



COMPETITIVE NEUTRALITY COMPLAINT AGAINST SUPPLY SA
under the Government Business Enterprises (Competition) Act 1996

REPORT SUMMARY

being a summary of the contents of the report on the outcomes of the
Competition Commissioner's investigation

JUNE 2003

COMPETITIVE NEUTRALITY COMPLAINT REGARDING SALES OF SCHOOL STATIONERY BY SUPPLY SA

REPORT SUMMARY

1. Investigation origins and background

1.1 Terms of reference

A privately owned wholesale stationery supplier complained that Supply SA, a government business activity within the Department for Administrative and Information (DAIS), was competing unfairly by selling exercise books to schools at less than cost. The Premier referred the complaint to the Competition Commissioner in August 2002 for investigation and report as to whether any of the principles of competitive neutrality had been infringed and, if so, recommendation of policies and practices to be implemented to avoid further infringements of the same kind.

The letter of reference said that Supply SA had been listed as a Category 1 business activity in the Competitive Neutrality Policy Statement for some time and had implemented cost reflective pricing.

1.2 Policy guidelines

The guiding framework for the investigation has been the Government's Competitive Neutrality Policy Statement (the Policy Statement), specifically published for the purposes of Part 4 of the Government Business Enterprises (Competition) Act 1996 which contains provisions related to competitive neutrality.

The Policy Statement commits the Government to the application of competitive neutrality principles described in Clause 16(1) of the GBE Act as:

“ ... designed to neutralise any net competitive advantages that a government or local government agency engaged in significant business activities would otherwise have, by virtue of its control by the government or local government, over private business operating in the same market.”

1.3 Investigation process

The letter of reference to the Commissioner included copies of correspondence from the private wholesaler outlining its complaint and a response prepared by DAIS.

The Commissioner visited both parties to explain the process to be followed for the investigation and invite further submissions on any relevant matters. DAIS

subsequently submitted additional information that was provided to the complainant for response.

A draft report was circulated to the parties for comment before preparation of the report to the Premier required by the reference, but neither party made any further submissions.

1.4 Activities involved in the complaint

To an increasing extent over recent years, schools have adopted the practice of placing a bulk order for specified ‘student packs’ containing exercise books, drawing instruments and related items before the start of the school year. Some schools also buy and maintain stocks of individual items for supplementary supply during the year.

Schools usually negotiate individually with potential wholesale suppliers, sometimes on a year-to-year basis and in some cases under longer term contract arrangements. State government schools in South Australia are not required to purchase from Supply SA and their business is keenly sought by privately owned firms because of their relatively large student populations.

Three main stationery suppliers to SA schools together appear to supply about 80% of total school bulk orders. Alongside the complainant and Supply SA, the third supplier is a subsidiary of a large international forestry, paper manufacture and office products company that entered the school stationery supplies market relatively recently. It apparently gained much of the market share held by a business that withdrew from sales to schools but whose owner company continues to supply exercise books to Supply SA and the complainant. This recent entrant draws its exercise books from other sources.

While Supply SA’s sales are principally to SA schools, the State’s long-standing links with the Northern Territory’s education system have encouraged Supply SA and its local competitors to develop a significant market presence there as well.

2. Submissions

The complainant said that correspondence already presented to the Commissioner adequately outlined its position and undertook to respond to any further specific questions. Supply SA said that the correspondence summarised its views but that it would also prepare a further submission.

2.1 Complainant’s submissions

A letter from the complainant to the Minister for Government Enterprises in October 2001 presented its concerns regarding low prices that Supply SA had just published for the 2002 school commencement.

The Minister responded in January 2002:

“In relation to the products mentioned in your letter ... a review has indicated that the Supply SA purchase cost is significantly less than you have indicated. The difference between the cost price and sell price of the products is significantly less than you identified. I am advised the pricing offered by Supply SA is identical to that offered by other suppliers in the market place.

“I trust this information provides reassurance that Supply SA is operating within its bounds and is acting in an appropriate manner in the market place.”

The complainant claimed that some of the Minister’s statements were ‘factually incorrect’ in that:

- Supply SA was the dominant player in the wholesale school supply market and therefore had significant power to support predatory pricing;
- the price list of the third major supplier to the school market had been overstickered with a lower price offer on exercise books ‘due to Supply SA issuing their predatory prices forcing the market to match those prices’; and
- Supply SA could not have been buying at prices low enough to support the heavy discounts it was offering because the common supplier of exercise books to itself and Supply SA had advised that prices charged to the complainant’s parent company were ‘the lowest for the South Australian market place.’

Its letter to the Minister added:

“We must further advise that we consider Supply SA’s action as a serious breach of the principles of competitive neutrality and will lodge a complaint with the National Competition Council should a prompt and satisfactory response not be received.”

The complainant subsequently wrote to the NCC, which advised that the complaint should be presented to the SA Government’s Competitive Neutrality Complaints Secretariat.

Submissions suggested that the prices of commonly used exercise books were sometimes used as ‘bait’ to attract schools to a supplier for their total student pack business. The complaint said Supply SA had made a ‘blatant attempt’ to gain market share in price schedules issued for the start of the 2002 back-to-school promotional period, offering prices that were about 28% below its costs to buy exercise books.

Because sales in the December and January period typically accounted for about 60% of the total annual volume, the complainant said competing suppliers had not been prepared to attempt to hold their higher prices for fear of a substantial loss in sales volume. It submitted a copy of the third major supplier’s price schedule that it said was ‘overstickered’ on the front page with special offers on popular exercise books at prices lower than those shown inside, to remain competitive with Supply SA.

The complainant added that Supply SA had ‘gone back to more sensible prices’ in its promotions for 2003 back-to-school stationery sales.

2.2 DAIS responses

DAIS said that ‘the items in question represent approximately 2% of the 1,300 line items offered by Supply SA and approximately 2% of the total value of Supply SA sales’, and added:

- The complainant’s price information was inaccurate and significantly overstated Supply SA’s costs of stock. DAIS said that might be because, although Supply SA and the complainant probably had a common provider, special arrangements (such as discount for bulk purchases etc) and the age of stock had not been taken into consideration.
- Because Supply SA was only able to supply to a restricted market that included government agencies, schools, hospitals and certain benevolent institutions, ‘its impact on the total market is limited and it does not have significant market power to support predatory pricing.’
- Supply SA was a price taker rather than a price setter, and ‘a decision was taken to reduce the price of some products to match our competitors.’

DAIS said that five years ago Supply SA and the complainant had been the two leaders in back-to-school stationery supply. With the entry of new competitors, each now held about 25% market share only, with one of the recent entrants now holding about 40% share. Supply SA had concentrated on maintaining its market share and developing its relationships with schools. For that reason it had followed the larger of its main competitors when setting pricing for the 2002 school commencement for those items that were critical in schools’ selection of offers.

DAIS said it had been advised by the Crown Solicitor’s Office that it was not engaging in predatory pricing in contravention of the Trade Practices Act 1974, nor did it appear to be violating the principles of competitive neutrality under the GBE Act. It said the advice had suggested that:

“ ... in a competitive market loss leadering and cross subsidisation of products are both marketing strategies adopted by businesses in general; Denying these strategies to government businesses would provide a competitive advantage to private businesses competing in the same market.”

DAIS said its prices were in line with advice in an SA Department of Treasury and Finance paper, ‘A Guide to the Implementation of Cost Reflective Pricing’:

“In a monopoly market, costing can have a strong influence on pricing, but in a competitive market, competition will determine pricing sometimes independently of the associated fixed and variable costs.

“The pricing of an output will depend on a number of factors, in addition to the competitively neutral costs estimated above, including:

- *the level of competition between service providers; and*
- *market strategic pricing behaviours, such as the introduction of loss leaders or cross product subsidisation, subject to the prohibitions of certain behaviours under the Trade Practices Act 1974.*

“Prices should be set to achieve competitive neutrality in the medium to long term. This policy may allow for less than full cost recovery in the short term, but this obviously cannot be sustained by a viable commercial business for an extended period of time.”

3. Tasks for the investigation

Relevant SA Government policy guidelines against which the conflicting viewpoints of the parties to this complaint need to be viewed require that a government business in a position to exercise substantial power within a defined market be identified as a significant business activity and required to adopt appropriate principles of competitive neutrality.

As noted in the terms of reference, Supply SA has been listed as a Category 1 business activity in the SA Government’s Competitive Neutrality Policy Statement for some time and is required to implement cost reflective pricing. The essential task for the investigation was therefore to determine whether it has done so with regard to its pricing of school supplies.

Supply SA has wide-ranging activities concerned with the provision of goods and services for government agencies in markets that are clearly different and separate from the supply of school stationery.

3.1 Defining the market

The delineation of a market may be addressed with reference to four dimensions:

- the product dimension identifies the goods or services (including possible substitutes) provided by existing and potential businesses;
- the functional dimension identifies the stage(s) in the chain of production and supply to the consumer at which businesses presently, or could, operate within the market;
- the geographical dimension identifies the area(s) over which competing businesses currently, or could, supply; and
- the time dimension identifies opportunities for transactions between existing buyers and sellers, given the potential for substitution (including product changes or new entrants) that might constrain the exercise of significant market power by existing suppliers.

Those dimensions together help to describe what the Trade Practices Tribunal called the ‘field of actual and potential transactions between buyers and sellers’¹ that will exist only if buyers and sellers find common ground within all four. The boundaries of a market define what might be conceptualised as a common area or overlap embracing

¹ Trade Practices Tribunal, *Re QCMA and Defiance Holdings (1976)* ATPR 40-012

all four dimensions that allows ‘substitution between one product and another, and between one source and another – in response to changes in prices.’²

The product dimension

The complaint focused on exercise books supplied to schools and the main suppliers agree with its contention that exercise book price offers are important elements in individual schools’ decisions between suppliers. Supply SA said:

“Schools predominantly will place a complete order with one supplier only for their total back-to-school requirements. Therefore it is unlikely that schools will opt to purchase only the specific items in question.”

The Commissioner was able to confirm through independent inquiries that stationery suppliers and schools regard exercise books as key indicators of the competitiveness of individual suppliers during the main promotional period for school sales. As items with virtually standard specifications, their prices are likely to come under fierce pressure at that time and to change quickly as suppliers jostle for preference.

Nevertheless, it needs to be noted also that during that period, the emphasis is on student packs that contain a range of other stationery items. The Commissioner suggests there is a reasonable argument that the product being offered is, for that time at least, not merely an exercise book requirement but a total pack that includes other products whose prices are not under the same competitive pressures.

The functional dimension

The complainant and Supply SA provide essentially the same function in the market. Both are wholesalers to schools and, at least at the time of the complaint, were drawing their exercise book supplies from the same manufacturer.

The geographical dimension

Both parties agreed that the market in which they compete against each other covers South Australia and the Northern Territory. Although the other major supplier of school stationery in that market area operates nationally, the complaint related only to Supply SA.

The time dimension

The complaint was presented essentially with regard to supplies for the 2002 back-to-school period, and noted that Supply SA prices for 2003 had increased.

² *ibid*

Conclusions on market definition

The Commissioner suggests that the market within which the complaint should be considered is the wholesale supply of student stationery requirements to schools in South Australia and the Northern Territory. While the complaint related specifically to prices offered for exercise books during the back-to-school period, the Commissioner considers that those offers need to be seen within the context of:

- a general preference for bulk supply of student packs containing a range of other stationery requirements; and
- the apparent ‘loss leader’ role of exercise book prices within the total cost and selling prices for such packs supplied to schools at that time and for any supplementary supplies that might be required during the year.

The complaint related specifically to exercise books, but it is clear from submissions to the investigation and the Commissioner’s own inquiries that exercise books are likely often to be used as loss leaders supported by cross subsidisation from other items in the complete student packs that are actually bought by most schools.

For all practical purposes, the main field of competition between alternative suppliers of school stationery appears therefore to be standard student packs whose costs do not depend wholly on the imputed costs of exercise books contained within them. The Commissioner suggests that it would be inappropriate to define the market as related only to exercise books. The major suppliers all offer student packs and confirm that the focus of their marketing campaigns for school commencement is on bundled stationery rather than the individual items.

3.2 Market significance

Supply SA claimed that the items named in the complaint represented only 2% of its total sales. While it did not explicitly present this as an argument that the activity was not significant for competitive neutrality purposes, the Commissioner believes it important to refute a possible inference that size alone is the determinant of significance. The test for significance in a competitive neutrality investigation relates to a government business activity’s ability to exert a substantial influence in its market.

The Commissioner believes that Supply SA has that ability within the market defined above. While it does not hold the largest share of that market, it appears to be comparable in size to the complainant and its association with government would appear to provide a ‘loyalty’ attraction for government schools.

Acceptance of the complainant’s contention that the other two major suppliers to the market were forced to follow Supply SA’s price reductions towards the end of 2001 to maintain their own sales would appear to confirm its ability to influence the market.

3.3 Extent of cost recovery

The principles of competitive neutrality relate mainly to the way in which government business activities set their prices. Cost reflective pricing requires significant government businesses to bring to account the costs of all inputs and recognise cost benefits, including particularly taxation differences, that they may receive because of their government ownership.

The complainant estimated that Supply SA had offered prices 28% below its cost of stock, and presented a letter from the supplier of the books to both wholesalers that was apparently used to derive its estimate.

Supply SA said the claimed margin overstated its costs. It submitted in confidence invoices and calculations of its average buying prices for a range of exercise books during the period covered by the complaint to show that its average cost of stock sold was lower than the complainant's estimates. The gap between that cost and selling prices varied between items, but was less than 28%. The information also indicated that Supply SA did price exercise books below its average cost of stock for the 2002 back-to-school period.

In the Commissioner's view, the brief letter submitted by the complainant does not in itself prove the contention of a 28% gap between stock purchase cost and selling price. Its relevant section states:

"I wish to confirm that (the complainant's group parent company) purchase volumes of products during the Back to School period justifies the lowest prices from (our company) for the South Australian marketplace."

No actual prices were indicated. Nor for reasons of ordinary commercial confidentiality would the Commissioner expect them to be disclosed between competitors by their common supplier. The complainant's interpretation apparently assumed that its buying prices for exercise books must be no higher than Supply SA at any time. The Commissioner does not draw the same conclusion.

First, if exercise book prices are frequently used as 'bait' to attract orders from schools, their prices are likely to be discounted often and unlikely to remain stable for long periods.

Second, in the face of fierce competition, retailers and wholesalers are likely as normal commercial practice to approach their suppliers for support in meeting competitors' lower prices. Such special allowances may not always follow standard volume-related pricing schedules. The Commissioner would be surprised if that did not occur in stationery supplies when the practice is common across a wide range of products sold in highly competitive wholesale and retail markets.

The Commissioner therefore does not accept that the complainant's interpretation of the letter submitted is the only possible view that might be taken of its meaning. Furthermore, while both parties appeared to focus on the claimed 28% margin, the issue is not whether the complainant erred in an estimate based on limited information

but whether sales below Supply SA's costs were in breach of its obligation to observe cost reflective pricing.

3.4 Compliance requirements

The Commissioner suggests that the question of whether a specific sales campaign may be in breach of competitive neutrality principles is not easily answered by the application of a precise formula. Elements of judgment are likely to influence the importance attributed to particular characteristics of price setting behaviour. Those characteristics might include, for example:

- the length of time for which lower prices were offered;
- whether there were repeated reductions that effectively constituted long term discounts from 'normal' prices;
- whether special prices were offered essentially to specific customers or in a limited sector of the market; and/or
- whether they were essentially tied to particular purchase volumes or to packages that included other items as well as those offered at low prices.

As noted earlier, competition may sometimes determine pricing independently of associated fixed and variable costs, giving more weight to:

- the level of competition between service providers; and
- market strategic pricing behaviours, such as the introduction of loss leaders or cross product subsidisation.

Nevertheless, the Guide to Implementation adds:

“Prices should be set to achieve competitive neutrality in the medium to long term. This policy may allow for less than full cost recovery in the short term, but this obviously cannot be sustained by a viable commercial business for an extended period of time.”

The Commissioner considers it relevant to note the acknowledgement that Supply SA apparently increased its prices for the 2003 peak selling period. The prices that led to the complaint therefore appear to have been offered for one season only, and can reasonably be seen to have been a short-term response to market competition.

The timing of SA Supply's decision to offer lower exercise book prices for its 2002 promotion generated another substantial difference in opinion between the parties. There was no agreement as to whether Supply SA led with price reductions or followed another supplier that was not a party to the complaint. The Commissioner has been unable to resolve that difference.

All major suppliers to the market concede that they expect vigorous competition during the peak school supplies season. They watch intently for indications of price reductions, and their determination not to be far away from their competitors can spark rapid responses. The apparent overstickering of a price schedule to offer special discounts on some exercise books may have been a planned marketing tactic rather

than an indication of a late decision following an indication that Supply SA was already discounting.

Whatever the situation, the Commissioner believes the question of who moved first has little significance in a competitive neutrality investigation. Its prominence in the initial complaint appears to have been driven by the contention that Supply SA had engaged in predatory pricing.

After considering all the information provided to the investigation, the Commissioner believes that Supply SA in 2002 was selling exercise books below their cost but not in breach of competitive neutrality principles. Rather, it was attempting through short-term price reductions to hold an established market position against vigorous new competition.

The complaint related to the 2002 selling season and indicated that Supply SA had increased its prices for 2003. Had Supply SA maintained its price reductions for an extended period or sold below cost reflective prices in repeated campaigns, the Commissioner would be likely to have reached a different conclusion.

3.5 Other matters

Letters to SA Government Ministers before the complaint was formally referred to the Commissioner claimed that Supply SA had engaged in predatory pricing. In October 2001, the complainant said that it intended to lodge a complaint to the Australian Competition and Consumer Commission under misuse of market power provisions of the Trade Practices Act.

The complainant subsequently wrote to the National Competition Council and was advised to approach the SA Government's Department of the Premier and Cabinet for investigation of its complaint for possible non-compliance with competitive neutrality principles.

This investigation has been conducted with regard only to the competitive neutrality provisions of the South Australian GBE Act under which the Commissioner was appointed. It would not have been appropriate for it to consider any possible infringement of Commonwealth Trade Practices legislation.

4. Findings and recommendations

The Premier on 21 August 2002 referred to the Competition Commissioner, as a competitive neutrality complaint for formal investigation under the Government Business Enterprises (Competition) Act 1996, claims regarding sales of school stationery requirements by Supply SA.

In referring the complaint for investigation and report, the Premier added:

“Pursuant to section 18 of the Act, I refer the attached complaint (and) the response prepared by the Department of Administrative and Information Services ... for your investigation and report. DAIS contends that Supply SA is not pricing exercise books under cost in the mid to long term and is only matching the price of a third competitor in the market in order to retain market share. It also states that Supply SA receives no appropriation from the Government and has to cover its costs.

“Supply SA has been listed as a Category 1 business activity in the Competitive Neutrality Policy Statement for some time. It has implemented cost reflective pricing.

“I would appreciate your advice as to whether any of the principles of competitive neutrality have been infringed and, if so, recommendation on the policies and practices to be implemented to avoid further infringements of the same kind.”

After consideration of the complaint and further submissions from the parties involved, the Commissioner finds that:

- (i) Supply SA sold exercise books at prices below their cost during the back-to-school promotional period in 2002; but
- (ii) those sales were mainly as ‘loss leaders’ within standard student packs in response to strong competition for market share; and
- (iii) Supply SA has since increased its exercise book prices.

The Commissioner finds that Supply SA’s actions as a short-term response to competitive pressures within a market in which it has been established for some time were not in conflict with its obligations to set cost reflective pricing in line with competitive neutrality principles and SA Government policies for their implementation.