappies, milk and cereal, which are used to attract customers to a store, and to which I have referred above. Over the past 18 months, price competition has intensified as result of increased competition between Coles and Woolworths.

The Commission accepts that there is vigorous competition at the retail level. However, it says, the relative extent to which that vigorous competition finds expression in direct head-to-head price competition, or in competition across a range of price and non-price factors, does not ultimately impact upon the proposition that there is vigorous competition at the retail level and that that competition closely constrains the ability of Metcash to give less and charge more to independent retailers.

The Commission accepts that there is some indirect constraint on Metcash’s wholesale prices from the major supermarket chains. However, it says, the fact that the major supermarket chains may be ultimate constraints on wholesale prices does not make them substitutes at the wholesale level. It says that there are critical qualitative and quantitative differences between, on the one hand, the actual or potential threat to Metcash of losing the wholesale supply of stores to Franklins or to a new owner of the assets of Franklins, and, on the other hand, the threat to Metcash of one of the independent retailers to whom it supplies losing retail sales to the major supermarket chains.

In any event, the Commission says, only some of the stores that Metcash supplies are subject to close constraint from Woolworths and Coles. Thus, Metcash has taken advantage of the diversity of its customer base by encouraging banner groupings in an attempt to exploit specific niches in the market, to meet customer demand that the chains cannot satisfy. Metcash engages in different pricing as between the stores supplied by it. The Commission says that only Supa IGA stores, being large format supermarkets, compete with the large format Coles and Woolworths supermarkets. IGA stores, being medium format grocery stores, and IGA X-press stores, being convenience stores, have smaller formats and only offer a supplementary or top-up range of products. Forty per cent of those stores are regarded by Metcash as trading in a competitive area. They generate significantly higher margins than the Supa IGA stores.

Further, Metcash deploys targeted price support programmes to those of its retailers facing the most direct competition from the major supermarket chains at the retail level. Those programmes are not offered to retailers that do not operate under the IGA banner, or to retailers operating under the IGA banner who refuse to sign a supply agreement with Metcash. The level of rebates paid by Metcash to a particular retailer reflects, in large part, whether or not the retailer is regarded by Metcash as subject to competition with other supermarkets at the retail level. In addition, the prices charged to consumers by IGA X-press convenience stores are significantly higher than the prices charged by IGA stores, which are in turn materially higher than the prices charged by Supa IGA stores. Therefore, the Commission says, the major supermarket chains do not uniformly constrain Metcash-supplied stores such that, by way of indirect constraint, Metcash and the major supermarket chains operate in the same market.

The Commission contends that the Mix & Match System operated by Metcash for its IGA retailers indicates the weakness of the constraint imposed on many of those retailers by the major supermarket chains. I have already said something about zone 60 prices, which generally match Woolworths’ pricing, subject to a minimum gross profit requirement. Some retailers ensure that a minimum margin, additional to the zone 60 minimum margin, is maintained on the cost of goods supplied by Metcash. Accordingly, a retailer using zone 60 does not match Woolworths on items where to do so would not deliver a sufficient profit margin. That, the Commission says, indicates a degree of pricing discretion. Further, most IGA retailers choose a price file under the Mix & Match System that prices their products above Woolworths’ prices. In addition, many of the stores that adopt zone 60 pricing for some product categories apply a higher margin pricing file for other product categories.

Metcash operates the Mix & Match System to enable retailers to fix retail prices in their stores. The Commission prepared an analysis of the zones requested by Supa IGA and IGA retailers. It says that the analysis indicates that the majority of such retailers, even for the category of items described as **major branded grocery key value items**, request retail price zones two or more per cent higher than the Woolworths-based zone 60 prices. The Commission further contends that its analysis demonstrates that IGA retailers were much more likely than Supa IGA retailers to request price files in excess of zone 60 prices. While approximately three-quarters of Supa IGA retailers requested zone 60 pricing, fewer than one-third of IGA retailers requested zone 60 pricing for four categories of key value item. The Commission contends that this analysis highlights the differences in the pricing constraint imposed by the major supermarket chains on Supa IGA retailers and IGA retailers. Supa IGA stores appear to account for around 40 per cent of the sales of the IGA-Distribution division, and IGA stores account for around 30 per cent of such sales. The Commission contends that its analysis, which is based on two-thirds of the Supa IGA and IGA stores that receive supply from Metcash’s NSW distribution centres, has probative value.

The Commission points out that a key point of competitive differentiation between supermarket retailers is geographic location. Each supermarket has at least some degree of pricing discretion because of its location. The location of a particular store may make it a more attractive option for nearby consumers, other things being equal, than other stores.

The Commission also contends that the wholesale prices for a large number of top selling Black & Goldproducts supplied by Metcash, including flour, sugar and cream, are significantly higher than the retail prices of comparable Coles Smart Buy products. The Commission contends that Metcash’s wholesale price for its top selling Black & Goldproducts provides retailers with little or no margin, on average, if they match the retail prices of comparable Coles Smart Buy products.

The Commission contends that, in the light of the above matters, the level of indirect constraint from the major supermarket chains on Metcash’s wholesale pricing is far from close and is limited to a minority of the stores supplied by Metcash. Accordingly, the Commissioner says, there is no more than a limited constraint on Metcash from retail competition by the major supermarket chains.

The material upon which the Commission’s analysis was based does not show the pricing requested by non-IGA retailers, such as Supabarn, which represents about 16 to 17 per cent of the national wholesale volume of the IGA-Distribution division. Further, the pricing requested by approximately one-third of Supa IGA and IGA retailers in NSW and the ACT is not included.

While it is true, as the Commission says, that a majority of Supa IGA and IGA retailers request pricing zones two or more per cent higher than zone 60, it is a bare majority. It is equally true that a majority of those retailers request pricing zones two per cent higher than zone 60 or lower. In addition, the Commission’s analysis demonstrates that 84 per cent of Supa IGA stores request zone 60 pricing for major branded grocery key value items, and that 91 per cent of Supa IGA stores request pricing zones 2 per cent higher than zone 60 or lower.

Further, it does not necessarily follow that retailers who request a price zone 2 or more per cent higher than zone 60 are not closely constrained by vigorous competition. The fact that some retailers charge higher prices than Woolworths does not necessarily lead to the conclusion that those retailers are not constrained by Woolworths. Rather, to the extent that some independent retailers charge prices above the major supermarket chains, that may reflect higher costs rather than any supra-normal profits. The superior purchasing power of the major supermarket chains makes it very difficult for independent retailers to match the major supermarket chains on price. Smaller stores, with lower turnover, are likely to have to charge higher prices to make a profit, since they have higher per unit costs. The analysis carried out by the Commission does not attempt to address the cost to Metcash of supplying the smaller stores, or the other fixed and variable costs faced by those stores compared with larger supermarkets.

The Commission’s analysis does not take into account promotional pricing, which is an important element of price competition. Conducting a zone 60 analysis without detailed consideration of promotional pricing is likely to lead to erroneous conclusions. At any given time, 40 to 50 per cent of the volume of the IGA-Distribution division is sold to retailers on promotion. Also, through investment buying, retailers are able to charge prices below the recommended standard shelf prices beyond the promotional periods.

The Commission’s analysis also does not address the question of the volume of goods sold by retailers at prices matching or close to the prices charged by the major supermarket chains. The analysis does not identify the volume of goods sold to stores in each tier. That can create a false picture: for instance, while there are 175 IGA X-press stores nationally, sales to those stores represent only two to three per cent of the total volume of Metcash’s sales, and, consequently, information about those 175 stores is minimally significant to the question of whether or not the major supermarket chains relevantly constrain Metcash.

A decrease in the quality of a product, without a change in its dollar denominated price, can be viewed as a price increase. Similarly, an increase in the dollar denominated price accompanied by a corresponding increase in quality may not constitute a price increase in economic terms.

Non-price factors are an aspect of competition, not an alternative to it. Retailers unable to meet the major supermarket chains on price look for other ways to remain competitive. In particular, they endeavour to compensate for their higher costs and prices by emphasising other features that appeal to customers, including location, convenience, access to parking, breadth and depth of product range, community involvement and local connections, level of customer service, trading hours, quality of fresh produce, appearance, layout, and environment. I have already referred to some of these factors, which are very important to competition and result in price dispersion across supermarkets.

Independent retailers are unable to increase their prices in response to increases in wholesale prices without losing significant volume to the major supermarket chains. If independent supermarkets lose business, Metcash loses business. On the other hand, Woolworths and Coles have greater bargaining power with manufacturers and primary suppliers than Metcash and, consequently, are able to negotiate better terms of supply than Metcash. An inference can therefore be drawn that Woolworths and Coles have significantly lower costs than Metcash.

Metcash has adopted a strategy of assisting independent retailers supplied by it to compete against the major supermarket chains, in terms of both the price and non-price aspects of their offerings. The services Metcash provides in terms of price include aggregating the requirements of independent retailers to get better trading terms from manufacturers and primary suppliers, negotiating promotional prices with those manufacturers and primary suppliers, conducting price checks against the major supermarket chains, devising offers to respond to particular promotions by the major supermarket chains, and supplying retailers with zone 60 prices. Metcash also assists retailers by subsidising the costs of certain products to strengthen retailers’ ability to match the prices of Coles and Woolworths and, in turn, boost the sales of the IGA-Distribution division.

The non-price services provided by Metcash to assist independent retailers to compete with the major supermarket chains include the following:

Metcash organises and supplies the Black & Gold product range, so that independent retailers can offer a private label option to compete with the private label ranges of the major supermarket chains.

Metcash negotiates schemes whereby suppliers fund donations by retailers to local communities.

Metcash provides loans to retailers to finance store refurbishments and adopts strategies to improve the appearance of IGA branded stores.

Metcash funds marketing activity for IGA branded stores, enabling retailers to attract customers from the major supermarket chains.

Some of those programmes are only available to support stores that face particularly intense competition from major supermarket chains. With that exception, Metcash offers the same prices and programmes to all retailers.

It is reasonable to conclude that the scale and intensity of retail competition is extreme and is increasing. Volume is the key to success for the major supermarket chains, independent retailers and Metcash alike. Volume ensures profitability and improved buying power. Both Metcash and the major supermarket chains are constantly on the lookout for ways to build volume. Metcash and its retailers have a common interest in ensuring that the product offered by IGA retailers is competitive with that offered by the major supermarket chains. That will secure the maximum volume of sales for both the retailers and Metcash as wholesaler. In those circumstances, it is reasonable to conclude that there is competition between Metcash and the major supermarket chains for volume.

As I have indicated, the Commission, while accepting that the major supermarket chains provide some form of constraint on Metcash, says that the constraint is not a close one. Thus, it says, the possibility of Metcash’s retailers losing customers to the major supermarket chains did not operate as a sufficiently close constraint on Metcash to prevent it from deciding to increase the service fee charged to its retailers by five cents per carton in late 2006. Rather, the Commission says, Metcash imposed the fee despite vigorous opposition from the independent supermarket retailers, and notwithstanding that it was enjoying significant reductions in its cost of doing business following its acquisition of the Foodland business. The Commission says that the cost of the service fee increase was significant for retailers. Thus, in the case of Supabarn, the imposition of the fee cost about $80,000 in the first year.

The Commission says that Metcash’s ability to increase its prices unilaterally in that way, without loss of business, demonstrates the weakness of any pricing constraint imposed by the major supermarket chains on Metcash’s wholesale business. The Commission further contends that the imposition of the five cents per carton increase is evidence of the ability of Metcash to increase prices profitably. It says that the independent retailers’ ability to pass the increase on to consumers shows that there was not a sufficiently close constraint by the major supermarket chains to prevent the price rise. It is also evidence, the Commission says, that customers cannot discern a small price increase at the retail level. The Commission says that the possibility of the retailers losing customers to the major supermarket chains did not operate as a sufficiently close constraint on Metcash to prevent it from making the decision to impose the increase.

The Commission points out that, when Metcash imposed the five cents per carton increase, it informed its independent retailers about how they could pass the increase on to customers. Metcash’s recommendation to retailers to pass the levy on is also evidence, the Commission says, that Metcash was not particularly concerned about independent retailers losing business to the major supermarket chains if they did so. Alternatively, the Commission says, it is evidence that Metcash considered that it was profitable for Metcash to impose the fee increase, notwithstanding any potential loss of business for its independent retailers. It says that, if Metcash were more concerned about independent retailers losing business to the major supermarket chains than about independent retailers switching to another wholesaler, Metcash would not have encouraged retailers to pass the fee increase through to customers.

However, if anything, the circumstances of the imposition of the five cents per carton increase bear out Metcash’s contention that it is constrained by the major supermarket chains. Metcash initially sought to introduce an increase of ten cents per carton. It did not simply impose the increase unilaterally: first, it consulted with the state and national boards, and, in the face of resistance from retailers, it settled on a five cent increase. If the source of constraint had been Franklins, one might have expected to see a smaller, or no, increase in NSW, and the full increase imposed outside NSW where, on the Commission’s case, Metcash in effect operates as a monopolist. The fact that Metcash was unable to impose the full ten cent increase that it proposed, notwithstanding that that was the first increase in a number of years and was a relatively modest one, supports the contention that Metcash is constrained by reason of the vigorous downstream competition between independent retailers and the major supermarket chains.

The Commission says that a wide range of firms might have some actual or potential constraining effect on Metcash. The relevant test under s 50 is not a test about ultimate constraints, but one that assesses the impact of an impugned acquisition on the close competition that occurs in the relevant market. The market enquiry, the Commission says, focuses on the leeway that Metcash has to raise its prices before encountering a constraint that prevents a further price increase, or a reduction in the value of its product, through, for example, the reduction of services. The relevant question, the Commission says, is whether or not the major supermarket chains **closely** constrain Metcash, to such an extent that the removal of competition by Franklins would not increase Metcash’s measure of discretion. The Commission says that a distinction must be drawn between close constraints and ultimate constraints. The Commission points out that Metcash’s margin on earnings before income tax, depreciation and amortisation exceeds Coles’, a fact which it says throws doubt on any proposition that Metcash is closely constrained by the scale of the major supermarket chains.

The Commission says that even a relatively small increase in Metcash’s margin would be highly profitable for it. The relatively small proportion that the wholesale margin charged by Metcash bears to the price of packaged groceries would suggest that a relevant increase in price, being in this case the margin, by a monopolist wholesaler would not be noticed by, or elicit a negative response from, a sufficient number of ultimate customers to cause them to switch their grocery purchases to retail stores not supplied by Metcash, and so make such an increase unprofitable.

A firm supplying goods or services at the wholesale level in a vertical supply chain may be constrained directly by other firms operating at the same level. However, it may also be constrained indirectly by competition at a downstream level. If such indirect constraints help give a clearer picture of the relevant competitive process, they must be taken into account in a purposive approach to market definition. If vertically integrated firms are not active in the wholesale market, they will only exert competitive pressure at the retail level. The amount that a vertically integrated firm sells directly in the downstream market, for which the phrase **captive production** is sometimes used, will not show up in a narrow analysis of the wholesale market. Thus, where there is strong competition at the retail level, exerted by vertically integrated firms such as Woolworths, Coles, Aldi and Franklins, the importance of considering indirect constraints is heightened.

The demand of independent retailers for groceries at the wholesale level depends on the demands of their retail customers. Accordingly, where there is an increase in price at the wholesale level, vertically integrated firms that do not face that increase are able to take market share from non-integrated firms. Where there is an integration of wholesale and retail activities, the exercise of market power at either of the two upstream functional levels is closely connected with, and capable of affecting, competition downstream in the relevant chain.

The separation of wholesaling and retailing functions tends to confuse the analysis in the present case. The true competitive constraints on the activities of Metcash come, to a great extent, from the major supermarket chains. While those constraints are, at least in part, indirect, they are powerful, and are much closer and more effective than constraints imposed by Franklins. Thus, it is not possible to determine the competition consequences of the acquisition of Franklins by Metcash without taking into account the constraints from the major supermarket chains.

If there were a separate wholesale market for supply to independent retailers, and there were no close constraint from the major supermarket chains, one might expect Coles and Woolworths to be happy to supply in that market, because the pricing strategies they adopt in that market would not have any significant effect in the retail market. However, it is precisely because there are tight margins in the industry, as the Commission contends, that wholesale pricing directly affects retail competition and retail competition likewise constrains wholesale pricing, giving rise to reluctance on the part of the major supermarket chains to engage in the difficult task of juggling wholesale and retail prices.

There is either a separate wholesale market, in respect of which Coles and Woolworths face low barriers to entry, and in which they are supply-side substitutes, or there is a single market in which they compete. Accordingly, it is clear that Coles and Woolworths constrain Metcash. Multiple retailers have given evidence of their direct head-to-head competition with Coles and Woolworths, including head-to-head competition on price. Similarly, retailers have given evidence that even very small increases in the wholesale price of packaged groceries would cause significant difficulties for them, and could cause them to cease to be viable. The Commission itself relies on the tight margins in the industry, and accepts that there is intense retail competition in the supermarket market in NSW and the ACT. In the light of all of the circumstances that I have described, there is no scope for Metcash to raise its wholesale prices and obtain monopoly profits.

### Threat of Sale as a Constraint

The major supermarket chains have continued to expand beyond large scale format stores into medium and smaller stores. They have become ubiquitous across Australia, making them accessible to almost everyone. Thus, almost every independent store faces local area competition from one of the major supermarket chains. Extended trading hours are now standard across both the major supermarket chains and independent retailers, and the major supermarket chains have placed an increased emphasis on their ties to local communities, an area in which independent retailers have previously sought to differentiate themselves from the major supermarket chains. The major supermarket chains and the larger independent retailers also offer a comprehensive product range, including fresh produce. Both the major supermarket chains and the IGA branded stores seek to build their own brands at the expense of their rivals’ brands.

Since 2002, Woolworths has acquired at least thirty-five supermarkets or supermarket sites, including at least six supermarkets that were being supplied by Metcash. In the same period, Coles has acquired at least two supermarkets, including at least one being supplied by Metcash. It is tolerably clear that the threat of the major supermarket chains buying independent retailers’ stores has been a significant and constant source of concern to Metcash, as reflected in the frequent references in the minutes of executive management committee meetings to particular IGA stores being targeted by Woolworths, Coles and Aldi. Woolworths and Aldi have also opened a large number of new stores, particularly in small towns and local shopping centres, where previously independent retailers had faced less competition from the major supermarket chains.

In 2004, in order to try to combat the threat of Woolworths and Coles purchasing independent supermarkets, Metcash established the Barons Strategy, involving the acquisition of minority equity interests in independent retailers’ stores. Metcash also makes loans to fund the purchase of stores by independent retailers and, in some instances, becomes the head lessee in respect of a store site in return for a right of first refusal. Thus, there is competition between Metcash and the major supermarket chains for the retention and acquisition of retail stores and sites, which Metcash characterises as “scarce assets”. Metcash wants all available Franklins Corporate Stores, while Woolworths, among others, has indicated interest in acquiring what it regards as the more profitable stores.

Since Franklins commenced its franchise business in 2005, it has persuaded only two owners of IGA stores to convert their stores to Franklins stores. In one case, Franklins was forced to sell two of its more profitable stores to persuade the IGA store operator to convert its two IGA stores to Franklins franchises. No IGA store owner has converted to the Franklins banner since May 2007. Further, four retailers who gave evidence on behalf of the Commission identified several reasons as to why they decided against taking up a Franklins franchise. The reasons included the undesirability of surrendering their own brand name in favour of Franklins, and the fact that Franklins rebates are calculated on retailers’ sales rather than on their purchases. There are also logistical limitations, inflexibility, and inability on the part of Franklins to supply smaller stores. Finally, there are limitations on the range of products that Franklins can provide.

The Commission appears to accept that supermarket stores and sites are a scarce asset. However, it says that, if an IGA store is bought by a major supermarket chain, or merely closes down, the relevant fact, from a competition point of view, is that the IGA store supplied by Metcash goes out of business. In other words, the Commission says, it is not the threat to Metcash from the major supermarket chains that is identified but rather the threat that even a monopolist faces that its prices will not allow its customers sufficient margin to survive.

The Commission says that, if an independent retailer were to be faced with the prospect of going out of business, the independent retailer would be likely to seek alternative supply from another source before selling or closing down its business entirely. The capacity of the Franklins business and assets to produce such an alternative source of supply is more likely, the Commission says, to provide a closer constraint than the major supermarket chains. Further, it is by no means clear, the Commission says, what an independent retailer has available to sell to a major supermarket chain. Typically, the independent retailer will occupy the premises from which it conducts business under a lease. In those circumstances, the most that the independent retailer could sell would be the assignment of the balance of the term of the lease, subject to the consent of the lessor, who in many cases is Metcash.

The Commission says that an important factor for an independent retailer, in considering the more extreme option of selling its business, would be the practical point that, for many retailers, their stores are likely to be too small or too close to an existing Woolworths or Coles store to be of any interest to those companies, or to be able to be bought by them without offending s 50 of the Competition Act. Metcash labels stores supplied by it that are not in close proximity to the major supermarket chains as not being in a “competitive area”. Thus, the Commission says, for independent retailers whose stores are further away from the major supermarket chains, there is even less reason to fear that they will go out of business because of price competition from the major supermarket chains. The Commission says that the likelihood that the alleged threat constrains the wholesale pricing decisions of Metcash is quite remote.

I consider that the evidence, including evidence of the Barons Strategy and of leasing arrangements, demonstrates that there is vigorous competition between Metcash and the major supermarket chains for the retention and acquisition of retail stores and sites. The present proceeding itself demonstrates the competition for those assets, in that Metcash desires to take control over all available Franklins assets, while Woolworths, among others, has indicated interest in acquiring what it regards as the more profitable stores. I consider that the threat of sale by independent retailers to the major supermarket chains relevantly constrains Metcash’s wholesale pricing decisions.

### Threat of a Constraint by Woolworths as a Wholesaler

On 6 December 2010, Mr Jardim met with Mr Tom Pockett, the chief financial officer of Woolworths. There was a discussion about a possible combined bid by SPAR and Woolworths for the assets of Franklins. One of the options put forward by Mr Pockett was that Woolworths would become involved as a wholesaler, competing with Metcash. Following the meeting, Mr Jardim sent Mr Pockett an email confirming Mr Jardim’s interest in the possibility of a joint venture between Woolworths and SPAR.

On 14 December 2010, a telephone conference took place involving representatives of Woolworths, on the one hand, and representatives of the Commission, on the other. Mr Pockett and Mr Peter Horton, the company secretary and general counsel of Woolworths, participated on behalf of Woolworths. The Commission was represented by its chairman, Mr Graeme Samuel, together with Mr Tim Grimwade, the executive general manager of the Commission’s mergers and acquisitions group, and Mr Rami Greiss, general manager of the mergers and acquisitions group. Also participating were Mr David Jones, Ms Sophie Ward and Ms Louise Hird of the Commission, and Mr Matthew Blunn of the Australian Government Solicitor, acting for the Commission. Notes of the meeting were made by Messrs Horton, Greiss and Blunn and by Ms Hird.

Messrs Jardim, Greiss and Grimwade gave evidence and were cross-examined about the telephone conference of 14 December 2010. I do not consider that the evidence they gave, where it was inconsistent with the notes to which I have referred, was reliable. Given that none of Mr Samuel, Mr Jones, Ms Hird or Mr Blunn was called to give evidence, an inference can be drawn that none of them would have given evidence inconsistent with the contemporaneous notes. While a subpoena to Mr Pockett requiring him to give evidence was issued at the request of the Commission, and the Commission provided Metcash and Pick n Pay with an outline of the evidence expected to be given by Mr Pockett, Mr Pockett was ultimately not called to give evidence. The account of the telephone conference set out below is taken from the notes.

Messrs Pockett and Horton indicated that Woolworths had spoken with Mr Jardim and that Mr Jardim had told Woolworths that he wanted to merge SPAR and Franklins, but that the financial hurdle would be too high for SPAR on its own. Woolworths canvassed three scenarios concerning Franklins. The first was that Woolworths would acquire some Franklins stores, which would reduce the capital cost to SPAR of acquiring the balance of the Franklins stores. The second was that Woolworths would fund, or partly fund with others, possibly as an equity participant, the acquisition of Franklins in order to set up a wholesaling business. Woolworths would sell its interest after two to three years and would acquire some of the Franklins stores. The third scenario was that Woolworths would buy the Franklins business itself, set it up to be run independently, probably by Mr Jardim, and sell out after five years.

Mr Samuel indicated that he was opposed to the first scenario. He said that the second scenario had potential, so long as there were other private equity participants and Woolworths did not have control. He said that the third scenario was interesting, but that a difficulty would be how Woolworths could buy Franklins without having control.

Mr Horton raised the possibility that Woolworths would second staff to SPAR. Mr Pockett said that Woolworths had made an offer to buy 22 of the Franklins Corporate Stores, a topic about which I shall say more below. Mr Pockett said that Woolworths wanted those stores to fill gaps in Woolworths’ network, and that Woolworths thought that it could acquire the stores on the basis that that would not raise local market competition problems. Mr Samuel responded that removing 25 per cent of the stores would start to undermine the viability of the remaining stores. Mr Pockett said that Woolworths was prepared to provide up to ten of its smaller stores to the independent sector, being stores that Woolworths did not really want. The meeting concluded with Mr Pockett asking for feedback and Mr Samuels saying that he would talk to the other members of the Commission.

Metcash contends that it is significant that, following the telephone conference of 14 December 2010, the Commission and its officers had the following information:

Woolworths was very keen to obtain up to 22 of the Franklins Corporate Stores.

Woolworths and SPAR had discussed an investment by Woolworths in SPAR in connection with the acquisition of the Franklins Corporate Stores.

Woolworths was prepared to contemplate providing financial assistance to SPAR to acquire the Franklins assets.

Mr Samuel had indicated that the option of Woolworths investing with others in SPAR to acquire the Franklins assets had possibilities.

Woolworths was prepared to contemplate being involved in a wholesaling operation as an owner or financier in the short to medium term, as a means of acquiring more stores.

Woolworths had an incentive to **engage in wholesaling**, a business that was otherwise outside its core business, in the short to medium term, if that was what it took to acquire more stores.

Metcash accepts that Woolworths was not putting a concrete or definite proposal to the Commission in the telephone conference of 14 December 2010. However, Metcash says, the conference indicates that Woolworths was showing that it was interested in, and had an incentive to engage in, wholesale supply, at least for a period of years.

Metcash contends, therefore, that the telephone conference is relevant to the question of market definition. The market propounded by the Commission excludes the major supermarket chains because, it says, the major supermarket chains do not relevantly constrain firms operating at the wholesale level. Metcash says that the telephone conference is evidence of the contest between Metcash and the major supermarket chains for stores and for scale. Metcash says that it also shows that the contest for stores and scale is so intense that Woolworths was prepared to contemplate operating as a wholesaler to independent supermarkets over a five year time period in order to acquire stores. Metcash says that that gives rise to the conclusion that Woolworths is a potential supply-side substitute for Metcash.

From 1996 to 2002, Woolworths supplied grocery products to independent retailers in the eastern states, and it continues to do so in Tasmania through a 60 per cent holding in a company known as Statewide Independent Wholesalers. In 2004, Woolworths considered entering into a joint venture with Pick n Pay to supply franchise stores. As recently as December 2010, Metcash contends, Woolworths contemplated re-entering the wholesaling business in the circumstances outlined above. Woolworths does not restrict its activities to self-supply. Metcash contends that the continuing participation of Woolworths in wholesaling in other parts of the country, and its recent contemplation of re-entering wholesaling in NSW, suggest that, in the right circumstances, it would make business sense for Woolworths to be involved in wholesaling.

Metcash says that the major supermarket chains want to take volume away from independent supermarkets. At present, they do that through retail competition, in which they take advantage of their superior buying power. As they take business away from independent stores at the retail level, their retail volumes increase, as do their notional wholesale volumes. In effect, substitution is occurring, and the Metcash wholesale volume goes down as the major supermarket chains’ wholesale volume goes up.

Thus, the possibility of entry by Woolworths into wholesaling in NSW and the ACT, even for a limited period only, means, according to Metcash, that Woolworths cannot be excluded from a properly defined market. Woolworths has previously been a wholesaler to independent retailers, it has the capacity to be one again, and it seems that it would be willing to be one given the right incentives, such as its being one providing a means of obtaining valuable retail stores.

I have set out above the relevant criteria for supply-side substitution. Having regard to those criteria, Woolworths was not really saying that it was a potential supply-side substitute for Metcash. Woolworths was not indicating to the Commission that it was either transferring its vertically integrated capacity to wholesale supply, or that it could do so without significant investment. Rather, its interest was to acquire retail stores, although, clearly enough, any such acquisition could only occur if the Metcash acquisition did not proceed. The options were expressly described as short to medium term options, and, on any account, were not to run beyond five years. They were transitory. Thus, any interest that Woolworths had in acquiring stores probably failed with respect to two of the relevant criteria. First, no acquisition would occur if the Metcash acquisition proceeded, and thus any acquisition by Woolworths could not have constituted a competitive constraint on a merged Metcash-Franklins entity. Secondly, any acquisition by Woolworths would involve participation in an acquisition of assets of an existing market participant, rather than the redeployment of Woolworths’ assets.

It appears unlikely that it would be profitable for Woolworths to supply to its competitors at the expense of its own sales. I have already said something about the difficulties associated with the prospect of juggling wholesale and retail prices. It is equally unlikely that independent retailers would rely on wholesale supply from their largest retail competitor. None of the independent retailers who gave evidence suggested that he would or could seek to obtain wholesale supply of packaged groceries from Woolworths or Coles in response to any price increase by Metcash.

It is unlikely, therefore, that the major supermarket chains will, in the foreseeable future, offer wholesale supply to independent retailers in NSW or the ACT. The major supermarket chains have shown minimal, if any, inclination to do so. Mr Pockett’s limited consideration to supplying such services in December 2010 was confined to Woolworths playing a role in assisting the acquisition of Franklins by SPAR. SPAR’s acquisition could only occur if the acquisition of Franklins by Metcash did not proceed. Further, there is no evidence that Coles has any interest in supplying wholesale packaged groceries to independent supermarket retailers.

One reason that the major supermarket chains will not supply independent retailers is that they want to drive those retailers out of business and appropriate their market share. In the light of the intensity of competition in the retail supermarket sector, instigated by the major supermarket chains, it would be strange for the major supermarket chains to be endeavouring, at the same time, to enter the market for wholesale supply to competing independent retailers. By doing so, the major supermarket chains would only assist the independent supermarket retailers to compete better with their own retail supermarkets.

Having regard to the matters set out above, I do not consider that the discussions in December 2010 gave rise to a realistic prospect of wholesale supply to independent retailers by Woolworths, or any other major supermarket chain. In any event, such prospect as there may have been was not sufficiently strong to support any inference that Metcash was constrained in this regard by Woolworths, or any other major supermarket chain, in such a way as to add weight to Metcash’s contention that the relevant market should be defined so as to include the major supermarket chains.

### Franklins as a Constraint

At the extremities of a market, there is such a break in the possibilities for substitution that firms within the market’s boundaries would collectively possess substantial market power (see *In re Tooth & Co Limited; in re Tooheys Limited* (1979) 39 FLR 1at 39). The Commission characterises the market definition issue in this case as being the existence or non-existence of such a break in substitution possibilities between what Metcash and Franklins offer to independent supermarket retailers by way of the wholesale supply of packaged groceries, on the one hand, and the absence of any such offer by the major supermarket chains, on the other hand. It says that that break in substitution possibilities is at the heart of the market definition, and is the major reason for a likely substantial lessening of competition if the acquisition of Franklins by Metcash proceeds.

The Commission contends that a comparison with the goods supplied by Franklins to retailers who switched from Metcash supply shows how closely substitutable the ranges offered by Metcash and Franklins are. Supabarn, for instance, saw Franklins as an alternative to Metcash, and was very close to being in a position to conclude a supply arrangement with Franklins when the proposed acquisition by Metcash was announced.

The Commission says that Metcash at all times maintained a watching brief on Franklins’ wholesale activities to ensure that it was aware of any risk that its customers were considering a switch to Franklins. The Commission says that the evidence indicates that Franklins was Metcash’s closest competitive constraint in NSW and the ACT. It points to Project Energise and another project, **Project Ling Chi**,both of which I shall shortly discuss further, as evidence of the concern of Metcash at the entry of Franklins into the market for the wholesale supply of packaged groceries.

#### Project Energise

In late 2004 Metcash introduced what became known as **Project Energise** to IGA retailers. Metcash accepts that Project Energise was prompted, in part, by a concern about Franklins’ decision to begin self-supply, and by the possibility that Franklins might make some form of offering to independent retailers supplied by Metcash. Metcash says, however, that that was only one of a number of concerns that led to Project Energise. More generally, Metcash says, Project Energise was designed to increase IGA retail sales volumes and, in turn, increase the revenue of the IGA-Distribution division. Specifically, Metcash says, Project Energise was prompted by a desire to encourage IGA retailers to invest in the refurbishment of their stores, and by a concern that Woolworths and Coles might acquire IGA stores.

A presentation made by Metcash to retailers described Project Energise as a deal between Metcash and the retailers, which required both parties to make a commitment. Metcash undertook to provide additional rebates in the order of 1.2 per cent to retailers, who, however, had to achieve certain targets, in part referable to purchases made from Metcash, in order to receive those rebates. Retailers were also required to increase their **teamwork score**, being the percentage of a store’s total purchases acquired through Metcash, to earn an increase in rebates. Thus, a teamwork score of 70 per cent was required for a 0.5 per cent increase in rebates, and a teamwork score of 75 per cent was required for a 1 per cent increase in rebates. Retailers were also required to enter into a five year supply agreement with Metcash, and to submit to Metcash a detailed five year business plan for each store, detailing refurbishment strategies. Retailers also had to provide Metcash with a fixed and floating charge over their business, and give Metcash a right of first refusal in the event of sale.

The Commission asserts that Project Energise did not confer upon Metcash any significant benefit, other than the benefit of locking in its retailers and preventing them from switching to Franklins. Rather, the Commission says, Project Energise was conceived and executed as a competitive response to the threat from Franklins at the wholesale level. The Commission reiterates its reliance upon the internal materials of Metcash referring to the “fighting plan” to block the threat of new wholesale entry.

Metcash responds that Project Energise was not a straight price cut. Benefits and burdens flowed both ways, as Mr Jardim accepted.  The fact that Project Energise was not conceived as a straight price cut is reflected in calculations considered at the meeting of the executive management committee held on 1 October 2004, at which, as I said when discussing the minutes of such meetings, the introduction of Project Energise was foreshadowed. Those calculations are consistent with the proposition that Project Energise was in part motivated by a desire to boost sales figures. Metcash executives were considering the sales growth necessary to ensure that Project Energise did not cost Metcash money.

In March 2006, Metcash offered improved terms to the operators of the Supabarn stores. The terms were superior to the standard Project Energise rebate, offering a total rebate of 6 per cent, which represented a significant increase from the previous 4.5 per cent rebate paid to the operators of the Supabarn stores. The new terms were the most generous that Supabarn had ever received from Metcash. Metcash says there were two reasons why Supabarn received higher volumetric rebates. The first was that Metcash does not pay for any advertising in relation to those stores whereas, for the IGA network, Metcash spends an amount roughly equal to 2 per cent of relevant sales each year on advertising. Secondly, Metcash does not incur banner group costs, such as, for instance, the employment of channel managers and business managers, in relation to Supabarn stores.

The Commission disputes that the improved terms offered to the operators of Supabarn could be explained away by those matters. The Commission asserts that, prior to the increase from 4.5 per cent to 6 per cent, Supabarn had already negotiated an increase from 2.5 per cent to 4.5 per cent in the Metcash rebate to reflect the fact that Metcash did not supply marketing services to Supabarn. The Commission points out that the improved terms were backdated by more than eight months, thus increasing the benefit to Supabarn while lessening the amount of time for which Supabarn was locked into supply. Finally, the Commission asserts, the improved terms did not require Supabarn operators to undertake a store refurbishment programme.

Next, the Commission points to the fact that Project Energise terms were offered to other independent retailers without a requirement that they achieve teamwork scores for the first six months. The Commission contends that that demonstrates that Metcash was willing to compromise on the Project Energise offer, provided that independent retailers were willing to commit themselves to fixed supply agreements. The Commission contends that Metcash’s primary intention was to lock in and secure commitment from independent retailers, in order to prevent them from shifting to Franklins.

When Franklins announced that it was entering the market for the wholesale supply of packaged groceries to independent supermarket retailers by offering franchise agreements, there was significant competitive response by Metcash in the form of Project Energise. Project Energise was, the Commission says, in direct response to the threat of the entry by Franklins into that market. Both Messrs Reitzer and Jardim were involved in formulating its strategy, which led to significant increases in the percentage of rebates paid by Metcash to independent retailers in NSW and the ACT. The Commission says that there was no corresponding increase in the rebates paid to retailers in other states.

The Commission says that Project Energise is evidence that what I have described as a relevant increase in price would be profitable for Metcash as a monopolist supplier of packaged groceries by wholesale to independent retailers. The price faced by those independent retailers is, the Commission says, the relevant consideration, not whether Metcash could in fact extract some other value. The Commission says that Project Energise presented independent retailers with the incentive of a 1.2 per cent reduction in wholesale prices, with a further effective discount through extended payment terms. The Commission contends that an inference should be drawn that that level of price reduction was considered by Metcash to be a necessary change to its profit-maximising pricing in response to the competitive threat posed by Franklins. Thus, the Commission says, when operating as a monopolist in NSW, Metcash’s prices were significantly higher than when it faced a wholesale competitor. Until it faced a wholesale competitor, the Commission says, Metcash did not offer the Project Energise rebate or similar rebates such as those offered to Supabarn. The Commission says that, accordingly, there would be an incentive for Metcash to revert to higher pricing if, following the removal of Franklins, its monopoly were restored. The Commission relies on four further arguments in support of those contentions.

First, the Commission says, an additional rebate of 1.2 per cent, together with the increase in the trading terms available under Project Energise, is a significant discount, accounting for well in excess of ten per cent of the wholesale margin charged by Metcash to its retailers. Further, the Commission says, the level of rebate increase offered by Metcash to Supabarn, being approximately 33 per cent, represents six times the level needed for a relevant increase in price under the application of hypothetical monopolist test for which it contends.

Secondly, the Commission says, the profitability of a small but significant non-transitory increase in price depends on the reaction of marginal customers, being those who are likely to switch to another supplier. The loss of large marginal customers can have substantial effects on profitability. The Commission points again to the fact that Supabarn, a large marginal customer, was offered a 1.5 per cent price reduction without incurring any obligation beyond signing a supply agreement, which was itself backdated.

Thirdly, the Commission says, Project Energise in NSW was significantly more generous than a later programme introduced in Victoria. The Victorian programme, unlike Project Energise, did not lead to any increase in the overall rebates paid to independent retailers. The programme offered less than half the maximum rebate offered under Project Energise. Thus, the rebates under the Victorian programme were 0.5 per cent for a teamwork score of 75 per cent and 0.25 per cent rebate for a teamwork score of 70 per cent. The equivalent rebates under Project Energise, were, as I have said, 1 per cent and 0.5 per cent respectively. Under Project Energise, moreover, an additional 0.2 per cent could be achieved for promotional compliance. In any event, the Commission says, the Victorian programme seems to have had a similar design as Project Energise, in that its stated aim was to prevent independent retailers moving to other sources of supply. Thus, the Commission says, Metcash provided discounts of that kind to counter the risk of losing wholesale sales to wholesale competitors, and, the more significant the threat was, the more generous the increase in rebates.

Finally, the Commission disputes that a later programme, **Project Lion**, in which targeted support was offered in 2009-2010 to IGA retailers facing direct competition from the major supermarket chains, was an answer to the inference, which the Commission would have the Court draw, that Project Energise demonstrates the ability of a hypothetical monopolist to apply profitably a relevant increase in price at the wholesale level. The Commission says that, while Metcash contends that those later programmes can only be explained as being responsive to the major supermarket chains, rather than to Franklins, there is no evidence for that claim, and that, even if it were true, that would not alter the clear evidence about the original purpose of Project Energise. The Commission says that the terms of Project Lion reflected the varied nature of competition faced by IGA stores at the retail level from the major supermarket chains. The Commission asserts that the premise of the PwC Report, to which I have already referred, was that only certain stores supplied by Metcash were subject to close competition from the major supermarket chains. The terms of Project Lion were expressly based on the competitive status of the stores and, therefore, the pricing decisions made by Metcash were based on an assessment of that status. Thus, the Commission says, the later, less generous, rebate programmes do not detract from the inference that it invites the Court to draw.

At a reasonably late stage in the hearing of the proceeding, the Commission sought to rely on a report dated 23 March 2011 (**the Potter Report**) made by Mr Michael Potter, a chartered accountant and a director of Axiom Forensics Pty Limited, a forensic accounting firm. Mr Potter was instructed to review profit and loss reports for the IGA-Distribution division of Metcash, together with other financial information for the financial years ended 30 April 2001 to 30 April 2010, and to provide an analysis of the state and national trends for key revenue and expense items.

The Commission explained that it had understood that Metcash would call witnesses, including Mr Reitzer, who could be cross-examined as to the material that was the subject of Mr Potter’s report. However, when Metcash indicated that it did not propose to call any witnesses, the Commission sought to tender the Potter Report in order to establish the matters that it had hoped to establish through cross-examination. Having regard to the lateness of the tender, the Potter Report was admitted only as a submission, and not as evidence of the opinions of Mr Potter.

The Potter Report suggests that Metcash’s external sales/pricing margin, which includes the service charge and freight charges, was less than the cost of doing business in NSW, such that there was a shortfall on the supply of goods in the relevant years. It also suggests that there was a declining shortfall in NSW during the period of the operation of the Metcash Supply Agreement, by which Metcash supplied to Franklins until 2005, but a material increase in the shortfall from 2006 to 2010, subsequent to the termination of the Metcash Supply Agreement. The shortfall was between $8 million and $10.5 million during that period.

The Potter Report states that the shortfall in external sales/pricing margin to the cost of doing business is recovered by, and almost all of the net contribution and EBIT generated in NSW are from, the following:

stock profit less price margin subsidies;

net deal sheet income; and

net rebates and net co-op income less rebates paid.

The analysis in the Potter Report suggests that stock profit, after deduction for price margin subsidies and net deal sheet income in NSW, fluctuated within the range of $10 million to $17 million but, apart from the year ended 30 April 2009, did not grow. The analysis suggests that the key drivers in net contribution and EBIT over the period were as follows:

For the years 2001 to 2005, EBIT grew from $25 million to $36 million as a consequence of the improvement in external sales/pricing margin less cost of doing business.

After the Metcash Supply Agreement came to an end, EBIT was reduced to $24 million for the year ended 30 April 2006 and increased each year thereafter to $48.8 million for the year ended 30 April 2010, primarily as a result of net rebates and net co-op income, less rebates paid, increasing;

In the period during which net rebates and net co-op income less rebates paid increased, the amount spent on advertising was relatively stable, other than in 2008.

The Potter Report also contains a graph recording the movement in the ratio of rebates paid to rebates received and net co-op income in NSW, which exhibited the following trends:

For the years ended 30 April 2001 to 30 April 2005, when the Metcash Supply Agreement was in operation, the ratio generally declined.

There was a material increase in the ratio in the year ended 30 April 2006, which may have been a result of Project Energise.

Following the year ended 30 April 2006, the ratio increased by two per cent in 2008 and then reduced by approximately two per cent by 30 April 2010.

The Commission contends that the analysis in the Potter Report, and particularly the graph, gives rise to an inference that Franklins was an effective constraint on Metcash’s profitability.

The Potter Report plots the rebates paid by Metcash for Victoria, Queensland and NSW in the period from April 2001 to April 2010. The Commission relies on the increasing NSW rebates from April 2005 as evidence of the competitive constraint imposed by Franklins. That is to say, there were increases in rebates after the entry of Franklins into the market for the wholesale supply of packaged groceries.

However, the analysis in the Potter Report actually shows rebates in NSW gradually converging with those paid in Victoria and Queensland, where, according to the Commission, Metcash already operates as a monopolist. In any event, the Commission’s reliance on increasing rebates as evidence of constraint is based on a misunderstanding of the nature of rebates. Metcash’s offer of higher rebates had the effect of driving higher retail sales, which resulted both in higher rebates paid to retailers and in higher profitability for Metcash. If the analysis of rebates contained in the Potter Report demonstrates anything, it would be the symbiotic relationship between Metcash and its retailers.

The analysis in the Potter Report indicates that, after Franklins commenced self-supply, the loss of sales experienced by Metcash was substantially less than the total amount of sales represented by the Franklins business. That is to say, while Metcash lost the Franklins business, it gained significant new business. That increase was also reflected in enhanced profits. If the analysis can be used to say something about the impact of Project Energise, it provides evidence that Metcash did receive tangible benefits from the project, contrary to the contentions of the Commission.

Metcash accepts that the figures in the analysis and the graph in the Potter Report are accurate, in the sense that they accurately reflect Metcash’s accounting and other financial information. However, it contends that accounting data is a poor basis upon which to identify the effect of competitive constraints. Metcash says that, in order to isolate the cause of various trends, the Commission would need to analyse the impact of other variables including, but not limited to, the competitive constraint imposed by the major supermarket chains. Metcash points out that no such analysis was attempted by the Commission, and that, accordingly, the Commission’s speculations about the causes of changes from one year to the next should be given no weight.

The Commission’s characterisation of the graph in the Potter Report as a “margin analysis” is not particularly appropriate. The rebates that Metcash pays are only one component of its overall profit. The whole point of Project Energise was to give greater rebates in exchange for retailers meeting certain targets. The meeting of those targets would improve Metcash’s volume. That in turn would be likely to improve its profitability. Therefore, looking at rebates alone tells one nothing. Indeed, it is likely to mislead. The Potter Report indicates that rebates in Victoria and Queensland were higher than rebates in NSW and that, over time, the level of rebates in NSW rose to meet those in Victoria and Queensland. That is inconsistent with the Commission’s contention that Metcash was facing particular competition in NSW, which it was not facing in the other states. According to the Commission’s interpretation of the Potter Report, retailers in Victoria and Queensland were much better off than those in NSW.

I do not consider that Project Energise demonstrates that the threat from Franklins led Metcash to reduce its prices significantly and thereby surrender what would otherwise be monopolistic profits. Further, Project Energise does not give rise to any inference as to what Metcash would be likely to do if it acquires Franklins. Project Energise was driven by a desire to increase the volume of sales in NSW. It is fair to conclude that it was as much a response to Woolworths and Coles as it was to Franklins.

Project Energise did not merely represent a price cut to independent retailers in NSW and the ACT at a level of 1.2 per cent. The evidence about Project Energise does not establish that a hypothetical monopolist wholesaler could profitably introduce a relevant increase in price, in the way contended for by the Commission in support of the market definition that it pleads.

#### Ling Chi

The Commission also points to **Project Ling Chi** as being evidence of the likelihood of retaliatory action by Metcash against any new competitor. Project Ling Chi, which is also known as **Project Death By A Thousand Cuts**, was a response by Metcash to an announcement by Franklins that it would be expanding its wholesale operations. The events of Project Ling Chi occurred in the second half of 2007.

Project Ling Chi was to be a formalised ten month campaign with a support budget of $1 million. Metcash’s strategies for attacking Franklins’ wholesale operations included:

asserting to Franklins’ provider of logistics services that the provider was in serious conflict, and would keep its current contract for IGA-Distribution logistics for six months, until the contract was put out to tender;

advising suppliers that, if they used Franklins’ provider of logistics services in the future to deliver products, Metcash would not accept deliveries;

having a head-hunter target Mr Bill Morgan, Franklins’ franchise manager, for a job at Metcash;

putting pressure on suppliers who provided product for both the Franklins No Frills and the Metcash Black & Gold ranges to provide Metcash with a better deal than Franklins, by threatening to call a tender to seek a new supplier for the Black & Gold range; and

spreading false information about Franklins in various ways, including to suppliers and retailers.

Metcash contends that the Court should focus on the evidence of what was done, not what was merely proposed, in relation to Project Ling Chi. There is no evidence as to what amount Metcash actually spent, if any, implementing Project Ling Chi. Even if one assumes that Metcash did spend in the vicinity of $1 million, that amount is fairly minimal in the scheme of things. The Commission itself contended that the $1.063 million spent by Metcash in 2009-2010 on Project Lion, providing price support to IGA retailers, was minimal. I do not consider that Project Ling Chi bears significantly on the degree of competitive constraint imposed by Franklins on Metcash.

### Conclusion as to Constraints

In any market definition, considerations of commercial reality, not just economic theories, are relevant. The economic concept of **market** must be applied in a practical way, in order to accommodate the concern of the Competition Act with business and commerce.

In the light of all of the matters to which I have referred, I consider that the competitive constraint imposed by Franklins upon Metcash’s wholesaling activities is far less significant than the constraint imposed by the major supermarket chains. Further, the constraint imposed by Franklins has diminished somewhat over time. On the other hand, the constraint imposed by the major supermarket chains is strong and is increasing. The contrast between the constraint imposed by Franklins and the constraint imposed by the major supermarket chains demonstrates that the Commission’s contention that Franklins is a participant in the relevant market in respect of its supply to the Franklins Franchise Stores, while the major supermarket chains, and Franklins insofar as it supplies to the Franklins Corporate Stores, are not, should be rejected.

Not only does the Commission seek to exclude Coles and Woolworths from the relevant market, it also seeks to exclude Franklins’ wholesale supply to the Franklins Corporate Stores. However, the value of groceries supplied by Franklins to the Franklins Corporate Stores far outweighs the value of its sales to the Franklins Franchise Stores. For the two periods of ten months ended 31 December 2009 and 31 December 2010, Franklins’ sales to the Franklins Franchise Stores represented approximately 13.5 per cent and 16 per cent respectively of the value of supplies to the Franklins Corporate Stores. Franklins does not regard itself as a wholesaler, and its franchise operations are not set up or conducted on the basis that it is a wholesaler.

To show not only that the relevant market includes Franklins’ supply to the Franklins Franchise Stores but also that it excludes the major supermarket chains and Franklins’ supply to the Franklins Corporate Stores, the Commission must show that Franklins poses a greater threat to Metcash than the major supermarket chains. The evidence suggests that direct demand-side substitution by consumers between supermarkets operated by independent retailers and supermarkets operated by the major supermarket chains imposes a substantial competitive constraint upon Metcash as a supplier of packaged groceries at the wholesale level. On the other hand, the evidence suggests that direct demand-side substitution by consumers between supermarkets operated by independent retailers and supermarkets operated by Franklins does not impose any substantial constraint on Metcash. Further, Franklins has weaker bargaining power with manufacturers and primary suppliers than Metcash and, consequently, has been unable to obtain the same terms as Metcash. In addition, Franklins operates only in NSW, whereas Metcash operates throughout Australia, something that enhances its relative bargaining power.

Further, the threat of independent retailers ceasing to take supply from Metcash and selling their stores to one of the major supermarket chains imposes a substantial competitive constraint on Metcash as a supplier of packaged groceries at the wholesale level. On the other hand, the threat of independent retailers switching to the Franklins franchise model does not impose a meaningful constraint upon Metcash. Thus, Metcash is constrained at the wholesale level by the threat of demand-side substitution by retailers. Metcash is more concerned about losing volume to the major supermarket chains than to Franklins. That indicates that the major supermarket chains are a closer competitive constraint upon Metcash than is Franklins.

Accordingly, if Franklins is in the relevant market with Metcash, **the major supermarket chains must also be included in that market**. Given that the major supermarket chains are a closer competitive constraint upon Metcash than Franklins, it follows that, if Franklins would be able to prevent a hypothetical monopolist wholesaler from imposing what I have described as a relevant increase in price, being a small but significant non-transitory increase in price, so must the major supermarket chains be able to do so. Necessarily, the application of the hypothetical monopolist test would include both the major supermarket chains and Franklins in the relevant market with Metcash.

On the one hand, the Commission seeks to rely on Project Energise to show that Franklins’ entry into self-supply and franchising arrangements forced Metcash to drop prices, thus demonstrating that Franklins became a constraint. On the other hand, the Commission points to Metcash’s profits to suggest that Metcash is not presently constrained in some relevant sense. There is a real tension between those two propositions. Either the position of Franklins in the market was such that Metcash was forced to drop its prices, or Metcash is not constrained in relation to profits and prices, notwithstanding that Franklins is in the market. The Commission, further, appears to be saying that Metcash is not constrained in its profits by the major supermarket chains, but is constrained by Franklins. That proposition, in the light of the evidence, is untenable.

If Metcash is not closely constrained, the proposed acquisition will not change anything, because there could be no substantial lessening of competition. If, on the other hand, Metcash is closely constrained, the question arises as to by whom it is constrained. As I have said, the Commission no longer contends that SPAR is a close constraint and offers a viable alternative to Metcash for wholesale supply. SPAR does not have a warehouse in NSW, which is a significant disadvantage. Further, SPAR’s product range, including its home brand range, is considerably smaller than Metcash’s. That leaves the major supermarket chains and Franklins as the other candidates for closely constraining Metcash. As I have said, the major supermarket chains pose a much more powerful constraint than Franklins does, and it would be wrong to include Franklins, but exclude the major supermarket chains, in the definition of the relevant market.

## Conclusion as to Market

Metcash is not simply a wholesaler. Metcash is closely involved in the retail process, partly through ownership but mainly through contract. The IGA banner or brand is a significant element in the rivalry between IGA retailers and the major supermarket chains. That banner or brand provides opportunities for IGA retailers to promote their stores. Consumers come to know and trust the brand, which helps to attract custom to all of the IGA stores. The IGA brand is owned and controlled by Metcash. Metcash promotes programmes that are designed to advance and promote the IGA brand. Thus, Metcash is intimately involved in the retail activities of the IGA stores, and those activities cannot be divorced from the other relevant activities undertaken by Metcash. Accordingly, the separation of Metcash’s wholesale activities from its activities at the retail level involves a significant degree of artificiality.

On the other hand, Franklins is essentially a supermarket retailing business. Franklins owns the Franklins Corporate Stores. Its warehouse and distribution operations are largely carried out by separate firms under contract. If the acquisition of Franklins by Metcash proceeds, Metcash intends, over time, to shut down those activities. Thus, Metcash is not acquiring Franklins to acquire wholesale assets. Rather, it is buying retail stores, albeit with the hope of expanding the volume of its wholesale sales. It would be illogical, in those circumstances, to exclude the retail level from the analysis of the relevant market.

The grocery industry is characterised by a high degree of vertical integration in the distribution supply chain. The major supermarket chains are wholly vertically integrated. Metcash and Franklins are vertically integrated to a lesser, but still significant, extent. Metcash has extensive integration downstream, at the retail level, by way of contracts, and Franklins has extensive integration upstream, at the wholesale level, also by way of contracts. Accordingly, constraints arising from competition at the retail level between independent retailers supplied by Metcash and supermarkets operated by the major supermarket chains are highly relevant in defining the market for the purposes of the application of s 50 of the Competition Act.

Wholesalers, such as Metcash, SPAR, and Franklins insofar as it supplies the Franklins Franchise Stores, supply retailers with goods together with ancillary services. In applying the hypothetical monopolist test, it is unrealistic to speak in terms of an increase in the margin added on by wholesalers to their cost of acquiring goods from manufacturers and primary suppliers. It is meaningful, as I have indicated above, only to speak in terms of an increase in the price charged by wholesalers to their customers, the retailers. The position of the major supermarket chains, particularly Coles and Woolworths, is such that there is a very significant constraint on the capacity of independent retailers to increase price or decrease other services without the likely loss of business. That constraint also constrains the capacity of the wholesaler to increase its prices to independent retailers. I am not persuaded that an increase of between five and ten percent in the price at which goods are supplied by Metcash to independent retailers could be sustained without a resultant significant loss of business.

There is clearly vigorous competition at the retail level. It may be that there is a market for the supply of grocery products generally by retail. As I have said, Metcash and Pick n Pay contend for a national market for the supply of packaged groceries, fresh products, general merchandise and health, beauty and cosmetic products to the consuming public by way of integrated retail chains and independent wholesalers supplying independent grocery retailers. The participants in that market would include the major supermarket chains, Franklins in respect of the 80 Franklins Corporate Stores, the operators of the Franklins Franchise Stores, the semi-integrated arrangements involving Metcash and the IGA bannered stores and the semi-integrated arrangements involving SPAR and the SPAR and 5 Star bannered stores. However, the Commission has not suggested that the proposed acquisition of Franklins by Metcash would be likely to have the effect of lessening competition in such a market.

I am not persuaded that there is a separate market for the wholesale supply to independent supermarket retailers of packaged groceries, as the Commission defines those terms in the Statement of Claim. The Commission has based its case solely on there being a separate market for the wholesale supply to independent retailers of packaged groceries, as defined. The Commission’s pleaded case as to market definition has not been made out. It follows that the proceeding must fail. However, I propose to deal with the issue as to the counterfactuals propounded by the Commission.

# THE COUNTERFACTUALS

I have already said something about economic principles relevant to the counterfactual analysis, and about the relationship of that analysis to the terms of s 50 of the Competition Act. The analysis involves comparing the likely state of market competition both without and with a proposed acquisition.

Ordinarily, the first hypothetical situation, being the future without the proposed acquisition, involves the continuation of the *status quo*. However, the circumstances of the present case are, in some respects, out of the ordinary. Whether or not the acquisition of Franklins by Metcash proceeds, the Franklins business will not continue under the ownership of Pick n Pay. That is to say, it is common ground that Pick n Pay will sell the Franklins business and assets to the acquirer who makes the best offer and has the capacity to complete. An essential requirement of completion will, of course, be that the acquirer is not prevented from making the acquisition by s 50 of the Competition Act.

The Commission contends that, having regard to the substantial value of the Franklins assets, being between $100 million and $215 million, those assets will continue to be employed in the market even if the Metcash acquisition of Franklins does not proceed. The Commission contends that those assets have value because they can be profitably deployed, not only by Metcash, but also by other interested prospective acquirers.

The Commission says that, if the acquisition by Metcash proceeds, Metcash will close down Franklins’ wholesale supply arrangements, will sell most or all of the Franklins stores to independent retailers, who will then operate those stores, and will require those retailers to enter into supply agreements with Metcash that prevent the retailers for a significant period of time from obtaining supply from an alternative wholesaler. The consequence, the Commission says, will be that, in the future, there will not be enough independent wholesale volume available to support the establishment of a competing wholesaler able to offer the wholesale supply of packaged groceries to independent supermarket retailers in NSW and the ACT. The Commission says that, because of the high barriers to entry into the market alleged by it, Franklins is the last opportunity for independent retailers to control their cost of goods at the wholesale level.

On the other hand, the Commission says, if Metcash does not acquire Franklins, the Franklins assets will continue to be available for use as a close and direct competitive constraint on Metcash, albeit in a different form and under new ownership. It says that there is a real chance that a consortium of retailers will become an alternative owner and operator of Franklins’ assets, or a sufficient part of them, and will use those assets to provide a continuing competitive constraint on Metcash in NSW and the ACT for the foreseeable future.

The Commission postulates, as I understand its contention, that the **minimum efficient scale** that an alternative wholesale supplier would require to be viable would be wholesale volume of approximately $400 million. Such a volume of sales would be the minimum efficient scale necessary to support the establishment of a distribution centre. Franklins’ annual wholesale volume in NSW is between $400 million and $500 million. Metcash’s wholesale turnover in NSW and the ACT is approximately twice that volume. Therefore, the Commission says, the NSW and the ACT market could support a competitor for Metcash, even without account being taken of any future growth in the market.

It is therefore necessary to consider the likelihood that the consortium postulated by the Commission might be established and acquire Franklins, or a substantial part of its assets, so as to engage in the wholesale supply of packaged groceries to independent supermarket retailers. I consider that, for the Commission to succeed, the Court must conclude that it is more probable than not that one of the Commission’s counterfactuals will come to pass if the proposed acquisition does not proceed, and that there is a real chance that, if the proposed acquisition does proceed, there will be a substantial lessening of competition as compared with those counterfactuals. Since the Commission has abandoned its original contention that SPAR was a viable alternative acquirer of the Franklins assets, the Commission’s counterfactual case now rests upon the prospects of the consortium’s acquiring all, or a substantial majority of, the Franklins assets in the event that the sale to Metcash does not proceed.

I have already mentioned the possible members of the proposed consortium. They are all presently participants in the retail grocery industry in NSW and the ACT, being businesses controlled by the Koundouris, Karellas, Krnc and Lionis families. I shall now say something about the process leading up to an indicative non-binding offer that was put forward to Pick n Pay on behalf of the consortium, the offer itself, and the prospects of Pick n Pay’s accepting an offer from the proposed consortium.

However, before dealing with the consortium, it is necessary to say something about a sale process that Pick n Pay put into operation in October 2010 (**the Store Sale Process**). The Store Sale Process was implemented by Pick n Pay as an alternative means of disposing of the Franklins assets against the possibility that the acquisition by Metcash does not proceed. By reason of the intervention of the Commission and the prosecution of this proceeding, such a process would need to begin again, if it were ultimately required to be followed through. Nevertheless, the results of the Store Sale Process to date are informative. Although they do not provide a precise indication of the outcome that would occur were the process to be repeated, assuming that the proposed acquisition by Metcash is prohibited, they provide meaningful information relevant to the assessment of what is likely to happen in that event.

## The Store Sale Process

On 8 October 2010, an email was sent by Mr Gareth Ackerman to officers of the Pick n Pay Group, including Messrs Cope and Perlov, dealing with the implementation of Pick n Pay’s “fallback strategy”. Mr Ackerman said that all efforts were being directed towards convincing the Commission that the transaction with Metcash was in the best interests of the Australian consumer. He also said that a tender process was being initiated to dispose of the stores. He said that there were two reasons for initiating that process. First, he said, it directly addressed concerns that the Commission had raised, and therefore increased the chances of the current deal being cleared. Secondly, he said, it ensured that, should the Commission not clear the proposed transaction, Pick n Pay would be best placed to move swiftly to complete its exit from Australia. Mr Ackerman said that he believed that that was in the best interests of all concerned.

Mr Perlov said that there were two reasons for the Store Sale Process. The first, described as the commercial reason, was that the store sale process was formulated by Pick n Pay’s corporate advisers to enable an alternative quick exit from Australia. The second, described as the legal reason, was to assist in responding to the Commission’s concerns during an informal merger clearance process. Mr Cope, on the other hand, said that his understanding was that the commercial reason, being a speedy exit from Australia, was the only reason for the Store Sale Process. The Commission contends that the Store Sale Process was driven primarily by legal considerations. Pick n Pay responds that, on any view, and consistently with the evidence of Messrs Perlov and Cope, there was a commercial rationale for undertaking the Store Sale Process, being that which I have just described.

On 13 October 2010, an advertisement was published in the Australian Financial Review newspaper by Momentum Corporate Pty Limited (**Momentum**), advertising the Store Sale Process. Under the Store Sale Process, prospective purchasers were required to complete a form, in which they were to express interest in receiving further information about particular Franklins Corporate Stores. Upon signing a confidentiality deed, those who expressed interest about particular stores were provided with information about those stores. The information included sales for each six monthly period over the past three and a half years, store area, lease expiry date, options, rent, outgoings, number of employees and stock holding. A prospective purchaser was then required to make a non-binding indicative offer, nominating a price for each store that the prospective purchaser was interested in buying.

As a result of the Store Sale Process, 43 parties made non-binding indicative offers for one or more Franklins stores. Offerors included Woolworths, Coles, Metcash, Franklins staff and independent retailers, including owners of IGA stores. All of the offers, except those from Woolworths and Coles, identified separate amounts for each store included in the offer. Woolworths offered $85 million to $100 million for 26 stores. Coles offered $49.5 million for 8 stores. Neither of those offers identified a separate amount for each store. However, Coles said that it would be prepared to pay a fixed sum for the purchase of two identified stores only.

A number of offers included amounts in respect of a store at Summer Hill, which is not owned by Franklins. Franklins merely manages it. Although that management right may have some value, the amounts offered for the Summer Hill store were excluded by Pick n Pay in assessing the total value of the non-binding indicative offers received.

As indicated above, the value of stock was included in the information sheets provided to persons who expressed interest during the Store Sale Process. The total value of stock at that time was $45.76 million. The offer form completed by those who expressed interest made clear that the purchase price for stock would be added to the consideration to be paid on completion, based on a stocktake to be conducted prior to completion. All of the offers, except those received from Woolworths and Coles, were exclusive of stock.

In order to enable comparison between the Woolworths and Coles offers, on the one hand, and the other offers, on the other hand, the amounts offered by Woolworths and Coles were converted to amounts exclusive of stock. Thus, the amounts indicated by Woolworths and Coles were reduced to $72.321 million and $43.728 million respectively. The position is somewhat complicated in relation to Woolworths, because the Woolworths offer specified a price range, and because the offer included the Summer Hill store. For the purposes of comparison, the midpoint of the range that resulted from the exclusion of stock was used. Further, because the Woolworths indication did not identify an amount for each store, the total bid price amount among the stores was apportioned according to each store’s annual sales, relative to the total annual sales of all of the stores for which there was an offer.

In the case of Coles, the offer distinguished between the two specific stores to which I have referred and the other stores. Accordingly, the stock-exclusive amounts were apportioned between the two specific stores, on the one hand, and the remaining six stores, on the other.

Mr Cope accepted that, because the Store Sale Process attracted overlapping offers, it was not possible to conduct a simple exercise to determine the total financial return that Pick n Pay might expect under the Store Sale Process, by reference to the non-binding indicative offers received. Thus, it is not possible to say what would happen if not all stores for which an offer was made by a particular offeror were available to that offeror. The offeror might be content to take the remaining stores, or it might not be prepared to proceed without all of the stores for which an indicative bid was made. Further, it might be that an offeror would not offer an equivalent price for the remaining subset of stores. Similarly, it is not possible to be certain as to how much would be offered by Coles or Woolworths for a subset of the stores that were the subject of their offers.

Clearly enough, considerable interest was attracted through the Store Sale Process. A comparative table prepared by Pick n Pay indicates that the aggregate of the highest bids for each store, exclusive of stock, but including the Metcash bids, is substantially higher than the aggregate of the highest bids for each store, exclusive of stock, from offerors other than Metcash.

## The Consortium’s Offer

Mr Koundouris first became aware that Pick n Pay was interested in selling Franklins when the proposal for the sale to Metcash was announced publicly in July 2010. Mr Koundouris says that, if the acquisition of Franklins by Metcash is prohibited, Supabarn would be interested in purchasing either the whole of the Franklins business or any parts of it that are offered for sale separately. Mr Koundouris considers that all of the assets of Franklins have value, including many of the stores, the contracts for running the distribution centre, the No Frills house brand and the software and trading terms.

TMT Partners Pty Limited (**TMT**) is a financial and advisory services company. Mr Garry Lowrey is a representative of TMT. In August 2010, Mr Koundouris asked Mr Lowrey to advise him in connection with the possible acquisition, by a proposed consortium of independent supermarket operators led by Supabarn, of some or all of the assets of Franklins. Mr Koundouris told Mr Lowrey that he and the other prospective consortium members needed to stay anonymous because Metcash was their major supplier. Mr Lowrey gave a presentation on the proposal to Mr Koundouris in August 2010. The proposal was code named **Project Vertigo**.

In early October 2010, Mr Koundouris asked Mr Lowrey to prepare a business plan for Project Vertigo. Shortly thereafter, Mr Lowrey prepared a business plan and showed it to Mr Koundouris. The business plan indicated that the proposed objective was, primarily, to secure the future of the consortium members through their becoming the leading group of independent supermarket operators in NSW, and the establishment of a strategic relationship with a dedicated warehouse service. The secondary objectives were:

to improve the financial performance of the existing and acquired supermarket stores;

to improve the performance of the acquired warehouse operations;

to offer an alternative to other independent retailers;

to improve the competitiveness of independent retailers;

to deliver better outcomes for consumers; and

to provide a platform for geographic expansion.

The business plan proposed that the consortium would comprise leading independent NSW-based grocery retailers with the capacity to participate in the purchase of the Franklins Corporate Stores and to be serviced by the Franklins warehouse infrastructure. Consortium members would be expected to enter into mutually binding agreements relating to wholesale supply, marketing, branding and trading terms.

Following the Momentum advertisement of the Store Sale Process on 13 October 2010, Mr Koundouris asked Mr Lowrey to tell Momentum that the consortium was interested. Mr Lowrey spoke to Mr Paul Kaplan of Momentum, and told him he was acting on behalf of a group of investors, some of whom might already be independent operators in the industry. He told Mr Kaplan that they were interested in the Store Sale Process and in the Franklins distribution assets, but did not think the business was worth $215 million, that being the purchase price in the proposed Metcash share capital acquisition. Mr Kaplan replied that the distribution assets were not for sale and that they were only selling the stores and brands. Mr Lowrey asked for information about the Store Sale Process and Mr Kaplan subsequently sent to him a confidentiality agreement and expression of interest form.

On 19 October 2010, Mr Lowrey and other officers of TMT met with Mr Koundouris in Sydney, and agreed the terms of an expression of interest and the contents of a covering letter. The completed expression of interest form and a marked up confidentiality deed and cover letter were sent to Momentum on 19 October 2010.

On 20 October 2010, Mr Mark Burns, the managing director of TMT, was informed by Blake Dawson, the solicitors for Pick n Pay, that, because the consortium was interested in acquiring the distribution assets in addition to the stores, Pick n Pay proposed that further discussions regarding the sale of the stores, distribution assets and other assets of Franklins, or of the share capital of Franklins, would be conducted by Blake Dawson rather than Momentum, and that Momentum would only deal with the tender process.

Between 20 October 2010 and 25 October 2010, Mr Lowrey, Mr Burns and other officers of TMT met Mr Mark Stanbridge of Blake Dawson at Blake Dawson’s Sydney office, and discussions took place concerning the participation of the proposed consortium in the tender process. The TMT representatives indicated that they had concerns about the confidentiality agreement, and needed to make changes to it so that potential members of the consortium could participate in the tender process, and so that TMT could receive additional information about the stores and other assets of Franklins. Mr Stanbridge of Blake Dawson said that the response to the Store Sale Process had been very strong, and that indications were that the Store Sale Process might produce proceeds equivalent to the offer that had been made by Metcash.

Following the meeting, Mr Lowrey sent to Blake Dawson a request for further information that he required to enable him to prepare an indicative offer. One of the items that he requested was a copy of the agreement between Franklins and Linfox relating to warehousing and distribution services. Mr Lowrey considered that, for due diligence purposes, it was important to consider the terms of that agreement. He says that he would have advised the consortium, if a binding offer was made, to make the offer conditional on being satisfied with the terms of that agreement.

Independently of the consortium, on 25 October 2010 Karellas Investments submitted an indicative offer to acquire 14 of the Franklins Corporate Stores. The purpose of making that offer was to ensure that, in the event that the consortium offer was not accepted, Karellas Investments would have an alternative opportunity to expand its retail investments in NSW. The intention of Karellas Investments was that it would become more competitive, with more volume, and would secure stores that, together with the stores already owned by Supabarn and Karellas Investments, would have sufficient volume to support a warehouse.

On 26 October 2010, Mr Lowrey met with Mr Koundouris and with Messrs Andrew and Vasilli Karellas. Mr Koundouris signed an engagement letter concerning the appointment of TMT. Mr Lowrey told Mr Koundouris and Messrs Andrew and Vasilli Karellas that TMT would deal only with Mr Koundouris, because of the confidentiality terms for the Store Sale Process. Apart from the meetings described above, and a subsequent meeting on 3 November 2010, Mr Lowrey did not have dealings with anybody on behalf of the proposed consortium other than Mr Koundouris. All of TMT’s instructions in relation to Project Vertigo came from Mr Koundouris.

In late October and early November 2010, Mr Lowrey undertook a financial analysis of the Franklins store information that had been provided to him in connection with the tender process. He examined sales trends, inventory turn rates, sales per square metre, the rent to turnover ratio, and the lease terms of stores, which he regarded as key indicators of the health of a store. Based on that analysis, Mr Lowrey ranked the Franklins Corporate Stores in terms of attractiveness for acquisition, and concluded that the overall quality of the portfolio of stores was low. He considered that there were about 40 stores that, after acquisition, would require review to determine whether they should be kept or sold. Based on that analysis, Mr Lowrey identified stores that he considered were attractive for acquisition, stores that he considered might be attractive for acquisition but in relation to which there were possible problems, and stores that he considered were not attractive for acquisition.

On 29 October 2010, Mr Lowrey and Mr Burns met with Mr Perlov and Mr Stanbridge at Blake Dawson’s office in Sydney. At that meeting, Mr Perlov gave a presentation, which included some slides. During the course of the meeting, Mr Stanbridge said that Pick n Pay would need to understand the consortium’s plan to deal with the landlords, who were concerned with the change of brand from Franklins to IGA. Mr Perlov said that scale efficiency in the distribution centre would require another 20 good stores, and that Franklins was currently operating at 60 per cent capacity. He said that Franklins was losing $2 million a month, and that, were it not for Pick n Pay’s support of Franklins, Franklins would be in voluntary administration. He said that Franklins’ operating trading loss until the end of August was $3.6 million for six months. Mr Lowrey told Mr Perlov that the consortium needed more detail about the Linfox agreement. Mr Perlov said that he could not give them the agreement at that stage, but that the agreement with Linfox, including lease and outgoings, cost $350,000 per week.

At the end of the meeting, Mr Burns thanked Mr Perlov and Mr Stanbridge for the presentation and said that it was one of the most negative sales pitches he had ever heard. Mr Lowrey agreed. Mr Burns said that it was hard to understand how anyone could value the business at $215 million when it was losing $2 million a month. Mr Lowrey said they would go away, do some work and get some instructions.

On 3 November 2010, Mr Lowrey prepared a strategy analysis and recommendation for Project Vertigo, and a list of issues for the proposed consortium. He then attended a meeting with Mr Theo Koundouris and Messrs Andrew and Vasilli Karellas, and discussed making a non-binding indicative offer for the purchase of the Franklins Corporate Stores, the Franklins brands and the Franklins distribution centre. At the end of the meeting Mr Koundouris said that he wanted to go ahead with a non-binding indicative offer of $110 million. Mr Lowrey agreed that the figure of $110 million was appropriate, having considered the information received about the Franklins Corporate Stores and their recent performance. In coming to that view, he had applied industry-based rules of thumb to the gross revenue figures that had been provided on a store by store basis. That included applying higher valuation multiples to higher quality and profitable stores, and lower multiples to lower quality stores.

Mr Lowrey subsequently prepared a draft letter to Blake Dawson making an indicative non-binding offer, and sent a copy of the draft letter to Mr Koundouris. Mr Koundouris told Mr Lowrey by telephone that he was happy with the draft, and that it could be sent to Blake Dawson. Accordingly, on 4 November 2010, TMT Partners Consortium Pty Limited (**TMT Consortium**) lodged a non-binding indicative offer to acquire for the sum of $110 million the following assets:

the Franklins Corporate Stores;

the Franklins brand;

the No Frills brand; and

the rights and obligations relating to the Franklins distribution centre.

The bid was not accompanied by any information relating to membership of the proposed consortium or the consortium’s sources of funding. No information was provided concerning matters such as completion risk and landlords’ consents.

By letter of 12 November 2010, Mr Stanbridge acknowledged receipt of the non-binding indicative offer received from TMT Consortium. The letter said that it had been made clear at the meeting on 29 October 2010 that, to enable Pick n Pay to assess the merits of the offer by TMT Consortium, certain further information was required, but that TMT Consortium had failed to provide Blake Dawson with any of that information.

TMT Consortium responded on 17 November 2010, indicating that it had a strong interest in acquiring the assets and business activities detailed in the non-binding indicative offer, either through an asset purchase or a share purchase. The letter said that TMT Consortium remained committed to dealing with Pick n Pay in accordance with the process outlined, but that Blake Dawson had indicated that Pick n Pay’s first preference was to deal with Metcash. The letter went on to say that the form of any acquisition transaction, whether it be an acquisition of assets or shares in Franklins, was something that could only be determined with the benefit of due diligence and an understanding of what warranties or indemnities might be provided by Pick n Pay. The letter suggested that a decision in respect of the consortium’s non-binding indicative offer could not be made by Pick n Pay until after the Commission’s attitude was known, and that, if the Commission prevented the Metcash acquisition, the TMT Consortium proposal was likely to be relevant, as it could potentially provide a more certain outcome in a shorter time frame than was likely under the Store Sale Process.

On 18 November 2010, Mr Stanbridge told Mr Lowrey said that it was imperative that Pick n Pay understand who the consortium members were, how the consortium proposed to deal with landlords, and how the consortium proposed to fund the offer and associated financing requirements. Mr Lowrey replied that it had been made clear that the consortium could not take the commercial risk of identifying its members while Metcash was the likely purchaser and while Franklins was still arguing with the Commission. He said that, if Pick n Pay could not do a deal with Metcash, Pick n Pay should come to the consortium, whose members would be ready to sit down and talk.

After that conversation, Mr Lowrey spoke to Mr Koundouris and reported the tenor of his conversation with Mr Stanbridge. Mr Lowrey told Mr Koundouris that he thought the best solution was to get the financial information together so that the consortium could demonstrate its financial *bona fides*. He suggested that Mr Koundouris get in touch with his bank to arrange the documentation. A few hours later, Mr Koundouris told Mr Lowrey that he had arranged a meeting with his bank early the following week. Mr Lowrey then sent an email to Mr Stanbridge saying that arrangements were being made with the consortium’s bankers, and that they hoped to have something available early in the following week. The email said that the consortium remained acutely concerned about Metcash becoming aware of the identity of the consortium members.

Mr Stanbridge wrote to Mr Lowrey on 19 November 2010, indicating that Pick n Pay needed to be persuaded that the proposal from TMT Consortium would provide a more certain outcome in a shorter time frame than was likely under the Store Sale Process. The letter said that the information requested, which to date TMT Consortium had refused to supply, was directly relevant to timing and certainty of execution. The letter said that it was essential that the consortium provide details of its ability to complete the acquisition, details of its capacity to fund the purchase and replacement of bank guarantees in the order of $30 million, the sources of such funding, the identity of the members of the consortium, and the consortium’s position in relation to each of the key terms set out in the Store Sale Process documents. Mr Stanbridge said that it appeared that the consortium had supplied information to the Commission that had enabled the Commission to make the statement that there were parties who had expressed to the Commission strong interest in acquiring the entire Franklins business and continuing to provide strong competition in wholesaling to independent supermarkets. Mr Stanbridge asked that that information be shared immediately with Blake Dawson. Mr Stanbridge ended by saying that, if TMT Consortium wished to be considered by Pick n Pay as a potential purchaser, it would need to supply the requested information forthwith, but in any event no later than the close of business on 20 November 2010.

Mr Lowrey responded to Mr Stanbridge’s letter on 20 November 2010 saying that anonymity of the key consortium members was a key requirement of the bid. Mr Lowrey said that, while a significant amount of preparatory work had been completed, the consortium had been reluctant to incur large costs while it believed that Pick n Pay was focused on completing with another potential purchaser. He said that, if that situation changed, the consortium was ready to move quickly. The letter said that the responses required by Blake Dawson regarding financial capacity could be delivered on Monday 29 November 2010.

Blake Dawson replied on 23 November 2010, saying that Pick n Pay had agreed to extend the cut-off date for the sale agreement with Metcash to 30 June 2011. Mr Stanbridge said that the TMT Consortium had not afforded Pick n Pay the opportunity to consider the merits of its offer, and that the timely supply of the additional information was critical to Pick n Pay’s deliberations. Mr Stanbridge ended by saying that, because of the lack of information relating to the TMT Consortium’s offer, including the identity of the members of the consortium, funding sources, and the approach to completion risks and landlords’ consents, Pick n Pay was unable to place any meaningful weight on the offer.

Following receipt of that letter, Mr Lowrey spoke to Mr Koundouris and said that Blake Dawson had told him that they were still working with Metcash and that, if that did not proceed, they would come back to him. He said that he did not think there was anything else that they could do. Mr Koundouris agreed.

## The Consortium’s Prospects

The Commission contends that the Koundouris, Krnc, Karellas and Lionis interests are operated by persons with considerable experience and expertise in the retail grocery business, and who have formulated and continue to formulate plans for the acquisition of Franklins. It says that the Koundouris, Krnc, Karellas and Lionis interests are operated by astute business people who are ready, willing and able to acquire the Franklins business and assets, subject to acquiring the information that would be made available as part of an ordinary due diligence process. The Commission says that there is persuasive evidence that the proposed consortium consisting of those interests intends to acquire the Franklins assets and operate a business supplying independent supermarket retailers in NSW and the ACT in competition with Metcash. It says that the consortium members remain interested, despite the paucity of information provided to them and the apparent attempts by Pick n Pay to dissuade them from showing interest, which attempts include, the Commission says, the misrepresentation of the actual losses being incurred by Franklins. The Commission contends, therefore, that, if an offer were made by the consortium, there is a real chance that Pick n Pay would accept it, because an offer for the whole business would avoid substantial shutdown costs and would offer a faster and cleaner exit than a store by store sale process.

The Commission contends that Pick n Pay is most likely to sell Franklins as a going concern. The Commission says that a further store by store sale process would face numerous significant hurdles that render it unlikely as the means by which Pick n Pay will ultimately recover its capital invested in Franklins. It points to the following matters:

The Store Sale Process undertaken in October 2010 would need to be started again if the Commission were to succeed in this proceeding.

The Store Sale Process would face similar competition issues to those that affect the proposed acquisition by Metcash, if it would result in a reduction from two competitors, in the relevant market, to Metcash alone.

Only one of the non-binding indicative offers submitted by Woolworths, Coles and Ritchies is capable of being accepted, because those offers are indivisible and overlap. Even if all of the offers were capable of being accepted, Pick n Pay would be left with a significant number of Franklins Corporate Stores unsold, most of which are presently unprofitable. Additionally, Pick n Pay would be left with an assortment of wholesale and retail assets, such as the No Frills brand, warehouse agreement and agreements with suppliers in respect of which it would not be in a position to realise value, leading to the incursion of shutdown costs.

However, the Commission says that, even if an individual store sale process, as postulated by Pick n Pay, were credible, its outcome is not so certain that the Court would find that an offer by the consortium did not have a real chance of success. The Commission says that, even if Pick n Pay did decide to pursue a store by store sale process, despite the shutdown costs and other hurdles, each of the members of the consortium would be a credible offeror for stores and other assets under that process.

The premise for any sale of the Franklins Corporate Stores separately from the other Franklins assets is that the acquisition of Franklins by Metcash does not proceed. That will only occur if the Court concludes that the Metcash acquisition would contravene s 50 of the Competition Act. On that basis, the Commission says, there is every reason to believe that an acquisition by Woolworths or Coles of an individual store that prevents competition in the relevant market, by depriving an alternative acquirer of the opportunity to obtain sufficient of the Franklins assets to allow it to compete in that market, would also be unlawful under s 50 and would be prohibited. Similarly, the Commission says, the 26 per cent ownership stake that Metcash has in Ritchies, together with their binding supply agreement, means that an acquisition by Ritchies cannot be regarded as a new entry by an independent retailer. Therefore, the Commission says, it is credible to conclude that an acquisition by Ritchies would also be unlawful, on the same basis as that upon which it contends that the acquisition by Metcash would be unlawful. Such s 50 concerns add to the uncertainties surrounding the outcome of any renewed store sale process.

The acquisition of Franklins by Metcash is only the first step of those to be taken by Metcash, which intends to sell all the Franklins Corporate Stores to independent retailers who will be tied to Metcash for the wholesale supply of packaged groceries. Therefore, the Commission says, alternative offerors could be considered as credible, even if they could not establish that they were the highest offerors in any renewed store sale process that might be undertaken by Pick n Pay.

There are various ways in which Pick n Pay could proceed in a new store sale process. It could attempt to sell each store to the highest offeror. Alternatively, it could accept one or more significant offers for a group of stores and then seek to sell the balance of the stores to the highest offeror. For example, Ritchies has bid $90.1 million for 21 stores, exclusive of stock. Accepting that would leave Pick n Pay with 58 stores to sell. Likewise, Woolworths has bid $85 million to $100 million for 26 stores, including stock, and accepting that would leave Pick n Pay with more than 50 other stores to sell. The Woolworths and Coles bids only overlap in respect of three stores. If the Coles bid for eight stores, of $43.728 million plus stock, is added to the mid-point bid of Woolworths for non-overlapping stores, of $54.855 million plus stock, the total is $98.583 million, plus stock, for 31 stores, including the store at Summer Hill. If that exercise is reversed, with the Woolworths bid for all stores added to the Coles bid for non-overlapping stores, the total would be $91.151 million plus stock for those stores. As well as those major offerors, there are many other offerors who made significant bids for particular stores. Many stores attracted multiple bids. Stores that were not the focus of bids from Coles or Woolworths were the subject of significant bids from other offerors.

A prediction about who would be the highest offeror for the Franklins assets must be premised on the particular offeror making the highest **lawful** offer after taking into account the operation of s 50 of the Competition Act. Further, the offers received may reflect **strategic value** rather than **fundamental value**. Even in 2007, Pick n Pay considered that a sale to Woolworths, Coles or Metcash would deliver a price that reflected strategic value over and above the underlying value of the Franklins business. The Commission says that it would be erroneous to consider the strategic value to an acquirer as an appropriate benchmark for assessing whether or not the acquisition would lead to a substantial lessening of competition, in circumstances where that strategic value may in fact reflect an ability to benefit from a substantial lessening of competition. In addition, the Commission contends, the Store Sale Process was not itself credible in a commercial sense, because it was driven by lawyers and not by commercial considerations. Therefore, the Commission says, it does not offer a basis upon which to judge the relative merits of the offers received under it. The Commission says that the price achievable by Pick n Pay in a renewed store sale process is not a relevant consideration.

The Commission says that the difficulty faced by the prospective consortium is that the Store Sale Process was itself uncertain. The Commission says that, by taking control of the process, Pick n Pay seeks to be the gatekeeper of any merger counterfactual that might be considered by the Court. Thus, the Commission says, the provision of insufficient material by Pick n Pay is highlighted by due diligence reservations and conditions precedent in the non-binding indicative offers submitted on behalf of Coles and Woolworths, as well as by the communications associated with the consortium offer, to which I have already referred.

The Commission says that the uncertainty concerning the Store Sale Process, including uncertainty about each of the non-binding indicative offers, makes it difficult to draw with confidence any inference as to what is likely to occur if the proposed acquisition by Metcash does not proceed. It is also difficult to conclude, according to the Commission, that an acquisition by the proposed consortium could be ruled out as having a real chance of succeeding, particularly in circumstances where, as the Commission says, Ritchies provides no compelling evidence of being able to fund its offer and none of the other possible offerors has been called to give evidence.

The Commission says that Mr Cope’s evidence that an offer from the proposed consortium would not be entertained is not persuasive, since Mr Cope conceded that, at the end of the day, Pick n Pay, as a profit-maximising firm, would accept the highest lawful offer. Further, as I have already said, the Commission says that an offer for the whole Franklins business would provide a faster and cleaner exit than a fresh store sale process, and would avoid substantial shutdown costs for Pick n Pay.

The Commission says that there are compelling pieces of evidence that there is a realistic possibility, in contrast to a mere possibility, that a wholesale operation conducted by the prospective consortium would be viable, and that such a possibility should not be dismissed out of hand as being based on nothing but speculation or theory. First, the members of the prospective consortium, by pursuing an offer for the Franklins assets, have concluded that the possibility is economically feasible and not merely speculative. The Commission says that the planning engaged in has elevated the possibility well beyond speculation or theory. The views of market participants, the Commission says, should be preferred over the submissions of parties interested in securing the proposed transaction with Metcash. The Commission contends that the evidence of Mr Perlov and Mr Cope that Pick n Pay would not consider the prospective consortium should also be discounted for this reason.

The Commission also says that the viability of a wholesale operation conducted by the prospective consortium is supported by the fact that the current volumes of retail sales of the members of the prospective consortium could be added to a sufficient proportion of the volumes of Franklins sales to achieve greater scale than Franklins was able to achieve while operated by Pick n Pay. In addition, the Commission says, the members of the prospective consortium have indicated that they would sell stores to attract franchisees, prioritising independent retailers who would bring extra volume to the proposed wholesale operation. That, the Commission says, is to be contrasted with Franklins’ inconsistent strategies. From all of this, the Commission asks the Court to infer that there exists an opportunity for increased scale and a credible opportunity for the viable alternative wholesale supply of wholesale packaged groceries in NSW and the ACT if the proposed acquisition by Metcash does not proceed.

There are several reasons, however, why the proposed consortium could not succeed in an offer along the lines foreshadowed by TMT. For the reasons set out below, Pick n Pay is unlikely to accept such an offer from the consortium, and it is difficult to conclude that the proposed consortium is a credible alternative purchaser, either of all of the Franklins Corporate Stores or of a significant majority of them.

**First,** there is no credible evidence to support the proposition that the proposed consortium is likely to make a serious binding offer for all, or a significant part, of the Franklins assets. As I have indicated, many fundamental aspects of its intentions remain unresolved. The Commission’s hypothesis involves the formation of a rival wholesale business to Metcash. Thus, the relevant outcome is not only the acquisition of the Franklins assets by the proposed consortium, but also the use of the assets acquired to create a new wholesaling business in competition with Metcash. The formation of such a business would require a great many matters to be resolved and a great deal of work.

The proposed consortium is far from having undertaken the detailed steps that will be required. Importantly, no binding offer could be submitted until the following matters were resolved:

the identity of the members of the consortium and the share that each member in the consortium would take;

the corporate structure that would be used to acquire the assets for the consortium;

the terms of any consortium agreement, including the rights and obligations of members of the consortium, the equity structure, voting rights and decision-making process, board representation, transfer of equity interests and provision for exit;

the precise assets that the consortium would wish to acquire;

the price to be paid for the assets to be acquired;

the amount of working capital necessary to operate the business, including expenditure for the improvement of stores;

the funding of the purchase price, including the relative proportions of debt and equity funding;

the numbers of Franklins Corporate Stores that would be retained by the consortium, be sold or be closed down;

how the proposed consortium would obtain landlords’ consents and assignments of leases of the Franklins Corporate Stores;

the brand that would be used by the consortium;

the relationship between the consortium members in relation to the operation of a warehouse and distribution assets, and the terms, including pricing strategies, on which any warehouse or wholesale business would supply groceries, both to consortium members and to non-members;

ownership of the warehouse assets; and

the employment of personnel who would operate the warehouse and carry out buying functions.

Mr Vasilli Karellas gave evidence that, if the acquisition of Franklins by Metcash does not proceed, he intends to join with Mr Koundouris and others, including Mr John Krnc and possibly Mr Lionis, to acquire a sufficient number of Franklins Corporate Stores, the warehousing system of Franklins and the No Frills brand. However, in cross-examination, Mr Vasilli Karellas agreed that, before putting in a binding offer for the Franklins business, the proposed consortium would need to resolve most of those matters, that there was a lot of work to do, and that the consortium was not yet in a position to commence what was a very detailed process. Mr Koundouris also agreed that there were many matters to finalise.

TMT appreciated, as at 4 November 2010, that many significant issues remained to be finalised by the consortium. In late October or early November 2010, Mr Lowrey produced a document dealing with the proposal, which highlights that fact. There is no evidence that any of those matters has subsequently progressed in a material way. Another document, prepared by TMT in November 2010, makes no complaint about inadequacy of information for the purposes of providing a non-binding indicative offer. Rather, TMT acknowledged that it had received standard form information regarding the Franklins Corporate Stores, together with other information specifically requested to assist the development of an offer. TMT’s document further noted that certain requested information had not been provided but that TMT had access to the chief executive officer. The TMT document identified certain benefits of proceeding with the “current strategy” of engaging with Blake Dawson, Pick n Pay’s solicitors, with a view to making an offer for Franklins. It also identified a significant number of issues with that strategy, including the high levels of risk involved.

**Secondly**, there is no evidence that the consortium has adequate funding to acquire all or a significant part of the Franklins assets, and there is no credible evidence of the capacity of the prospective members to obtain such funding. Specifically, there is no credible evidence to suggest that the prospective consortium could secure funding in the total amount of well in excess of $100 million, which was the amount of funding Mr Koundouris estimated would be required to finance an acquisition with a purchase price of $100 million. There is no evidence that prospective members of the consortium have either collectively or individually approached prospective financiers to ascertain their willingness to finance the possible acquisition of the Franklins business, as distinct from financing the participation by individual consortium members in the acquisition of individual stores, where the relevant amounts involved are much less than the $110 million non-binding offer submitted by TMT. A letter that was sent by the National Australia Bank to the directors of the Koundouris Group on 10 October 2010 falls well short of providing any assurance of funding. No information was provided as to the number of stores or the amount of funding required. The letter simply indicates a willingness on the part of National Australia Bank to consider any detailed requests for funding. Such a letter says nothing about the likelihood of funding.

Mr Vasilli Karellas told the Commission in September 2010 that it would be difficult for the consortium to get financing should it decide to make an offer. Mr Koundouris said, however, that he was confident of obtaining funding because his local bank manager told him in 2007, when he was contemplating a possible offer to acquire Franklins, that the bank was willing to look at any deal that he wanted to put together. It is unlikely, however, that Pick n Pay would share that confidence.

**Thirdly**, there remains doubt as to the final membership of the proposed consortium. Mr Koundouris has known Mr Lionis for many years through associations in the grocery industry. Mr Koundouris told Mr Lionis in late 2010 that he was looking at putting together a consortium to make an offer to acquire Franklins in the event that the Metcash acquisition did not proceed. Mr Lionis said that he might be interested in being part of the consortium. Mr Koundouris said that he was sending someone to make enquiries of Franklins’ advisers. Mr Koundouris subsequently told Mr Lionis that Franklins was not interested in dealing with them.

While Messrs Koundouris, John Krnc and Vasilli Karellas suggested that Mr Lionis was to be a member of the consortium, Mr Lionis said in evidence that, as at 4 November 2010, when the non-binding offer was lodged, he considered that it was more in the nature of an exercise in getting information on the business, with a view to the possibility of putting forward a credible offer. He said that he would need a good deal more information before he was prepared to put in a binding offer for the acquisition of the Franklins business. That supports the conclusion that the lodging of the non-binding indicative offer was merely the first step in the process of engaging with Pick n Pay.

Mr Lionis said that there was no consortium at the time that the non-binding indicative offer was submitted to Pick n Pay. Mr Lionis gave evidence of two conversations with Mr Koundouris, to which I have already referred. Mr John Krnc accepted that he does not have a single document relating to his involvement in the so-called consortium, and said nothing in his affidavits about the acquisition of Franklins. Mr Koundouris gave generalised evidence about the making of the non-binding indicative offer on 4 November 2010, and said that Supabarn would be interested in purchasing the whole of the Franklins business, or any parts that might be offered for sale separately if the Metcash acquisition did not proceed, without mentioning any consortium. Mr Vasilli Karellas accepted that, before the consortium could make a binding offer, he and his family members would have to resolve whether they wished to participate. He gave evidence, in general terms, of several meetings with Mr Koundouris and later with Mr Koundouris, Mr Krnc and Mr Lionis. There is no certainty in the terms of the discussions to which he deposed.

Some of the individual consortium members say that they are prepared to follow through with the proposal if the Metcash acquisition does not proceed. That, however, does not provide an adequate foundation upon which to conclude that the proposed consortium’s interest is credible and is likely to produce a realistic binding offer.

**Fourthly**, Pick n Pay intends to sell the business on a store by store basis if the transaction with Metcash does not proceed. It says that, even if the consortium were to finalise all major outstanding issues and ultimately submit a binding offer, the offer would not be accepted unless it were for an amount that exceeded Pick n Pay’s assessment of the likely financial return to it from a disposition on a store by store basis. The non-binding offer of $110 million of 4 November 2010 would, therefore, in all likelihood, need to be substantially increased for the offer to have any prospect of acceptance by Pick n Pay. Mr Cope said that, as a director of Pick n Pay, he would vote against acceptance of the non-binding offer. He said that the $110 million price is markedly inferior to the net financial return that he expects through a competitive store tender process. Further, Mr Cope has serious doubts about the ability of the proposed consortium to complete the acquisition of the Franklins business. He would be concerned about its ability to fund the purchase and replace bank guarantees concerning leases and workers’ compensation. Additionally, the absence of any material indicating that the proposed consortium could provide landlords with sufficient comfort to persuade them to consent to assignments of leases means that completion of the transaction would likely be delayed unreasonably.

There is really no credible basis for concluding that, if the acquisition of Franklins by Metcash is prohibited, Pick n Pay would wait to see whether the proposed consortium members could resolve all of the matters described above and then proceed to make a binding offer. Even if the proposed consortium did make a binding offer, the high execution risk would make that offer unattractive to Pick n Pay.

If the acquisition of Franklins by Metcash is prohibited, then Pick n Pay would need to undertake a renewed store sale process. However, the offers in the original Store Sale Process suggest that it is unlikely that the proposed consortium would be the highest offeror for more than a handful of the Franklins Corporate Stores. When Pick n Pay called for expressions of interest under the Store Sale Process, the Koundouris interests submitted an offer for eight stores, the Karellas interests submitted an offer for 14 stores, and the Krnc and Lionis interests each submitted an offer for fewer than ten stores. The Karellas bid and the Koundouris bid overlapped in respect of every store for which the Koundouris interests submitted an offer. The Krnc interests submitted an offer for three stores for which the Karellas interests did not submit an offer, and the Lionis interests submitted an offer for one further store for which neither the Karellas nor Krnc interests submitted an offer. The Koundouris interests made the top offer for one store, the Lionis interests made the top offer for one store, and neither the Karellas interests nor the Krnc interests made the top offer for any store. Between them, the respective consortium interests submitted bids for a total of 18 stores, one of which was not in fact owned by Franklins. A consortium member was the top or equal top offeror in respect of only two stores. There is no indication that members of the proposed consortium co-ordinated their bidding in any way.

On that basis, the respective consortium is unlikely to obtain any material number of stores through a fresh store sale process. That is relevant to the assessment of the Commission’s contention that the proposed consortium could be expected to acquire sufficient stores under the fresh store sale process, as opposed to its prospects of acquiring the assets by way of a global bid.

The possibility of the consortium succeeding in an offer rests on the prospect of the consortium members offering for substantially more stores in any future store sale process than they have so far. It also rests on the prospect of either the consortium offering more than Woolworths, Coles, Metcash, Ritchies or any other independent retailer who intends to obtain supply from Metcash, or the Commission successfully preventing such entities from obtaining any number of stores that would prevent the proposed consortium members acquiring a significant majority of the stores.

Mr Grimwade, the most senior officer of the Commission to give evidence, accepted that the Commission had not yet considered what might happen under a renewed store sale process. He could not give any assurance that the Commission would oppose every sale of a store to any of Woolworths, Coles or Ritchies, and could not say that any particular offeror, including Woolworths, Coles and Ritchies, would be precluded from acquiring stores. The Commission has conducted the case on the basis that it is not necessary for it to carry out any enquiry or adduce any evidence to establish that there would be any contravention of s 50 by such acquisitions.

**Fifthly**, the evidence does not support the conclusion that the proposed consortium, if it acquired the Franklins assets, would establish a viable and sustainable wholesale operation in competition with Metcash. The members of the consortium are retailers, not wholesalers, and it would be necessary to employ people with considerable skill to conduct the wholesale operations. The preliminary work conducted by Mr Koundouris and Mr Lowrey was to the effect that a majority of the Franklins Corporate Stores would need to be sold or franchised to unidentified third parties. There was no evidence as to who those third parties might be or how any franchising business would work. Further, Mr John Krnc gave evidence, which is logical and compelling, that the last thing a retailer would want is to be taking supply from somebody who competed in the marketplace. The Commission places reliance on what is effectively the same point in its contention that Woolworths is unlikely to engage in wholesale supply to independent retailers.

Mr Koundouris apparently assumed that the consortium could simply take over any supply contract held by Franklins and thus get the benefit of any terms negotiated by Franklins. However, there is no reason advanced as to why manufacturers and primary suppliers would agree to the novation of their supply contracts to a new entity with no track record in wholesaling. It is more likely that the proposed consortium would need to negotiate new terms, which could well be materially less favourable than the terms under which Franklins operates.

The Franklins business has been a loss-making business and there is considerable doubt as to whether it is viable. Franklins has been unable to compete with Coles and Woolworths, and most of its stores are in need of significant work. That is a most unpromising foundation for a new and competitive wholesaling business. Mr Koundouris asserted that the proposed consortium would operate the warehouse as a cost centre plus 2.5 per cent margin. There is no evidence to support the proposition that the warehouse could be operated on that margin, or that the figure has been derived from any calculation. Rather, it appears to be no more than a purely speculative guess by Mr Koundouris.

Further, the margin that might be applied by the prospective consortium to the price of packaged groceries acquired from manufacturers and primary suppliers says nothing about the attractiveness of the consortium’s prices to independent retailers. Independent retailers would not choose between Metcash and the prospective consortium on the basis of the margin applied to the price for which Metcash and the consortium acquire their products. Rather, they would choose between them based on the price at which those groceries were supplied, and the range of associated services that were offered to support the retailer. There is no evidence as to the net price at which the proposed consortium could or would acquire packaged groceries from manufacturers and other primary suppliers. Further, it is clear that the proposed consortium would be at a significant scale disadvantage to Metcash, and that Metcash would be able to buy on better terms than the proposed consortium. Even if it were possible for the proposed consortium to step into the shoes of Franklins, Franklins has not been able to compete effectively or sustainably with Coles, Woolworths or Metcash. As to associated services, there is no evidence that the proposed consortium could provide any of the various support services provided by Metcash to independent retailers to assist them to compete with Coles and Woolworths.

**Sixthly**, there is no evidence as to who would buy, or take a franchise of, the unwanted Franklins Corporate Stores. Mr Koundouris prepared a two page document concerning Franklins. The document indicated that Mr Koundouris had plans to keep 23 stores, to franchise 45 stores up front for a return of some tens of millions of dollars, and to close 12 stores, the cost of which would be offset by the revenue from franchising the 45 stores. As I have said, Mr Koundouris estimated that the total amount required, for a price of $100 million, was well in excess of $100 million. However, that made no allowance for the stock in the 45 stores to be franchised, nor for any lease guarantees and workers’ compensation guarantees, which totalled $27.7 million. Further, there was no evidence as to any plan for franchising, nor as to any consideration having been given to the amount that would be realised on franchising. Franklins was able to produce only ten franchised stores in over five years of effort. The undeveloped plan to franchise 45 stores should therefore be given little weight.

There are, accordingly, obvious difficulties with the suggestion that the consortium will franchise the unwanted stores. If the consortium sought instead to sell those stores, the buyers are likely to include Coles, Woolworths, Metcash, Ritchies and other independent supermarket owners who may choose to be supplied by Metcash. There is no evidence as to why the consortium would adopt anything other than a profit-maximising strategy in any store sale process. That, however, is inconsistent with the Commission’s contention that all, or a substantial majority by revenue, of the stores would remain owned by third parties and not by the entities I have just mentioned.

**Finally**, the proposed consortium’s interest is, at best, speculative. That is to say, its interest is substantially undeveloped. Its primary goal to date has been, clearly enough, to block the Metcash acquisition without spending the money and resources that would be required to demonstrate that it is itself in a position to make a serious, binding offer. The interest of the consortium is driven by strategic considerations aimed at creating an opportunity for it to commence to develop some sort of proposal, the details of which are as yet unclear.

In the light of the matters set out above, including the numerous and detailed basic matters still needing to be resolved, such as membership and participation, the lack of any proper business plan, the lack of information as to available funding, the absence of identification of purchasers for the Franklins Corporate Stores to be sold or franchised, and the lack of evidence of experience of consortium members in wholesaling operations, the establishment of a viable wholesale business by the consortium must be regarded as entirely speculative. Further, based on Mr Cope’s assessment and analysis of the Store Sale Process, even if a serious proposal could be developed, any such proposal would be likely to produce a lower financial return for Pick n Pay than that expected from a store by store sale process.

As well as offers from Coles, Woolworths and Ritchies, Pick n Pay has also received significant offers from Metcash, including an offer for each store. While the acquisition of all of the stores by Metcash would be similar in effect to the acquisition presently under consideration, the acquisition of Metcash of a material parcel of stores is a more likely scenario than any acquisition by the prospective consortium.

Mr Cope said that, if Pick n Pay is prevented from completing the sale of Franklins to Metcash, it will sell the Franklins stores individually or in groups in order to realise maximum value from its investment. That evidence has not been materially challenged by the Commission. Accordingly, there is no reason to doubt that Mr Cope would make recommendations consistent with his views and that the board of Pick n Pay Stores would follow his recommendations.

If the Metcash transaction does not proceed, the likelihood is that the Franklins stores will be sold in groups or individually to purchasers including Ritchies, Coles, Woolworths and independent retailers. In relation to the stores that are sold to independent retailers, it is likely that those retailers would obtain supply of packaged groceries from Metcash. The Commission has identified no other likely source of supply. Further, the intention of the seller in these circumstances is critical. I am satisfied that it is unlikely that Pick n Pay would enter into any transaction with the proposed consortium.

## Conclusion as to the Counterfactuals

It is necessary to make an assessment of the ability of an acquirer of the assets of Franklins to operate them more profitably than Pick n Pay has. Pick n Pay has had considerable retail experience outside Australia, but has not been able to operate the Franklins business profitably. It is possible that an acquirer with more direct experience in Australia, either in wholesaling or retailing, would be able to operate the Franklins business more successfully than Pick n Pay has been able to. Alternatively, it may be necessary to evaluate the feasibility of bringing in additional investors or the viability of organic growth to determine whether, and to what extent, operation of the Franklins business by an acquirer might be successful.

On the basis of the evidence presently before the Court, I am not persuaded that it is more likely than not that the consortium propounded by the Commission will make an offer to acquire the whole, or a significant majority, of the Franklins assets, that will be accepted by Pick n Pay. If the acquisition of Franklins by Metcash does not proceed, it is highly likely that Pick n Pay will dispose of the Franklins assets by means of a store by store sale process. Rightly or wrongly, Pick n Pay perceives that it will realise greater proceeds by that process than by a sale of the Franklins business as a going concern. The uncertainties surrounding the terms of any potential binding offer from the consortium make it a matter of pure speculation as to whether a binding offer might ever be made, let alone whether it would be accepted by Pick n Pay. I am persuaded that it is quite unlikely that an offer by the postulated consortium along the lines foreshadowed would be accepted by Pick n Pay. As I have said, the Commission has abandoned any reliance on SPAR as a potential counterfactual acquirer. Accordingly, the Commission fails on the counterfactual analysis.

The Commission contends that it need only establish a **real chance** that its counterfactuals would come to pass in the event that the Metcash acquisition did not proceed. Even if that contention be correct, I am not persuaded that there is a real chance that the counterfactuals contended for by the Commission would come to pass.

# EFFECT ON COMPETITION

The question posed by the Commission is whether the proposed acquisition of Franklins by Metcash will expand the measure of discretion that Metcash has to “give less and charge more” in its wholesale supply of packaged groceries to independent supermarket retailers. The Commission says that the Franklins wholesale assets currently provide a material constraint on Metcash that limits its ability to charge significantly higher prices or provide inferior service to the independent supermarket retailers it supplies. It contends that that constraint would be removed if Franklins were to be acquired by Metcash. That would result, the Commission says, in a lessening of competition in a way that is meaningful or relevant to the competitive process.

The Commission asserts that, once Franklins is removed, independent supermarket retailers will have no alternative but to acquire packaged groceries from Metcash by wholesale, in that there will be no actual or potential supplier in NSW or the ACT that will constrain Metcash. On the other hand, the Commission says, without the acquisition, the Franklins assets could be operated by other parties so as to continue to provide the constraint on Metcash at the wholesale level. The Commission contends that the major supermarket chains will not offer sufficient constraint on Metcash’s ability to give less or charge more in the relevant market, and that there will be no alternative source of supply for independent retailers in the relevant market if the acquisition of Franklins by Metcash proceeds. Therefore, the Commission says, examined in the context of the factors set out in s 50(3) of the Competition Act, the Metcash acquisition will likely result in a substantial lessening of competition in the relevant market.

If the relevant market includes the major supermarket chains, as Metcash contends, there is no need to consider the possibility of a substantial lessening of competition. The Commission has never suggested that, if the market is as Metcash and Pick n Pay contend, the proposed acquisition would be likely to lead to a substantial lessening of competition. Accordingly, the Court need only consider the possibility of a real chance of a substantial lessening of competition, if it has been established, to the requisite standard, that one of the counterfactuals asserted by the Commission will come to pass, **and** that the market definition contended for by the Commission is correct.

I consider that, whatever the precise product, geographic or functional dimensions of the market, the major supermarket chains should be regarded as participants in the market. The Commission’s approach is to consider the indirect constraints of the major supermarket chains in the analysis of a firm’s market power rather than at the market definition stage. I consider that the preferable approach is to consider indirect constraints at the market definition stage. In addition, it is significant that the constraint imposed by the major supermarket chains is not solely indirect. The major supermarket chains also constrain through the threat of buying stores. However, it does not much matter, in the circumstances of the present case, whether the major supermarket chains are taken into account when defining the market or when considering the effect that the proposed acquisition will have on competition: either way, they constrain Metcash closely, and will continue to do so.

Even some of the putative consortium members did not appear to believe that an acquisition of the Franklins assets by the consortium would be better for competition than an acquisition of Franklins by Metcash. For example, Mr Karellas considered that the Metcash acquisition would help IGA in NSW to grow to become a third force in supermarkets. He thought that the Metcash acquisition would give IGA ammunition to take on Coles and Woolworths head on. Mr Karellas also thought that the Metcash acquisition was a good thing for the grocery market because it would help make the IGA brand stronger. Finally, he saw the acquisition as a pro-competitive way for IGA to strike back against Coles and Woolworths. Other independent retailers expressed similar support for the proposed acquisition.

## Section 50(3) Factors

Section 50(3) of the Competition Act provides that, without limiting the matters that may be taken into account for the purposes of determining whether an acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a market, certain specific matters must be taken into account, as follows:

actual and potential level of import competition in the market;

height of barriers to entry to the market;

level of concentration in the market;

degree of countervailing power in the market;

likelihood that the acquisition would result in the acquirer being able to increase prices or profit margins significantly and sustainably;

extent to which substitutes are available in the market or likely to be available in the market;

dynamic characteristics of the market;

likelihood that acquisition would result in removal from the market of a vigorous and effective competitor; and

nature and extent of vertical integration in the market.

I shall set out the parties’ contentions in relation to each of those matters.

### Import Competition

The Commission says that, because of distribution costs and issues concerning the shelf life of groceries and the like, the relevant market is not exposed to actual or potential **import competition**. Therefore, the Commission says, it is more likely that the acquisition would result in a substantial lessening of competition. Metcash also accepts that import competition does not presently constrain domestic suppliers. There is no evidence that that position is likely to change in the future, with or without the proposed acquisition. Metcash says, therefore, that the actual and potential level of import competition is a neutral factor.

### Barriers to Entry

I have already set out the Commission’s contentions as to barriers to entry to the market for which it contends. Metcash contends that there is no reason to suppose that there are any particular impediments or high **barriers to entry** that would prevent the major supermarket chains from using their supply chain experience and skills to enter the market contended for by the Commission. The Commission contends that the major supermarket chains are not presently in the relevant markets. Metcash says that the evidence emerging from the meeting of 14 December 2010, which I have discussed earlier, is that Woolworths does not see much to prevent it from engaging in wholesale arrangements, and that it is prepared to do so if an incentive exists. Metcash says that the opportunity to make profits would be such an incentive.

The Commission, on the other hand, contends that Woolworths was not telling the Commission on 14 December 2010 that it is a potential supply-side substitute to Metcash. Rather, the Commission says, Woolworths was telling the Commission precisely the opposite, namely, that its interest was to acquire retail stores, and that any such acquisition would be contemplated only if the acquisition by Metcash did not proceed. The Commission maintains its position that the major supermarket chains are neither a supply-side substitute nor a potential entrant.

### Level of Concentration

The Commission says that the market in question already exhibits a high degree of **concentration**. Thus, the Commission says, Metcash currently supplies all independent retailers in NSW and the ACT, with the exceptions of the Franklins Franchise Stores and the stores supplied by SPAR, which are mostly small. Following the proposed acquisition, Metcash would be supplying all of the Franklins volume, taking its NSW and ACT wholesale volumes to about $1.5 billion. That, the Commission says, would result in even higher levels of concentration than at present or in the counterfactuals. According to the Commission, that is a very relevant consideration. Metcash would, for all intents and purposes, be a monopolist, since SPAR is not an effective wholesale competitor.

Metcash accepts that the market contended for by the Commission is already highly concentrated. The level of involvement by Franklins, however, is very small indeed, comprising only Franklins’ franchising operations. Accordingly, market concentration would not markedly increase, irrespective of the acquisition.

### Countervailing Power

The Commission says that independent retailers have little **countervailing power** because they have no ability to bypass a wholesale supplier. They have limited or no access to direct supply from the major manufacturers. Independent retailers do not have the scale to integrate vertically and commence self-supply. Even if they were to seek to do so, they would be vulnerable to retaliation by Metcash during the lengthy period required to set up a warehouse. Mr Koundouris said that he has been interested in self-supply for some time. However, even though he represents one of the largest independent retailers in NSW and the ACT, he needs extra volume in order to embark on such a project.

Metcash contends that, even if the major supermarket chains are excluded from the relevant market for the purposes of considering the application of s 50, their existence can at least be characterised as a source of countervailing power. They compete vigorously with the independent retailers. Accordingly, Metcash’s retailers have a large degree of countervailing power. Metcash cannot increase prices, for fear that the retailers will take their capital elsewhere. That countervailing power will not be diminished by the acquisition. Thus, Metcash says, the proposed acquisition is unlikely to result in any change, one way or the other, in relation to the countervailing power of the independent retailers.

The Commission says that Metcash’s approach to the question of countervailing power involves a misapplication of that factor to merger analysis. It says that the factor requires an enquiry as to what degree of countervailing power is held by customers against the merged entity. The Commission says that the factor requires an assessment of independent retailers’ ability to bypass the need for a wholesaler by, for example, obtaining all of their packaged groceries directly from manufacturers and primary suppliers. That, however, is not a viable alternative. The Commission characterises Metcash as misinterpreting countervailing power as being not a measure of the countervailing power held by its customers, but, rather, a measure of the degree to which its customers, the independent retailers, are rendered powerless by being subject to close competitive constraint by the major supermarket chains. That incorrect approach, the Commission says, leads Metcash to state that the existence of the major supermarket chains is itself a source of countervailing power. The Commission says that such a contention has no basis in competition law or economics. In any event, the Commission says, even if the countervailing power factor were open to such an interpretation, Metcash’s contentions as to the three supposed sources of close constraint that the major supermarket chains represent should be rejected.

### Ability to Increase Prices or Profit Margins

The Commission contends that, in considering the likelihood that Metcash would be able to **increase price or profit margins** significantly and sustainably, it is necessary to have regard to the margin added by Metcash to the price paid to manufacturers rather than the total price for which Metcash sells wholesale packaged groceries to retailers. Thus, as indicated above, the Commission contends that the hypothetical monopolist test should be applied to the wholesale margin achieved by Metcash rather than the price actually charged by Metcash to its retailers.

Metcash contends that, by their conduct, the major supermarket chains will ensure that the likelihood that the acquisition would result in Metcash being able to increase prices or profit margins significantly and sustainably is very low. It says that the Commission has not shown that the acquisition will result in Metcash being able to increase prices or profit margins significantly or sustainably. It also contends, as I have said, that the hypothetical monopolist test should be applied to the price charged by Metcash to its retailers.

The Commission’s response is that Metcash’s contention relies on having shown that the major supermarket chains represent a close and uniform, or near uniform, source of constraint because of retail competition, IGA store owners selling their stores to the major supermarket chains, or direct entry by a major supermarket chain into wholesaling. The Commission says that the evidence does not support Metcash’s contention that those alleged constraints are close, or near uniform, or likely to arise. Therefore, the Commission says, the removal of the only potential threat of alternative wholesale supply of packaged groceries to independent retailers removes a close constraint on the merged firm that significantly limits its ability to increase prices, whether that increase be conceived either as an increase on wholesale margin or as a smaller increase on wholesale prices.

The Commission contends that an impediment to a monopoly wholesaler charging more and offering less is that a new entrant would be able to acquire the volume of disaffected independent retailers. The possibility of entry by another wholesaler under such circumstances has been described as the “ultimate constraint on the monopolist” (see *Re Queensland Independent Wholesalers Limited* (1995) 132 ALR 225 at 272). Since SPAR is not a viable wholesale entrant, a total monopoly will have been created if the acquisition proceeds, and, accordingly, competition will have been substantially lessened, prevented or hindered.

The Commission says that the most telling evidence of the extent to which Franklins has imposed a material price constraint on the wholesale supply of packaged groceries by Metcash is the launch of Project Energise. The Commission says that, in the context of the wholesale margin earned in the industry, the decrease of 1.2 per cent offered to retailers in Project Energise is very significant. The Commission says that the intended effect of Project Energise was to lock in IGA branded retailers, thereby reducing the risk that they would seek to obtain wholesale supply from Franklins by becoming Franklins franchisees or negotiating independent supply agreements with Franklins.

The Commission repeats that Project Energise is evidence of the constraint presented by the possibility of alternative supply. Project Energise, the Commission says, delineates the form and size of Metcash’s response to wholesale competition. The Commission says that there is every reason to expect a further, similar response were Metcash to be faced with a rejuvenated threat at the wholesale level. According to the Commission, Project Energise indicates pricing discretion, and there is equally good reason to suspect that a lack of competition would remove the pressure on Metcash to offer to independent retailers discounts and other benefits of the kind offered in Project Energise. The ability to choose the timing and level of the rebate is indicative, the Commission says, of a discretion to give less and charge more.

The Commission also points to the imposition by Metcash of the five cents per carton service fee increase, which, the Commission says, realised a substantial increase in Metcash’s prices and revenues. The Commission says that that was not prevented or rendered unprofitable by the indirect constraint provided by the major supermarket chains in competing with retailers operating under the IGA banner.

### Availability of Substitutes

The Commission asserts that there is no close **substitute** for **the service** of supplying wholesale packaged groceries to independent supermarket retailers. It says that fresh food is not a substitute for wholesale packaged groceries either on the supply side, because differing shelf lives and storage requirements mean that different infrastructure and facilities are required, or on the demand side, because a supermarket must offer a full range of groceries, including both packaged and fresh groceries. The Commission says that obtaining direct supply of the full range of wholesale packaged groceries is neither efficient nor feasible, and that independent retailers have little ability to bypass a wholesale supplier, having limited or no access to direct supply from the major manufacturers. The Commission says that, if the acquisition proceeds, the only alternative to Metcash will be SPAR. However, the Commission says, it is common ground that SPAR is not an effective wholesale competitor in NSW and the ACT. Further, the Commission relies on its contentions that the major supermarket chains are not participants in the relevant market for the purposes of assessing the effect of the acquisition under s 50.

Metcash says that, on the market contended for by the Commission, there is little real opportunity for independent retailers to obtain supply from someone other than Metcash. Neither SPAR nor Franklins can be regarded as providing a satisfactory substitute. Metcash says that that situation will not change to a marked degree, if at all, on the Commission’s counterfactuals. It says that a long list of speculative contingencies would need to occur before the counterfactuals would yield substitutes. Further, even with the acquisition proceeding, retailers would still have options if they were not able to make a satisfactory return. They could substitute another form of retailing or, in some instances, could sell their stores to a major supermarket chain.

### Dynamic Characteristics of the Market

Next, the Commission contends that the relevant market is not **dynamic**, and that there is very limited history of entry. Franklins is the only example of new entry in the past ten years. The Commission says that that position is likely to be exacerbated if Franklins is acquired by Metcash, the existing dominant incumbent in the relevant market. The Commission says that product differentiation at the retail level, including the benefits of geographical differentiation that each independent store enjoys, allows for price discrimination and the ability by Metcash to increase prices to most of the stores that it supplies on most products that it supplies. The Commission relies, in that regard, on its contentions concerning the adoption of zone 60 prices, and prices above zone 60, by IGA retailers.

Metcash asserts that it is an innovative and aggressive competitive force, and that it has to be such a force if it is to survive, given the presence of the major supermarket chains. That fact will not be diminished, it says, if the acquisition proceeds. On the contrary, Metcash’s scale will increase, and it will be better placed to obtain better prices from suppliers and better placed to help the independent retailers compete more aggressively with the major supermarket chains, particularly in NSW. The supermarket industry, Metcash says, is relatively dynamic. A feature of that dynamism in recent years has been the powerful movement by the major supermarket chains into territories that were once largely occupied by smaller, independent stores. In particular, that is reflected in the expansion of the major supermarket chains into smaller stores such as convenience stores, and in an extension of opening hours.

### Removal of a Vigorous and Effective Competitor

The Commission contends that Franklins, although relatively small when compared with Metcash, represents a **vigorous and effective competitive constraint** on Metcash. The Commission says that the reliance by Metcash and Pick n Pay on the financial position of Franklins, as managed by Pick n Pay, and Pick n Pay’s decision that it could better deploy its capital in southern Africa, is misconceived. The Commission says that it is more important to focus on what the assets of the Franklins business represent.

Metcash says that Franklins is not a vigorous and effective competitor, for the reasons raised above. Further, Franklins would not be departing because of the proposed acquisition, since Pick n Pay has decided to exit Australia in any event.

### Vertical Integration

Finally, in dealing with the nature and extent of **vertical integration** in the market, the Commission draws attention to the contractual relationships that wholesalers have with retailers. While there are some circumstances in which the interests of wholesalers and retailers are common, there are many circumstances, the Commission says, in which their interests conflict. Thus, the Commission says, the partial integration of Metcash and IGA bannered stores does not prevent a conflict of interest between them. The incentive of Metcash is to extract the highest margin it can, and its officers are rewarded for securing increases in shareholder earnings, not earnings of retailers.

Metcash says that vertical integration is inevitably a feature of the relevant market. It says that that position will not change in any significant way as a consequence of the proposed acquisition. Further, it says, the nature and extent of vertical integration in the market does not suggest that the proposed acquisition is likely to have anti-competitive consequences, since the IGA bannered stores, supplied by Metcash, will be in a better position to compete with the major supermarket chains. Metcash says that it is significant that s 50(3)(i) of the Competition Act recognises, through the concept of “vertical integration in the market”, that a market can be defined to include more than one functional level.

## Conclusion as to Effect of the Acquisition on Competition

The Commission says that Metcash is able to engage in sustained and significant differential pricing to the independent supermarket retailers to which it supplies packaged groceries by wholesale. It asserts that that ability to engage in differentiation creates and demonstrates an area of freedom that will exist for Metcash to raise prices once competition between Metcash and Franklins is eliminated. It says that that ability is not sufficiently constrained by the major supermarket chains to prevent Metcash from giving less or charging more to the independent supermarket retailers that it supplies.

The Commission also says that the Franklins assets represent the only credible potential constraint on Metcash as the dominant wholesale supplier of packaged groceries to independent supermarket retailers in the relevant market. That is why, the Commission says, those assets are so highly prized by Metcash, and why Metcash has offered what is effectively a significant premium for the purchase of those assets.

In the light of all of those matters, and applying the factors specified in   
s 50(3), the Commission contends that there is a real chance that, once the Franklins assets are removed from the relevant market, the area of freedom for Metcash, or its measure of discretion to raise prices to independent supermarket retailers for the wholesale supply of packaged groceries in NSW and the ACT, will be substantially enhanced by Metcash’s acquisition of the share capital of Franklins. Therefore, it says, a substantial lessening of competition is likely, and the acquisition of Franklins by Metcash would contravene s 50 of the Competition Act.

The Commission asserts that the pricing differentials inherent in Metcash’s wholesale pricing indicate that a decision by Metcash to implement price increases would not necessarily be noticed by a sufficient number of consumers to induce a strong response, if the independent retailers passed on the increase. The Commission further says that such price increases would not deter a sufficient number of marginal consumers, because they choose to shop at independent retailer stores based on non-price factors. Finally, the Commission says, Metcash would be able to implement price increases with respect to most independent retail customers, but compensate a select minority of independent retailers who face close price competition from the major supermarket chains, namely those retailers who operate stores that are considered to be in close proximity to the major supermarket chains. That, the Commission says, suggests that Metcash would have the incentive, ability and opportunity to impose a small but significant non-transitory increase in price on the wholesale supply of packaged groceries to independent retailers.

It is a matter of speculation as to whether, assuming the acquisition did not proceed, the consortium propounded by the Commission would ever be able to make an offer that would be accepted by Pick n Pay. Further, there is no evidence as to the extent to which Coles, Woolworths or Metcash would be prohibited from acquiring stores that might be disposed of by Franklins in a store by store sale process. On the other hand, I consider that it is quite likely that the acquisition of Franklins by Metcash will strengthen the capacity of independent retailers operating under the IGA banner to compete more vigorously with the major supermarket chains. In the light of those circumstances, and having regard to the factors specified in s 50(3) of the Competition Act, I am not persuaded that, if the proposed acquisition of Franklins by Metcash proceeds, there would be, or would be a real chance of, a substantial lessening of competition in the market propounded by the Commission.

# CONCLUSION

It follows from the conclusions I have indicated in relation to the issues for determination in the proceeding that the acquisition of all of the issued shares in the capital of Franklins by Metcash would not contravene s 50(1) of the Competition Act. Accordingly, the proceeding should be dismissed. The Commission should pay the costs of Metcash and of Pick n Pay.

|  |
| --- |
| I certify that the preceding four hundred and sixty-one (461) numbered paragraphs are a true copy of the Reasons for Judgment herein of the Honourable Justice Emmett. |

Associate:

Dated: 25 August 2011