

Costco Wholesale Australia

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11 September 2014

Ms Jenny Allen
Manager
Competition Policy Unit
Small Business, Competition and Consumer Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

BY POST AND BY EMAIL: grocerycode@treasury.gov.au

Dear Ms Allen

COSTCO WHOLESALE AUSTRALIA PTY LIMITED – SUBMISSION TO THE FOOD AND GROCERY CODE OF CONDUCT CONSULTATION

Costco Wholesale Australia Pty Limited (**Costco**) thanks the Honourable Bruce Billson MP, the Minister for Small Business, and the Competition Policy Unit, for inviting this submission to the Food and Grocery Code of Conduct Consultation.

Introduction

Costco is part of Costco Wholesale Corporation, which operates an international chain of membership warehouses carrying quality, brand name merchandise at substantially lower prices than typically found at conventional wholesale or retail sources. The warehouses are designed to cater to small-to-medium-sized businesses and reduce costs in purchasing goods for resale and for goods used in everyday business. The Costco model is also designed to attract membership for individuals who purchase for their personal needs.

Costco warehouses present one of the largest and most exclusive product category selections to be found under a single roof. Categories include groceries, confectionary, appliances, television and media, automotive supplies, tyres, toys, hardware, sporting goods, jewellery, watches, cameras, books, housewares, apparel, optical and hearing aid services, health and beauty aids, tobacco, furniture, office supplies, office equipment and liquor. Costco is known for carrying top quality national and regional brands, with 100% satisfaction guaranteed, at prices consistently below traditional wholesale or retail outlets. It deliberately provides for a limited selection in each such category. While many major supermarkets will carry from 50,000 to 60,000 active stock keeping units (**SKUs**), Costco

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carries an average of approximately 3,700 active SKUs in each of its warehouse locations. Many of the consumable products offered at Costco are sold in case, carton or multipack quantities. This unique style of operating allows Costco to offer lower prices to its members.

Although Costco understands the motivation behind the Government moving to better regulate the relationships between the major supermarket chains (**MSCs**) and their suppliers, it does not agree with the proposed regulation in that it attempts to treat very different businesses in the same manner. The draft Code is not attuned to the considerable nuances of each business it would purport to regulate resulting in extremely tight regulations across a broad spectrum of retailers. While attempting to reasonably address the practices of retailers, including the practically duopsonistic MSCs that dominate the Australian grocery marketplace, the draft Code impacts other companies inappropriately, and at a time when the state of the local grocery sector requires that those other companies must be supported rather than hindered in their operations.

The process by which the draft Code was composed – that is, in close consultation with the two MSCs – has resulted in draft regulations clearly targeted to the business practices of those two companies, and the concerns that are faced by suppliers when dealing with those two companies. Extending the application of the draft Code to other companies is, in many respects, inappropriate.

Costco has voluntarily implemented policies and procedures to ensure that its operations, wherever in the world they take place, comply with the high standard of integrity that Costco demands of itself. Costco has tremendous loyalty to its suppliers primarily because Costco considers that a sustainable relationship with its suppliers is commercially astute. Such an approach pervades Costco's buying culture. Costco's Code of Ethics provides that it shall respect its suppliers. Costco operates a Confidential Ethics Line, which allows suppliers (as well as employees) to anonymously file, and follow up on, complaints against the company, including in relation to Costco's accounting, auditing and internal controls, and the commission by anyone at Costco of unethical or illegal activity. Costco takes such complaints seriously. Each one is reviewed by Costco's Chief Compliance Officer at the company's global headquarters. In addition, Costco has policies regarding the rights and obligations of suppliers, which policies, including the Costco Supplier Code of Conduct, are available online.

Further, in order to prevent a supplier from relying too heavily on Costco's patronage, a Costco supplier is generally prohibited from having Costco represent more than one third of the supplier's customer base. This policy is designed to encourage Costco's suppliers to diversify their businesses in the interest of making each supplier's business more

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sustainable. This approach reflects Costco's strong belief that the health of its business is directly correlative to the health of its suppliers' businesses.

In the Code's current state, Costco would not volunteer to be bound by it. Following are some suggestions for improvement. However, Costco reserves all of its rights concerning whether it ultimately would voluntarily agree to be bound by a Code which targets a model of supply and operation so different to its model and which targets improper behaviour of which Costco has not been accused or found to have engaged in.

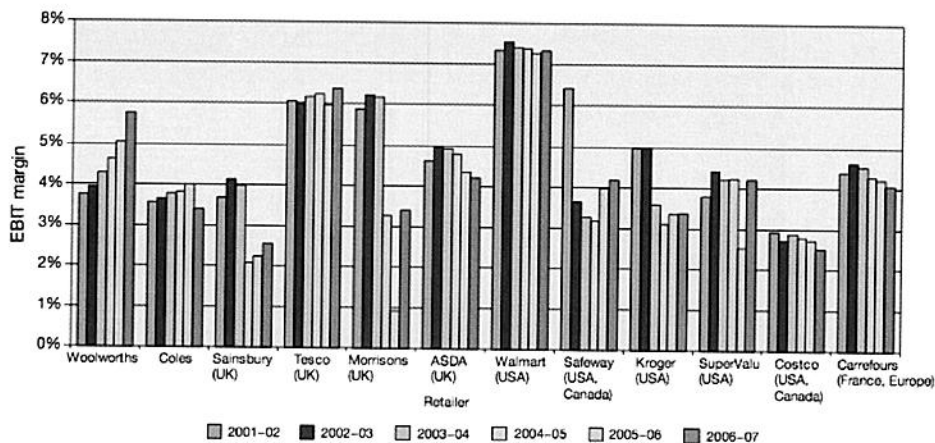
The importance of Costco to the Australian grocery market

Costco understands that the Australian government and its agencies have long harboured serious concerns about the state of the local grocery sector. On 5 August 2008, the ACCC publicly released its report on its enquiry into the competitiveness of retail prices for standard groceries. Amongst its key findings, the report identified that competition in the Australian groceries market was suffering from high barriers to entry and expansion, limited incentives for the major supermarkets to compete aggressively on price, and limited price competition from independent supermarkets which tend to focus on convenience and service.

That ACCC enquiry was not the first of its kind. It followed an examination in February 2007 concerning the prices paid to farmers for livestock and the prices paid by Australian consumers for red meat, an enquiry in February 2004 into shopper docket petrol discounts and acquisition in the petrol and grocery sectors, and a report to the Senate in September 2002 on prices paid to suppliers by retailers in the Australian grocery industry – to name only a few ACCC enquiries. It is clear that the ACCC, and various other governmental agencies, are unquestionably aware that the retail grocery market in Australia, particularly to the extent that it is dominated by a practical duopoly, produces numerous anticompetitive outcomes – including with respect to its suppliers.

In the face of that troubling reality, the ACCC applauded Costco's entry into the marketplace, which, when the 2008 report was released, was not to occur for another year: "Given the barriers to entry in grocery retailing, grocery retailing models such as ALDI or Costco are the most likely source of greater price competition in grocery retailing in Australia." (ACCC Report, p176).

Indeed, Costco has disrupted the practical duopoly of grocery retailers due in part to its emphasis on selling products at a low margin. The graph below demonstrates how differently Costco operates in the international grocery retail market from others who compete in this marketplace, including Coles and Woolworths.



Source: public annual reports

The importance of not conflating different business models

As the ACCC recognised, “Grocery retailers employ a diverse range of business models. The major supermarket chains (MSCs) offer a large range of products and brands in large stores located in large metropolitan shopping malls or in large stand-alone retail sites. These chains have their own wholesaling operations and operate on a national scale. Independent supermarkets such as IGA and Foodworks usually retail a smaller range of products and brands in mostly medium-sized stores. Recent entrant Aldi stocks a high proportion of private-label or less well-recognised brands.” (ACCC Inquiry into the Competitiveness of Retail Prices for Standard Groceries: Issues Paper, p14) And, as described above, Costco operates a unique business model.

To be sure, Costco notes that the draft Code defines a retailer as a corporation *to the extent that* it: (a) carries on a “supermarket business” in Australia for the retail supply of groceries; or (b) carries on a business of purchasing groceries from a supplier for the purpose of resale to a person carrying on a “supermarket business” in Australia for the retail supply of groceries. A “supermarket business” means a business under which a person sells to consumers bread, breakfast cereal, butter, eggs, flour, fresh fruit and vegetables, fresh milk, meat, rice, sugar and other packaged food, or most of those groceries. Accordingly, certain of the differences in the business models of the various retailers at whom the draft Code is directed are alleviated by binding the retailers only with respect to the business that they have in common (and not their entire operations). Costco is a retailer for the purpose of the draft Code, but only in certain respects. This is an appropriate mechanism for making sure that the Code does not overreach. However,

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significant difficulties remain. The nature of Costco's business, as compared to that of the MSCs', means that the complexity involved in separating the aspects of Costco's business which constitute "supermarket business" from the remainder of its operations (which are beyond the scope of the Code) is considerably greater than that faced by the MSCs at whom the draft Code is clearly directed.

One of the fundamental objections Costco has to the draft Code is that it incorrectly assumes that all grocery retailers are operating in a comparable manner. Costco sells only to members, who pay an annual membership fee. Annual membership fees form a major part of the Costco business model, and this fact differentiates it significantly from the MSCs. The lower margins require, in some respects, that Costco has more certainty as to what is being supplied. In addition, Costco currently has 6 locations in Australia, all on the East Coast. Suppliers are therefore commercially able to refuse to supply Costco; that would not be commercially feasible with respect to the business they do with MSCs. Costco does not purport to be a local retailer that supplies directly to individual consumers. First, Costco supplies to members only. Secondly, Costco sells to individuals (who are members), but generally in a bulk fashion that in some respects resembles the business model of a wholesaler. That is, the extent to which Costco deals with the general public is much smaller than the extent to which the MSCs do; it is simply not the way Costco models its business.

Australian regulators may be justified in seeking to rebalance the relationship between suppliers and certain retailers in Australia, given the longstanding practical duopsony that the MSCs have had in this market, and the resulting anticompetitive effects it has evidently had. But the situation is not identical in all foreign markets, including those from which Costco sources much of its products. The definition of supplier in the draft Code is silent as to the place of origin. In fact, the explanatory statement asserts that this is deliberate: "The definition does not specify country of origin and so includes international suppliers to Australian retailers as suppliers for the purposes of the Code." We believe the power of Australia to purportedly act for the benefit of suppliers outside its borders is questionable. Moreover, in Costco's experience, retailers often require protection from suppliers and, at least with respect to Costco's global dealings with foreign suppliers, Australian regulators should avoid projecting Australian concerns onto foreign market dynamics. To give two examples where doing so in the draft Code is entirely inappropriate:

- (a) Costco considers that clause 25 should be expressed in reciprocal terms, and can think of no acceptable reason why suppliers should be exempt from having to deal in good faith; and



- (b) a supplier should have no right to set-off, where retailers are deprived of such a right.

Recalibrating the relationship between retailers and suppliers in such a manner is entirely unjustified in evidence or in principle. The draft Code suffers from its inability to distinguish relative imbalances in negotiating power, for example, between a retailer and a local farmer on the one hand and a retailer and a major multinational soft drink company on the other hand.

While the Code provides for differences in stock (namely, where retailers sell items other than groceries), the Code does not provide for differences in business models (such as where products are sold only to members) or in supplier base. Not doing so burdens Costco with regulatory costs and a lack of flexibility, which its wholesale margins make difficult to absorb.

Lack of flexibility and increased regulatory costs

Costco notes that, in its view, parties should be free to vary all terms of the Code in a relationship that is not characterised by grossly unequal bargaining power such that a supplier effectively has no choice other than to deal with the retailer. Costco is not aware of any other Australian industry that is forced to operate under similar regulatory regimes, whereby the freedom of contract is so substantially superseded, and cannot understand why common law, statutory and public enforcement regimes are inadequate.

Although Costco is sceptical that it is possible to address the concerns of both a standard grocery supermarket and a Costco business format within the same set of regulations, Costco offers the following as some suggestions in respect of specific aspects of the draft Code.

1. With respect to clause 8, it should be clarified that these terms do not need to be specified in a single document, since multiple documents are commonplace when entering into agreements, particularly on a one-off or ad hoc basis.
2. The exceptions listed in subclause 13(2) are too restrictive. Parties should be free to agree to terms on this issue.
3. With respect to section 14, subsection 2 is deliberately vague, which unfairly exposes retailers to the risk of liability given that they, under subsection 3, bear the onus of establishing that the payment is reasonable.



4. With respect to subclauses 15(1) and 24(1), the purpose of these provisions is clear. However, it is targeted at the reported practices of other retailers. Costco does not punish its suppliers; in fact, Costco proactively encourages suppliers to bring complaints of wrongdoing to its attention (including through the Confidential Ethics Line referred to above). The inclusion of such a provision, however, creates uncertainty and undue scope for claims against Costco when making commercial decisions to delist products. The provision invites suppliers to second-guess Costco's commercial decisions, and could foreseeably provide the pretext necessary for groundless threats against Costco by suppliers who begrudge their products being delisted on genuine commercial bases. Costco's flexibility and certainty should not be sacrificed because of the undesirable practices of other retailers, as a matter of principle. In reality, such a provision may unwittingly make retailers less inclined to try new products from new suppliers, with whom they do not enjoy long-established relationships.
5. With respect to subclause 15(5), Costco objects to this scheme being mandated by the Code. Such a scheme would require a large investment in an entirely new area of its business. It is not uncommon for Costco to stock as many as 3,700 products from up to 1,100 different suppliers around the world. Having to provide both reasonable notice of a delisting, and a review process handled by the retailer's senior buyer, is an enormous regulatory cost. Moreover, Costco often sells products on a one-off ad hoc basis, which relieves suppliers of stock that is unable otherwise to be sold via the regular, formal processes – and such a scenario could not reasonably give rise to the obligations at clause 15.
6. Costco objects to the prohibition in subclause 16(2) against retailers setting off any amount against a supplier's invoice or remittance unless the supplier has consented in writing to the set-off or the amount. Removing this security that Costco has in its arrangements with suppliers would have the unintended consequence of making Costco less inclined to deal with smaller or newer suppliers, as the risk of not recovering debts owed would be considerably greater. Costco also considers that subclause 16(3) should be revised to delete any reference to the amount of the set-off, and instead make reference to the circumstances under which the set-off would occur. The amount of the set off could not be known at the time of the agreement.
7. Costco considers the inclusion of "indirectly" as a threshold in both subclauses 16(4) and 17(1) to be unacceptably vague in ambit. The term should either be omitted, or should be supplemented with guidance as to what indirect acts are prohibited.

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8. Costco considers that subclause 19(2) should include a further exception to subclause (1) where the supplier is made aware of the requirement by reference to company policies that are in effect as of the date of the agreement.
9. With respect to the intellectual property provisions in clause 21, Costco does not understand how the dispute resolution regime mandated by the Code will coexist with those provided for in the various intellectual property statutes. Does the Code expect that retailers will be in breach of the Code and subject to its penalties, if they exercise their rights to seek remedies provided to them by statutes? This clause should be alterable by agreement (and should not presume an inequality of bargaining power).
10. The dispute resolution clauses should confirm that an arbitration will only be binding if it is agreed to by the parties in the supplier agreement.
11. With respect to the dispute resolution provisions, including at clause 27, Costco considers that any dispute resolution regime should be able to be varied by means of contract.

Naturally, Costco would be pleased to discuss any aspect of its submissions with the Competition Policy Unit, if such further consultation is requested.

Yours sincerely

A handwritten signature in black ink, appearing to be "Patrick Noone", written over a circular scribble.

Patrick Noone
Managing Director
Costco Wholesale Australia

Rick Woods
For and on behalf of
Patrick Noone