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SUPERMARKET INQUIRY – SUPPLEMENTARY PAPER – COMPLEXITY

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COST OF LIVING CRISIS

All market surveys indicate the cost of living is by far the most dominant issue for voters. With the consumer price index placing food at 16% thus of the index it is inevitable that there will be a focus on the Supermarkets. But this focus lacks proportion because Governments have the greater influence on inflation which is driving up prices. Unfortunately, there is little public debate about how Government policy gives rise to inflation but attacking the Supermarkets diverts the publics gaze from Government to Supermarkets.

Supermarkets are far in fact inflation busters. We should focus on the root causes of inflation and drives those levers that will contain it. Attacking Supermarkets will not affect inflation or the food component in the CPI Index. An example of Government led inflation is energy in Queensland the energy companies owned by Government and by contrast to the South the cost of electricity is huge causing massive refrigeration cost blowouts. Inflation increases consumer prices which in turn without productivity gains lowers our standard of living.

It is important for all Inquiries that the Inquirers have a sound understanding of how Supermarkets operate and the environment in which they are operating.

The complexities that follow are designed to give some insight on Supermarkets when combined with the earlier paper "The Grocery Sector – Multiple Inquiries, Paper in Response to Inquiries, Some Context – Environment" of 26th February 2024.

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1. FIRST COMPLEXITY – TYRANNY OF PERCENTAGES

1.1 In the discussion about Supermarkets there is a misleading focus on the percentage margins earned by Supermarkets. I have described this as the tyranny, danger, or potential harm of focusing on percentages. Companies require capital to operate, and stock is a key Supermarket asset, so you need to understand the interaction between the margin percentage and the use of capital described as the stockturn.

1.2 The marriage of margin and stockturn to get the return on investment is only the first complexity in establishing whether the percentage return is fair or otherwise. The reality is you can have a 1% margin and be highly profitable and a 50% margin and be unprofitable and produce negative returns.

2. SECOND COMPLEXITY – WEIGHTED MARGINS

2.1 The opening margin percentage is rarely the final margin and can be very misleading. This is the case in many other business models. For instance, there are always factors which depreciate stock no matter what your business is. Fresh which includes fruit, vegetables, seafood, beef, pork, chicken, flowers, bread, milk, and deli always have a very limited life occasionally hours but more often a few days. Most of these products are very sensitive to changes in temperature sometimes as little as 1% so the product can rapidly deteriorate in value. Accordingly, there is often successive reductions in the pricing or the margin to ensure the product sells before it fails and has to be written off. So, in many respects the opening margin is illusionary, and it is the weighted average margin that should be calculated to determine the true margin and then relate to the margin to the stockturn as in Complexity 1 to establish the return.

2.2 You can understand this better when considering hard groceries. Take for instance a can of beans which for all intense purposes has a prolonged life. All products have a use by date but with most hard groceries there is a very high probability that the product will be sold way before its use by date. The reality is that you do not have to discount the hard grocery product because of its quality but only because you have more stock than the consumer wants or competitors have discounted the product so unless you match or exceed the discount you will not sell the product. So, the margin on hard groceries is much more determinant than with fresh.

3. THIRD COMPLEXITY – SUPPLY CHAIN

3.1 There is a real issue with the supply chain. The difficulty is that the various component parts of the supply chain are owned and operated by different entities. So, in moving product through the chain there has to be a negotiation with each participant as to their role and how much they are paid. It is only natural that each participant will act in its own interest and not in the interests of the smooth operation of the whole chain. The more steps or more fragmentation the higher the cost is conversely the more direct it is the lower the cost.

3.2 There are some examples outside Supermarkets like McDonalds where McDonalds owns all the steps in the chain including the transport so the chain can be managed not to optimise each part but to optimise the whole chain. The consequence is that McDonalds are able to deliver products like the burger meat at a very low cost to each outlet. If Supermarkets owned all the steps, they could take out a whole amount of cost. This is particularly so in relation to fresh which has unique challenges.

3.3 So from farm gate to Supermarket shelves there are many players are having an effect on the cost of the final product on Supermarket shelves. In considering Supermarket pricing you should also understand the role that each player has on the final cost. The greater cost is the Supplier cost and none of the Inquiries are addressing Supplier economics or the economics of others in the supply chain.

4. FOURTH OMPLEXITY – DCs

4.1 DCs have played a huge part in revolutionising distribution of goods to Supermarkets. It is about 25 years ago that technology and a robotics began in Supermarkets.

A DC of 25 years ago is hugely different than the DC of today. DCs are now accelerating the distribution of goods through the Supermarket taking out cost and reducing the days in the DC.

In the early days the benefits of the DCs gave a huge lift in the returns and profits in Supermarkets and now the benefits are flatlining.

Walmart's huge growth in the US was driven by distribution centres. Often Walmart would establish a DC in the market and then develop a cluster of stores around that Supermarket. In Australia this is not practical because of huge distances and lack of concentration of population. It will be very interesting to see how small DCs become with an appropriate cluster of Supermarkets around them.

So, the reality is that the DCs whether they be for hard groceries or fresh are critical assets. The Independent in the main have to rely upon third party distribution so they will not have capital invested in the physical infrastructure of DC, but an operating cost paid to a third party. To this extent the chains with their own DC have an advantage over the Independent with third party distribution because with greater integration of the chain costs can be taken out.

4.2 There is a perception that the Supermarkets have these giant DCs through which all product is channelled from Supplier to Supermarket. This is far from the case. There are multiple distribution arrangements. For instance, bread and milk have different chains and meat is quite separate from fresh. There is very little product that is delivered direct.

Whilst this does not matter to the supplier one DC is good as another it does put pressure on the Supermarkets even if they have multiple arrivals at each store. This is no longer ad hoc but booking arrangements are made so that on arrival the store staff can unload the truck rapidly not only to get the product on shelf or stored in the back dock enabling a rapid turnaround of the delivery truck.

4.3 The DCs for the distribution of fresh are completely different to the DCs for the delivery of hard groceries. The grocery DCs are highly automated and Australian DCs are world class in terms of their operating efficiency that is the speed at which product can be delivered through the DC via robotics into trucks to the stores.

4.4 In the balance sheets of Coles and Woolworths you will find their investment in plant and equipment is 42% and 36.7% respectively of the total assets. This is higher than the Supermarkets investment in stock. Much of this investment is in DCs which through their efficiency can accelerate the movement of stock. Woolworths is very conscience of the days of stock and in its 2023 Annual Report its disclosures that it has reduced days of stock by ¾ of a stock day. One day's less stock for Woolworths has a significant impact on the working capital involved and so the returns.

Woolworths is very conscience of its return on the net funds employed which at the moment sits at a modest 14%. This calculation is pre-establishing the performance of equity or debt. Coles is not much different. So, when the various Inquiries are looking at allegations of profiteering if that is taking place it is not reflecting in the performance of Coles or Woolworths. These Inquiries need to be reminded that the Supermarkets are like Greyhounds very finely tuned animals. For instance, Woolworths is proud to announce that its networking capital is minus 2.1 days and an improvement of 1.8 days over the prior period.

4.5 By contrast Fresh DC’s have nowhere near the same amount of robotics. It is much more labour intensive and unlike hard groceries there is a much higher operating cost with more invested in equipment like refrigeration. It is much more difficult to break up deliveries and do store allocations although there is a steady improvement with this by the use of dedicated boxing which in the case of Aldi goes from supplier via the DC and into the store in the same box.

4.6 So given the fragility and the need for controlled refrigeration for many products it is much more costly distributed. You need refrigeration in the DC, in the trucks, in the Supermarket stock rooms and in some of the fixtures at the Supermarkets.

5. FIFTH COMPLEXITY – PARADOX OF TIME

5.1 The analysis of bringing fresh to the market as opposed to hard groceries is quite different. From Farm to Supermarket shelf as the aim is to reduce the time of delivery at the lowest cost possible. This involves cost optimisation (linear) software where millions of iterations between time and cost can be computed to produce the best result. By contrast the paradox is when fresh is on the Supermarket shelf is one of maximising time and the lowest cost which sometimes means the cost of refrigeration. So, the linear programming required in reverse. The cost inputs can be very challenging both direct and indirect.

What the above highlights is that the more the Supermarkets have control of the supply chain the greater the chance of optimisation and placing of product on the shelves as expeditionary as possible and to remain on the shelf as long as possible.

5.2 One of the fascinating issues about the above is that every product is incredibly different so there is a huge inbuilt cost in managing this difference whereas with hard groceries is and many can be consolidated and dealt with in the same way.

6. SIXTH COMPLEXITY – MULTIPLE CATEGORIES

6.1 In most Supermarkets there are 60 to 70 category guides IN the high bay aisles. When you add the customer categories in fresh and the refrigerated units it will probably be over 100 customer product guides. But for the Supermarkets there will be 40 – 50 supplier categories. However, within these categories there are a number of subcategories like meat for instance, sausages, mince the various steaks etc. The difficulty is that even some of the subcategories have unique supply and distribution arrangements.

In some categories they suffer disadvantages from smaller competitors. The smaller competitor like the Butcher the livestock goes to the abattoir the same day for processing and within 48 hours to the Butcher to be hung for a couple of days before sale. Acute advantages in this short supply chain and the use by date of the meat can be extended. By contrast the Supermarkets with a longer chain the use by dates may need to be shortened. But, in most fresh the aim is to get the product from source to shelf as fast as possible. The Supermarkets a good example is flowers where flowers are picked late in the day and delivered to a refrigerated DC where they are bouquet and delivered to stores in say metropolitan area the following day.

6.2 Supply chains are dynamic and there is a lot of activity designed to shorten delivery time and cost and this is where the future lies particularly in relation to fresh.

7. SEVENTH COMPLEXITY – COST MANAGEMENT

7.1 Woolworths employs around 200,000 people and Coles 120,000 making in all 320,000. They are by far the biggest employers in Australia and the employment costs is huge for instance Coles pays $5.1 billion payments and benefits to team members and 883 million to shareholders, so team members are paid 6 times more. For Woolworths this would be considerably higher. The payroll tax and the amount collected on behalf of the Government for personal tax is huge.

Supermarkets are very people and transaction intensive businesses. Small changes by way of awards or otherwise can have a dramatic effect on their employment costs. With recent significant salary increases this has had a significant impact on costs.

7.2 Cost management is incredibly important for the Supermarket particularly wages, rent and freight. These costs can very quickly gobble up the profits and given the small margins this makes Supermarkets vulnerable to profit deterioration.

Costs can either be passed on to the consumer or offset by productivity gains. Little the government is doing at the moment to aid productivity gains. In fact, its policies are achieving the opposite.

The other alternatives are to lift margins and or drive sales. Margin increases are impractical because of the intense competition.

What the Supermarkets strive to do however is to drive sales so that the extra gross profits earned can absorb these cost increases. It is for this reason why the competition between Supermarkets is fierce. If sales flatten or deteriorate then in a rising cost environment this will mean a significant hit to profits and given the nature of the cost increases which are out of the control of the supermarkets this is a significant danger zone.

7.3 Should there be a flatlining or deterioration in sales then with constant margins and fixed cost profits will fall dramatically. Supermarkets are very finally tuned models and small changes in sales, margins or costs can be calamitous.

Sales and growth are the key to the excess of the models and inflationary policies by Government can have a profound effect.

To curtail the growth of the Supermarkets in Australia does not recognise the reality that Australia is a very small country with its population very disbursed as compared with the US and the UK. Given the smallness of our economy it is not surprising that we have players that have built significant market shares. We must not lose sight of the fact that unlike a number of international companies Coles and Woolworths pay a full rate of corporate tax and do not engage in the minimisation schemes adopted by some international companies. Many of the Supermarkets cost as in other sectors are out of the control of the operator and drive down productivity. A lot of cost increases induced by Government do not come with any productivity gains. The costs without productivity gains simply cannot be absorbed without increasing prices.

Stakeholder costs are exploding, and companies are being forced to engage in social engineering with does not add any value to a company's operations.

7.4 Whilst there has been significant growth in click and collect and e-commerce sales which can be regarded as new channels to market, but the reality is these channels are cannibalising sales from the principal channels. We are not informed of the cost of this cannibalisation.

The government has been very successful in putting the blame on Supermarkets for increased Supermarket prices, but the reality is that the Supermarkets are engaging in many activities which do not add any value just to suit government policies. Inevitably with these policies there is no attempt to access the cost and benefit where the intrinsic value of the policy can be accessed.

7.5 Woolworths discloses in its Annual Report that store costs amount to 17% of sales and non-store costs 6%. The latter is a high percentage, and it is likely to have increased over the years as more and more non-value activities get placed on business. Governments do not seem to understand that ultimately these costs reflect in pricing of groceries.

This non-store cost would contain a huge number of projects some of which will be productivity enhancing and others accepting compliance obligations and regulation. It would be great information for the market to have a bigger break up of these costs so that the public can become aware of some of the factors driving price increases.

No doubt Supermarkets would have very good program control departments to monitor the projects and report on the cost benefit. It is a shame that the Annual Reports are full of a lot of information to suit the accountants and all their precious standards, but it requires some effort to look through the haze and see new issues.

8. EIGHTH COMPLEXITY – SUPPLY / DEMAND / WASTE

8.1 Not only is it difficult to control or forecast the margin on fresh as opposed to hard groceries but is much more difficult to forecast demand and supply. The demand for fresh is very fickle and can change from day to day depending upon extraneous factors like weather time of the year alternate fresh products (apple or pear) and the other channels because with fresh retail and wholesale markets are a very viable alternative.

8.2 Not only is it a great difficulty in forecasting demand but the same applies to Suppliers. It is difficult to predict the volume of fresh available at any time. Farmers would love to be able to predict this, but the volume and quantity of product produced by the farmer is extraordinary volatile. The means it is very difficult for the Supplier and Retailer to reach agreement about volume and price and be able to stick to that arrangement. What is clear is that the bigger producer has a better chance of solving this problem because Supermarkets needs huge volumes and invariably a producer will call in product from other or smaller suppliers to meet the Retailers demand. So big producers often act as a consolidator. This often happens in a geographic area which concentrates on a particular product and there are multiple growers. So, if the demand is not there the big producer who you could describe as a consolidator takes less product from the smaller operator.

8.3 The reality is that it is much easier for the larger producer to work with the retailer than the smaller producer. Often smaller producers are seen as a secondary or top up Suppliers.

Apart from a good number of reasonably large producers there then is a multiplicity of smaller Suppliers without scale and able to cope with the ebb and flow of the market. It is inevitable that the smaller suppliers without scale and alternative channels are in a vulnerable position. Because of their lack of scale, the retailers just simply do not have to buy their product and so there is an inevitable imbalance of power. So, we have the tension between the small supplier and the larger player with scale. What should the Supermarkets do when there is a multiplexity of smaller players. There is a strong argument that the smaller player should get scale or consolidate with other smaller suppliers which sometimes happens. It is not the fault of the Supermarkets that for some refresh products there is a huge number of small suppliers. Adding more Supermarket chains to the sector does not solve this problem because it is a reality of supply and demand which is difficult to influence.

8.4 It is the dynamic in every fresh subcategory is very different. This is particularly noticeable when dealing with say sheep, cattle, pig, or chicken. Take one category, cattle. It is very dangerous to compare the live weight of cattle with the Supermarket prices. The carcass weight after the abattoir is somewhere between 46% - 48% of the live weight (sometimes called the dress weight). The dress weight can often depend upon the time cattle are isolated from food or drink or sex or the weight or the masculinity. Whilst the abattoir sells the byproduct such as the skins, brains, hoofs, and offal this is more often than not less than the carcass value. But that is not the end of the story because the carcass goes to the boning room where there is a further loss of meat weight dust. Then the Butcher cuts up the meat for sale and it is estimated that there is a further loss of 10% - 15%. So, the other categories have similar characteristics, so it is dangerous to compare live weight with Supermarket weight and pricing.

8.5 With fresh fruit and vegetables the volume harvested by category by the Farmer is way less than what ultimately ends up on Supermarket shelves. In the packing rooms there is considerable rejection of product based on size, colour, and perceived quality. Because almost all fresh are very temperature sensitive there is loss along the supply chain because it has not been possible to maintain an appropriate temperature.

8.6 The product failure between Farmer, Packing Shed, Freighter and DC can be ascertained by small battery control devices that track the product visibility in real time with the real temperature as it goes through the supply chain. So, temperature failure can be identified so identifying the blockage. Escavox is an Australian company which currently monitors temperature with its own world class software from farm to DC where problems have been identified reducing the amount of failed product and the reasons for the failure. This information of temperature and tracking can be seen on a television screen with warnings where something is wrong so it can be dealt with immediately. For example, a truckie turning off the refrigeration or changing the temperature because this can save money (*1 – See Conflict Note).

8.7 So far, the Supermarkets have resisted the tracking of product from DC to Supermarket shelf. This is a great shame because it will be possible to similarly immediately identify the causes of temperature and product failure so enabling changes to take place immediately. But the far greater benefit is the removal of argument between Farmer and Supermarket can be eliminated because the actual reasons for a great deal of product failure can be identified.

8.8 There is a huge amount of waste in the supply chain at all levels particularly at the Supermarket shelf where because of the short shelf-life products deteriorate before purchase. This discounting which can be huge can be substantially mitigated by monitoring the temperature and in effect through knowledge of the temperature where inappropriate temperature can damage the product and limit the shelf life of the product. With knowledge of temperature failure, you can identify the cause of such failure and fix the problem and see that it is not repeated.

It is for this reason that the opening margins for fresh have to be quite significant to cope with the subsequent discounting so it is in everyone’s interest to put the temperature real time tracking in place to identify problems taking out cost through less discounting where final margin will be more satisfactory and enabling better prices to be paid to produce and lower prices for consumers.

8.9 There is a huge amount of waste in a supply chain Woolworth in their 2023 Annual Report identified that 50,826 tonnes equivalent to 34 million meals per year with 80% going to land fill. Coles claims that 84% of waste was diverted from land fill.

The other retailers will do the same and it is a great credit to the retailers that we now have in place superb infrastructure to convert waste to a very valuable product needed by many people in distress. The infrastructure put in place that is the sorting, the moving and boxing of the fresh which comes at a cost, but it is likely the staff involved would get great satisfaction from the task. Those charitable institutions picking up the fresh are very grateful and the economics of some of these not-for-profit entities are considerably enhanced by the extra product. It is great to see so many charitable activities around Australia with a huge number of volunteers fulfilling the reasons for their existence. It is great for community cohesion.

8.10 Assuming at Woolworths say 37% of the fresh market then there are around 137 tonnes per year available for these charities providing around 92 million meals per year. This is an extraordinary contribution by the Supermarkets to the charities serving people in desperate need across Australia. If each meal had a theoretical value of $5.00 each then this is distribution of an extraordinary amount of $460m per year. The $5 theoretical value is way less than the $8 - $12 price of pre-prepared boxed meal which is likely to be less in quantity and quality. Further there is a huge voluntary labour component in the $5 so it is a very conservative estimate. The fact that those in need of food come to a central place enhances their sense of belonging and community care. This happens across Australia.

8.11 Unquestionably the Supermarkets are doing a great job when and after the fresh product is removed from the shelves but what the above figures demonstrate is the huge opportunity to deal with the waste before it occurs. This is difficult because of the various players in the supply chain who all contribute to this problem. Just say a 10% – 20% reduction in waste would have a profound effect on the profitability of the supply chain. At this stage Escavox with its real time temperature control device can identify the problems but so far it is only being done from Farmer to DC. If it is tracked in the DC and from the DC to Supermarket shelves there will be huge savings which could make a great contribution to solving the lack of profitability of some in the supply chain and containing some fresh food price increases.

8.12 It would be interesting to understand what overseas experience is in this territory. Further, it would be great if the pre-shelf waste could be identified by product member of the supply chain and the causes. Similarly, it would be great to understand the product by supplier and source of product and cause going into meals and also into land fill.

8.13 Woolworths as with some other Supermarkets provide free fruit for the children of customers visiting Supermarkets.

9. NINTH COMPLEXITY – CODES AND SMALL PLAYERS

9.1 There is a tendency for the smaller supplier that when prices and demand are high to plant more product in the hope of making more money and this make an assumption that the demand will be there.

It is not easy for the Supermarkets to deal with multiple small players on one product. It is better for these suppliers to sell to local food retailers on the wholesale markets which are much more able to cope with smaller quantities.

With Dr Emerson's recommendation for a mandatory code particularly helping smaller suppliers and using an arbitration process so that growers will not fear retribution. The difficulty about this process is that the mandatory code will force the Supermarkets to move away from the smaller supplier encouraging the larger ones to deliver either by acting as a consolidator or expanding their own supply.

The theory of independent arbitration and it being quick, easy, and efficient is great in theory. I question whether many suppliers will take this route but at least it will act as a deterrent and hopefully the threat of arbitration might resolve issues.

To repeat early warnings codes whether voluntary or mandatory are behavioural, and parties will simply adjust their position to avoid the problems created by the code. Dr Emerson has to think whether he is acting in the interest of small suppliers and not recognising the reality of the problem for smaller suppliers, but time will tell.

The effect of the code will be to strengthen the larger payers. These players have a wider range of product from different geographical regions, so they are more able to cope with the vagaries of each product in each growing region. Perhaps this is a good thing as it might lead to the rationalisation of the smaller suppliers and there are hundreds of them. There are no competition issues here as there are multiple larger players giving Supermarkets plenty of choice.

9.2 One of the reasons while codes fail and overtime the players adjust raising unforeseen issues is that the codes are not based on a very good economic analysis of the situation. Too little is researched into the structure and identifying in quantitative terms, where, when how and why issues.

It is extraordinary that Dr Emerson has made recommendations about the code without waiting for receiving at least the preliminary report from the ACCC. Presumably it was the government's intention for the ACCC to get the facts about the so-called crisis with the smaller players in the fresh market. We need to understand category by category where the issues are. Are the issues with the smaller players only or to the larger players have some gripes. What is the nature of these gripes and is it possible there is another side to the problem and the Supermarkets may have some justification for their actions.

9.3 Codes whether voluntary or mandatory will only be effective against a deep understanding of the issues and what they are trying to achieve. It is only then that you can frontend the codes or indeed any regulation with a clear statement of objectives and any underlying principles or values (behaviours) you want observed. What are you trying to achieve for whom and about what. When you ask questions to understand the objectives you will find imperfect connection between the objective and the regulation or code, so the behaviour is contemplated and not achieve and there are unforeseen circumstances.

This means that it is critical to put a time to review codes and regulations because inevitably they will become outdated and may cause dysfunctional behaviours. This is not surprising as it is difficult to translate behaviours into regulation or codes and achieve acceptable outcomes.

In the case of the grocery code is the objective to lower prices for consumers and or is it to improve the bargaining power of suppliers? There is a conflict between helping the smaller suppliers and satisfying consumers for lower prices. If the result of the code is that suppliers are paid more than this will reflect in the Supermarket pricing and benefit for consumers.

Supermarkets do not make super profits by whatever measure you use so the reality is that they cannot absorb pricing increases without passing them on to the consumer. There is a lot of data in this paper which reveals how finely tuned the Supermarket operations are and in the absence of huge productivity gains which are fundamentally in the hands of government higher prices to suppliers will translate immediately into higher consumer prices.

There is an acute tension here between two objectives and frankly we lack at this stage the facts and analysis that will help resolve this tension. Who is to bare the extra cost and is the extra cost justified.

To resolve this, it requires a deep dive into the operations and economics of Supermarket retailing. Even the ACCC with the use of Section 155 powers is not going to be able to do this in a few months because to repeat it involves a deep dive into many categories. Not to do this and to put in place a code will exacerbate the possibility of unforeseen circumstances.

For instance, it must be remembered that Supermarkets are not obliged to deal with any individual supplier and if the codes are going to load up the small players with too much power, then the cause of the small players will be severely damaged.

9.4 The Supermarkets will have a huge amount of data, analytics and intellectual property surrounding some of its systems and actions. This material is a critical part of the goodwill of the Supermarkets, and it would be critical to reach agreement as to what information the ACCC make public. Before release of this information could do great damage to a Supermarket and unfairly help competitors and suppliers.

There are not many sectors in retailing where in most categories you have a mix of very large players and a tail of small players who in reality are cottage players.

Maybe the reality is that you cannot manage the tension between multiple small players and Supermarkets who want to buy very large volumes. The answer maybe it is far better for the smaller players to deal with the local food provider or the local markets including wholesale markets which are much more able to cope with smaller volumes because in essence they are one site operators.

It is not the fault of the Supermarkets, but the structure of the sector is working against their interest is not it an argument that the Supermarket chains must be smaller to cope with the smaller volumes. In any sector we need scale to improve economics otherwise the consumer will be disadvantaged.

It is interesting to compare fresh with Dairy Farmers involved with the dairy code. It is easier to develop a code because Dairy Farmers are very well defined as a business entity are licensed and there is a minimum size because the economics will not justify small cottage players. Here the situation is dramatically different. The suppliers are not licensed and can be in all different sizes with fundamentally different economics. It is one area where there probably needs to be consolidation but is it fair that the Supermarkets should have to cope with the disadvantage of a cottage players.

9.5 The broad issue that is being raised is that a solution is being put on the table before the problem has been identified and defined. Solutions are much better when there is a thorough fact base which defines a problem and all of its component parts. The difficulty we face there is that the solution is based upon politics and ideology in that criticisms or beliefs or presumptions are put into the public arena without being adequately fact based. The difficult is that we are dealing with some very large and successful corporation who many would regard as good corporate citizens but reputations and share prices are being affected without a fact base. It is a shame much of the media comment is speculation and not fact based. It will be great if those involved including the media could say they have an open mind, but we really want to understand what the problem is in a well-defined and thought-out way. Often when a problem is very well defined the solution is self-evident and there is a greater chance that people will accept it and deliver the recommendations made for solution.

9.6 It is important to understand the degree of volatility of supply and demand in the categories because it is very different. If we had an index of volatility it would correspond to an index of difficulty in the relationship between Supermarkets and Suppliers. So, there is also an index of certainty and uncertainty. Everyone would like to know in advance what supply and demand will be before the product is seeded and everyone would like optionality.

There are two ideas to deal with this. The <u>first</u> is that contract arrangements of understandings are made pre the planting, growing, or breeding. The <u>second</u> is that there is no prior agreement and when the product is ready for sale the supply and demand is known negotiation takes place.

Pre-production contracts live in an uncertain world, and it is difficult to be precise, but these usually succeed because of past relationships and expectation of how people will behave should not the forecast supply and demand eventuate. With these contracts when the supply and demand are out of balance, there is a loose understanding. On the one hand if demand exceeds supply there is nothing the Supplier can do about it. But where supply exceeds demand it is likely the Supermarket would take the excess of its supply ahead of other Suppliers.

Postproduction contracts when the product is almost ready for sale then the law of demand and supply will operate. For the Supermarkets short supply means increase in prices and excess supply means lower prices. So, it is inevitable that there will be winners and losers.

In designing a code, it will be important to understand these two extreme positions and a myriad of positions in between.

It is only some fresh do you have this problem and as indicated earlier the degree of volatility and difficulty not only varies between products and sub products but over time but more often than not it is one season per year. The greater the degree of difficulty the more it is up to the invisible hand and God.

9.7 There is much more to the above problems than the imbalance of power and it is not about good, bad behaviour or ethical behaviour but understanding the real causes of the problem. This raises the issue as what the criteria should be for the code mediators and arbitrators. How could they make decisions without knowing what are the agreed behaviours. Even if behaviours as criteria are agreed this places massive power and pressure in the hands of the mediators, arbitrator's and the Tribunal in reaching decisions. This looks more like the field of our Unfair Contracts Legislation, but we have many cases where there is no contract, and it is the law of supply and demand that operates.

The raises the repeated issue of who's interest are we protecting Supplier or Consumer. On the basis that the decisions are literally transferring resources between Supplier, Supermarket and Consumer.

The recommended penalty regime is horrendous. It can be up to 10% of sales. A fine in those proportions would put any of the Supermarkets into administration. With the consequences being so profound. It is absolutely crucial that the sin is very carefully and finally articulated otherwise there will be an imbalance between the crime and the punishment. The fines are so huge that it raises serious questions about the intention and ideology of the reviewer. The huge fines are making a huge political statement. There are very few fines of this dimension in our Commercial Law and the question has to be asked. Why so extreme. It just seems that the fines are all out of proportion to the so-called sins of the Supermarkets. Without very precise provisions judges will have enormous difficulty in these deliberations and will want great certainty about concluding there is a sin and awarding huge damages.

9.8 Should Bunnings, Chemist Warehouse and Amazon be included in the code?

Each of these entities raises different competition issues. With the Supermarkets we have some strong players with multiple suppliers of different shapes and form, and the issue is whether some but not all suppliers are being disadvantaged by the power imbalance as a result of the structure of the sector.

With Bunnings it is one dominant player with 50% - 60% market share in some categories (e.g paint, horticulture) and no independents are not able to cope with their onslaught. Bunnings is an extraordinary successful model and with a return of 60% plus on funds employed are far more successful than the Supermarkets. Once a Bunnings box enters a market the independent has little chance of succeeding. The Bunnings current model is reaching footprint maturing but by reducing the size of their model as Coles and Woolworths have done there are a huge number of towns around Australia available to them. The smaller the market the less the chance of the independent surviving. Without intervention by a Code or Competition Law change Bunnings will finish up with a monopoly in many categories. So, for the hardware sector it is what steps need to be taken to keep the independents alive. It is difficult for suppliers because the Bunnings market share of their product is huge, and suppliers have no choice to deal with them. This is not the case with Supermarkets. With Chemist Warehouse it is not dissimilar to Bunnings in they have a huge market share, and it is the wholesalers who supply much of the market. When Chemist Warehouse enters the market, it will be very difficult for the independent even if it is in a franchised chain even if there is protection from the geographical area limits.

With Amazon it has a huge share of the direct delivery market in some of the categories in the proposed Grocery Code. Clearly with all these formats there will be overlapping categories and in time is only likely to increase.

You can understand Woolworths and Coles feeling so prosecuted by the focus on them because of the huge share of the consumer price index. It is politically expedient to those who want to make a point about the cost of living and supply pressures. The provisions of the Competition Act are not adequately coping with the above but clearly changes need to be made to the Act to cover the behaviour of dominant players, but this will not be solved by the Grocery Code but a Code for each of those areas that is the Chemist Code, Hardware & Timber Code, and an Online Delivery Code. The raises masses of political issues which the government will not face but the Supermarkets are entitled to feel they have been unfairly treated.

9.9 This does not mean that the large corporates with more than 5 billion is sales should not also be a party to the grocery code to the extent that they are trading in the products nominated in the Emerson report. To answer this, we need to understand what is it that we are trying to achieve. If our principal concern are the Suppliers particularly smaller ones, then the Suppliers should receive the same treatment in respect to all corporates of over 5 billion who are selling the same product irrespective of the fact that the particular product is a very small percentage of the corporates sales. Conversely, it is not without logic that the Supermarkets should seek an even playing field otherwise some will receive strategic advantages over them.

It is irrelevant that these other corporates face different competition issues, but the question should be asked why Supermarkets should be subject to special treatment and others be free. It is irrelevant that the other corporates should be exempted just because the bulk of Supermarket products effect the inflation index. The others do affect the inflation index but in a very minor way.

9.10 The possibility of unforeseen issues arising is considerable. It is suggested that any code should have a 3-year life with a compulsory view at the end of that period. This will make the code more effective and if all players will focus on the strengths and weaknesses of the code and have recommendations of the change at the end of the 3 years. The inevitability of this is obvious because of the behavioural nature of the animal.

10. TENTH COMPLEXITY - SOURCE

10.1 With fresh there are complications with source of product traceability and quality. In the interests of customers and because of regulation Supermarkets need to know where a product originated so that if there any quality issues, they can trace the problem to identify the issues and then correct.

The quality control involved in all of this is much more acute than with hard groceries. For instance, you cannot assume that a box or pallet of apples coming from a grower will be of the same quality of that product being delivered a week later. Towards the maturity of fresh that is when they are marketable the difference in the days of picking can have a dramatic effect on quality. Accordingly, Supermarkets in their fresh DCs have challenges in respect to monitoring quality and although source is comforting it is not totally reliable.

10.2 By contrast there is much more consistency with hard groceries and once quality is established it is much easier to rely upon the quality of all products delivered.

If you compared the quality control expenditure on hard groceries with fresh you would find it significantly different. This is not surprising but one bad apple identified in a pre-packaged bag picked to be eaten a few days after being acquired by the consumer can cause distress and worry the consumer about the quality of all other products. This can be a great turn off for customers and effect repeat purchases.

10.3 For a whole host of reasons there is a much higher risk with the delivery of fresh as opposed to hard groceries which must be reflected in the initial mark up of product given all the post purchase costs and risk incurred by Supermarkets.

11. ELEVENTH COMPLEXITY - RISK

11.1 There is a much greater inherent risk in a fresh product as opposed to a manufactured hard grocery product. With fresh say for meat from birth to abattoir it can be many months and during that period there are many factors which can change the quality of the end product. With hard groceries there is no such risk and from order to manufacture this can be a very short period and is much easier to control the process of manufacturing and the risk of poor manufacturing outcomes. This has to be partly modified because hard groceries the manufacturer has to rely upon a number of ingredients some of which may be unreliable and sensitive to quality issues as with fresh.

11.2 This risk plus the variability in quantity, quality and timing means that prices have to increase to cover this risk. This is a problem both for supplier and supermarkets. This unpredictability is difficult for both Supplier and Supermarket to manage and there is an inherent cost in doing so which has to have an effect on pricing.

12. TWELFTH COMPLEXITY – STOCK PLACEMENT

12.1 Each Supermarket category has a completely different dynamic as to its distribution, placement in the store and pricing etc. So, this means as well as Category Specialists and Business Analysts you need a lot of management to bring all the categories together to put a rational and appealing offer to customers.

12.2 Merchandise Categories are forever changing whether it be because of new or varied products because of the activities of competitors. So, Supermarket management needs to be very flexible pragmatic and active otherwise they will be overcome by competitors.

12.3 AI will have a profound effect on the placement of stock with stock appearing in more locations as AI analyses the pattern of shopper's purchases.

13. THIRTEENTH COMPLEXITY - SPACE

13.1 The argument that suppliers should not pay extra for Supermarket shelf space and promotions is complex.

The alternative to these extra cost inputs is a nett deal where agreement is reached on price and there are no other additions. This is certainly easier to manage but there are some diseconomies.

13.2 The value of Supermarket shelf space is very different for obvious reasons like visibility to the customer and the frequency of the customers potential view of a product. This means that suppliers can gain great advantage or disadvantage where their product is placed and a serious effect on the volume of sales.

There is no principle that different products should be priced at the same amount and shelf space is like in this context is a product. It is in both the interest of the Supermarket and the Supplier to be able to choose its location and pay an appropriate amount for that space. The only issue here is it a fair allocation of the premium above cost. The Supplier can say no.

13.3 The other complex issue is promotions and advertising. These are only undertaken to grow sales both for the Retailer and the Supplier. Given that the Supplier gains benefit from the extra sales it is not fair that the Supplier should contribute to the cost. It is fair for the Supplier to reject or negotiate down the cost if the Supplier feels that the objective of the advertising or promotion is to achieve outcomes for some other purpose.

There needs to be an alignment of objectives. It should be pointed out that with the Retailers ability to bulk up the promotion and lower the unit cost there is a benefit to the Supplier when the Supplier may not otherwise be able to achieve in terms of cost and exposure.

14. FORTEENTH COMPLEXITY - MARKETING

14.1 Marketing and promotion for fresh is much more difficult than with hard groceries. What Supermarkets seek to do is to provide consistent quality of the one product across all stores feeding out of its Fresh DC. With state-based pricing when marketing fresh the Supermarkets must be able to deliver to the same consistent product for all stores for state bases marketing. Store based marketing is much more flexible and has to be in any case for deteriorating product.

14.2 By contrast consistency of hard grocery product is quite easy and thus marketing and sales and marketing programs are much easier to facilitate and at much lower cost.

Fresh is only relevant for a few days so another complexity.

15. FIFTEENTH COMPLEXITY – SEE FEEL KNOW

15.1 With virtually all fresh for the consumer there is the issue of See, Feel and Know (SFK). By contrast with hard groceries, it is mainly about know. The know is usually a decision about which brand, size, and price the consumer will select. The consumer knowing the product wants to see the product less and not feel it.

The (SFK) has implications for where a product is located in the Supermarket and its packaging. So, with most fresh the product needs to be very visible and able to be seen and touched. The consequence is that it is more difficult to package particularly fresh fruit, vegetables, meat, and seafood in packs with multiple quantities.

15.2 The opportunity to move away from open display of fruit, vegetables, seafood, and meat is limited. Even where this product can be packaged there is the issue of the cube. It has been solved with some fresh by stacked boxes like avocados.

The inability to box and package has a meaningful effect on the cost of displaying fresh in the Supermarket which does not apply to hard groceries.

So, for Fresh there is a much higher shelf or property cost.

16. SIXTEENTH COMPLEXITY - FIXTURING

16.1 The fixtures needed for fresh at the stores are more varied and costly. Apart from the refrigerated cabinets you cannot use the cube like you do with hard groceries where they are stacked above head height. With fresh the stock is placed in fixtures in hand ready, so stock is easy to transfer from the fixture to the trolley or basket. Further there is more multiple buys of fresh, so hand level convenience is important. Supermarket Departments are designed to look like wholesale markets.

16.2. The consequence of the very different fixturing for fresh as opposed to hard groceries and the inability to use cube means that the physical count or cost per square metre in the fresh department is much greater than for hard groceries.

16.3 The movement of stock from back dock in and out of the Supermarket shelf is less regular and there is much more staff time involved in the management of fresh product.

17. SEVENTEENTH COMPLEXITY – GRAB AND GO

17.1 In Australia consumers are much more grab and go than in other countries. The consequence of this is that more packaging is required to achieve this which only adds to the cost of the product.

17.2 The consequence of the grab and go philosophy is that Supermarkets in effect need to have 2 or sometimes 3 options available for the customer. That is, single product, modest package products and large package products.

18. EIGHTEENTH COMPLEXITY – UK INFLUENCE

18.1 There has been a change in behaviour of the buying teams in Supermarket with the arrival in Australia of UK buyers who takes steps to ensure that there are multiple suppliers in every category and with the induced competition accept the lowest tender.

In the following year or years, the Supermarkets make it clear that the minimum price is the previous year's lowest tender price.

18.2 Whilst this approach is not everywhere it is prevalent in some categories with the consequence with the relationship between supplier between supermarket has changed and there is much more antipathy as opposed to working together for mutual benefit.

19. NINETEENTH COMPLEXITY - COMPARISON

19.1 Unlike hard groceries it is very difficult to compare the prices in fresh because for each fresh product being sources from different suppliers the quality and life span is very different.

19.2 To compare prices between supermarkets and shopping mall producers or suppliers on main street or even at wholesale markets price comparison is very difficult quite apart from the fact that can change by the day or even the hour. Supermarkets tend to promote the one higher graded product while others might promote second grade product because of the price appeal to its customers.

It is a moot point whether it is appropriate to sell two grades of the one product.

20. TWENTIETH COMPLEXITY – ALTERNATE MODELS

20.1 The model of some Supermarkets is to engage with suppliers on a net basis rather than the model in Australia where it is cost of product plus the cost of distribution, through the DC, transport cost, shelf, and marketing costs. In Australia, the latter has become significant divisions within Supermarkets where they are expected to make a profit or break even. These are profit centres.

20.2 An alternative is the net model is where the Supermarkets work with suppliers on a gross profit basis that is they build volume into the equation so that if volume can be increased by a lower price both the Supermarket and the Supplier contract to accept a lower margin because they will earn greater gross profit dollars.

The benefit of the gross profit dollars approach is that all on costs like DC, transport, promotion, and shelf costs are removed from the discussion because with the extra volume and gross profit dollars as it is easier to absorb these costs.

This approach simplifies and takes enormous cost out this equation to the benefit of the Supplier and Supermarket. It is the model adopted in some overseas countries with the consequence that Suppliers and Supermarkets claim they are better off, and the relationship is much better.

21. TWENTY FIRST COMPLEXITY – PROFIT GOUGING – COMPARISON WITH INDEPENDENTS

21.1 Allegations are being made that Coles and Woolworths are profit gouging at the expense of some Suppliers and their business models are profit gouging creating unacceptable high performances. At the macro level this is plainly incorrect and when you look at the material in the table below you will see that in the Return on Funds invested Capital % (equity) and the Return on Funds Employed (equity + debt) the independents that is Ritchies and Metcash are either equally or outperforming Coles and Woolworths. The table below extracts key benchmarks in **(Appendix 1)** from the four operators that confirms the above.

	COLES	WOOLWORTHS	RITCHIES	METCASH
Gross Profit % PPBT % PAT %	26% 3.6% 2.6%	26.7% 3.1% 2.5%	25.1% 3.7% 2.8%	11.7% 2.4% 1.6%
Return on Invested Capital (Equity) % Return on Funds Employed (Equity + Debt) %	9% 23%	7.63% 17%	9.6% 25.5%	 22.4%

Even when you compare the benchmarks in **Appendix 1** with the rest of the market of the companies on the ASX you will find that Coles and Woolworths returns are not excessive. This establishes that it will be difficult for Coles and Woolworths to incur supplier cost without increasing prices. So, the Government is facing a conflict in objectives. Is it possible to increase Supplier prices without affecting Consumer Prices. In other words, as the Supermarkets cannot absorb the cost for problems with shareholders and funders means that inflation will result.

What the benchmark table above reveals is that Coles, Woolworths, Ritchies and Metcash are very tightly managed businesses operating on low margins and huge volumes where there is a tension between both. So, small changes on volume, margin and asset turn can have a dramatic effect on profitability and returns. This is probably modelled by the retailers enabling sensitivity analysis undertaken to test the various scenarios.

The supermarket model depends upon controlling absolute costs as an amount not a percentage. The model depends upon driving sales and ensuring that gross profit is not absorbed by ever increasing costs.
The world's greatest retailer Sam Walton had a strong view about costs. You should think small and act big in other words he concentrated on individual store profitability and everything else has to serve that. In other words, think small.
An outcome of that was the identification of small changes in the efficiency of a supermarket which you would then multiply across his stores. The famous example was listening at a store to the most junior employee a part-time cleaner who said to Mr Walton "give me a broom with a wider head I can save 10mins an hour". So, at $20 per hour a thousand stores do the maths.

APPENDIX 1

PROFIT STATEMENT

	COLES	WOOLWORTHS	RITCHIES	METCASH
SALES	40.5 b	64 b	1.339 b	(15.8 b)
(Cost of Sales) %	(74%)	(73.3%)	(74.9%)	(88.3%)
CODB %	(21.4%)	(18%)	(20.3%)	(8.7%)
GROSS PROFIT %	26%	26.7%	25.1%	11.7%
EBITDA %	8.3%	8.7%	4.8%	3%
EBIT %	4.6%	4.7%	3.9%	2.6%
PBT %	3.6%	3.1%	3.7%	2.4%
PAT %	2.6%	2.5%	2.8%	1.6%

NET WORKING CAPITAL / SALES				
Debtor Days	5 days	6 days	8 days	41 days
Stock Days	28 days	29 days	29 days	31 days
Stockturn	13 times	13 times	12 times	12 times
Creditors (-) Days	(42) days	(47) days	(31) days	(55) days
(NET WORKING CAPITAL / SALES)	(3.7%)	(4.5%)	0.1%	4.2%

Plant & Equipment / Sales				
Amount	$4,985	$8,881	106	273
Percentage %	12.3%	13.8%	7.9%	1.7%

Operating Margin %	3.93%	3.6%	3.7%	2.4%
Return on Assets %	5.91%	4.8%	6.9%	5.5%
Return on Invested Capital (Equity)	9%	7.63%	19.6%	23.3%
Returns on Funds Employed (Equity + Debt) %	23%	17%	25.5%	29.6%%
Payout Ratio %	84.7%	74.8%	N/A	70.6%
Dividend Yield %	4.15%	2.98%	N/A	5.6%
Price Earnings %	20.57x	27.2x	N/A	13.7%
TAX PAID	**423 m**	**693 m**	**11 m**	**129 m**

BALANCE SHEET

	COLES	WOOLWORTHS	RITCHIES	METCASH
ASSETS				
STOCK				
Amount	$2,323	$3,698	81	1183
Percentage %	19.7%	15.29%	18.76%	24.84%
DEBTORS				
Amount	$605	$1,016	2.6	1767
Percentage %	5.13%	4.2%	6.5%	37.1%
PLANT & EQUIPMENT				
Amount	$4,985	$8,881	106	273
Percentage %	42%	36.73%	24.5%	5.73%
INTANGIBLES				
Amount	$2,035	$5,693	138	895
Percentage %	17.2%	23.45%	31.9%	18.79%
OTHER				
Amount	$1,837	$4,893	70	644
Percentage %	15.59%	20.23%	16.2%	13.53%
TOTAL				
ASSETS				
Amount	$11,785	$24,181	423	4762
Percentage %	100%	100%	100%	100%

LIABILITIES				
CREDITORS				
Amount	($4,434)	($7,623)	107	2295
Percentage %	37.62%	31.5%	25.3%	48.2%
OTHER				
Amount	$2,877	$6,704	74.0	649
Percentage %	%24.4%	27.7%	17.1%	13.63%
BORROWINGS				
Amount	$1,118	$3,289	48	733
Percentage %	9.4%	13.6%	11.35%	15.39%
EQUITY				
Amount	$3,356	$6,505	194	1085
Percentage %	28.48%	27.1%	45.9%	22.79%
TOTAL				
Amount	$11,785	$24,181	423	4762
Percentage %	100%	100%	100%	100%

Notes:

The Financial Metrics for Coles and Woolworths comes Morning Star February 2024 & 2023 Annual Reports. The information for Ritchies and Metcash comes from the 2023 Annual Reports. In comparing Coles and Woolworths note that Woolworths includes Big W. Ritchies like Coles is a pure Supermarket whilst Metcash also has hardware, tools and plumbing etc.