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IGA and the Coles-Shell Alliance

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Introduction

The Executive Management Group at IGA thought this was a serious problem. It was late-2004, and although they were not fuel retailers themselves, they were facing intense competition for the grocery dollar from two retailer/fuel company alliances - the Woolworths-Caltex alliance and the Coles-Shell alliance.

IGA (Independent Grocers Alliance) was founded in America in 1926. IGA is an alliance between wholesalers, retailers and manufacturers, and has become a vehicle for protecting and strengthening the relationship of the three groups against the growth of the chain store multiples. In Australia, IGA stands for 'Independent Grocers of Australia'. The brand was brought to Australia by David Holdings in 1988 when 10 stores initially became members of IGA. IGA is best known by the general public as a grocery retail brand. Since 1988, a growing number of Australian independent retailers have wanted to experience the benefits of uniting together under one brand, and today there are over 1000 IGA stores in the country. IGA stores are all independently owned.

There existed for a long time a host of different supermarket names in the market place. Independent retailers traded under many different names and there were few advantages for consumers in choosing one over another. The buying and marketing power of this network of IGA stores has enabled independents to pass on volume benefits on customers. Better buying, standards and disciplines have all meant a better shopping experience for consumers. The network now faced an additional risk - the powerful retailer/fuel company alliances.

There had been much talk in the IGA boardroom about the Woolworths-Caltex alliance. Woolworths had entered the petroleum retail market in 1996. In August 2003 Woolworths and Caltex announced plans for a 50/50 retail petroleum joint venture. The joint venture proposal added about 150 of Caltex's retail sites to Woolworths' existing 290 sites. The joint venture co-branded existing Woolworths Plus Petrol sites and selected Caltex sites. In November 2003 Woolworths and Caltex opened the first three co-branded petrol stations in Sydney. Since then, Caltex had continued to progressively open co-branded sites. The deal is that Caltex provides fuel and

Woolworths supplies convenience store items. Fuel retailers in the alliance offered a 4 cents per litre discount to shoppers who spent \$30 or more at Woolworths supermarkets or Big W stores. Independent retailers had already noted a 'strong negative effect' of this discount scheme on their businesses. Woolworths was attributing a considerable portion of its supermarket sales growth to the appeal of the scheme.

Now the Executive Management Group at IGA was considering a report about the Coles-Shell Alliance extracts from which appear below.

EXTRACTS FROM THE REPORT INTO THE COLES-SHELL ALLIANCE

Executive Summary

This report describes the alliance between Coles Myer Ltd (CML - a diversified retailer with a focus on grocery) and Shell Australia Limited (Shell - petroleum refining, distribution and retail). The alliance entitles Coles customers to receive a fuel discount voucher when they shop at specified CML grocery outlets. The voucher is redeemable at Shell refilling stations.

The grocery industry in Australia has been relatively stable and mature until the creation of an alliance between Woolworths and the fuel retailer Caltex. Also, in 2001, the grocery retail landscape changed with the arrival of low-cost entrant Aldi. This prompted CML to negotiate a partnership with Shell.

The structure of the alliance differs from that of the Woolworths-Caltex alliance in that CML assumes operational control of the co-branded sites, a move that prompted a downgrading of CML stock. Shell appears to have achieved outstanding success by reducing risk, and increasing throughput to achieve an increase in market share in the retail fuel market. Measures are in place to evaluate the outcome, using a number of metrics. However, due

to the dynamic nature of the marketing environment, it has proved difficult to measure the overall success of the alliance. Nonetheless, it has been applauded as a success by both CML and Shell, and by some analysts.

This is a strategic alliance, with each firm retaining its autonomy, and is operative for a single marketing offer - discounted fuel. There is a long-term commitment between the companies.

The companies

Two companies are directly involved in this alliance. They are Coles Myer Ltd (CML) and Shell Australia Limited (Shell). The alliance project commenced in Sept 2002; the first stage was completed in July 2003 with CML taking over the operation of more than 150 sites in the state of Victoria. Progressive rollout was planned for completion by July 2004, but was actually completed in March 2004, with more than 580 sites operated by Coles Express nationwide. Other companies and stakeholders are indirectly involved, for example legal and accounting firms and other suppliers to the alliance.

Coles Myer Ltd (CML).

CML's Mission Statement reads: "We are innovative industry leaders who provide customers with value, convenience and superior service"². CML, with its headquarters in Melbourne, is Australia's leading retailer with over 1900 stores in Australia and New Zealand. Revenue for the 2003 financial year was over AU\$27B and in 2004 CML reported a growth of 19.4% to AU\$32.3B². According to Datamonitor, "CML has businesses in most segments of the Australian retail market, and in the general merchandise sector of the New Zealand retail market. It also has an e-commerce and direct mail marketing business that encompasses food, gifts, liquor and other products"³. CML businesses include household names such as Myer (formerly Grace Brothers in some states), Coles, Bi-Lo, Liquorland, K-Mart,

Target and Shopfast. A SWOT analysis of CML has been carried out and is shown in Table 1.

Table 1: CML SWOT Analysis (adapted from Datamonitor³)

Strengths	Weaknesses
<ul style="list-style-type: none"> • House Brands: extensive range including organics, sound supplier agreements • Food & Liquor Financial performance: steady gain in revenue since 1999 • Store network: targeting different segments • Leadership & Culture: sound management team, leadership, strong succession 	<ul style="list-style-type: none"> • Shareholder card: expensive and poor ROI, benefiting small % of customers • Discount strategy: high volume at lower margin • Myer stores - reduction in shareholder scheme discount, key store closure, weak position in non-store brands
Opportunities	Threats
<ul style="list-style-type: none"> • 3-pronged loyalty program - including fuel offer • New marketing focus /campaigns - Myer and Bi-Lo • Store expansion - Coles/Bi-Lo new stores, refit existing stores, brand building initiatives • Theo's liquor stores - 2003 acquisition of hotel and liquor stores, cross promotion, economies of scale, supply chain integration 	<ul style="list-style-type: none"> • Poor economic conditions - recession • Competition - limited barriers to entry eg Aldi in 2001 • Raw material continuity of supply - no long term supply agreements • Major competitor fuel discount offer - Woolworths

Shell Australia Limited

Shell is a part of the Royal Dutch/Shell Group whose mission is “to meet the needs of society, in ways that are economically, socially and environmentally viable - now and in the future”⁴. Shell is a household name in Australia, known for its retailing of petroleum-based products. In its annual report, Shell Australia describes itself as being “involved in every stage of the petroleum value chain - from the discovery, production and refining of oil and gas to the distribution, marketing and retailing of oil, gas and petrochemicals. We trade with over 70,000 customers throughout

Australia, from individual farmers and small businesses to major industry and multi-national companies”.⁵

In 2003, a new dual-holding company structure was established for Shell’s businesses in Australia. Shell’s two businesses (wholly owned within Royal Dutch / Shell Group of companies based in the UK/ Netherlands) in Australia generated AU\$12B of revenue⁵ and consists of:

- Shell Energy Holdings Australia Limited - responsible for oil and gas exploration, production and marketing
- Shell Australia Limited (Shell) - petroleum refining, distribution, sales and marketing businesses “serving business customers and a national network of retail service stations”⁵.

This structural reorganisation reflects the differences in management focus and location, distribution and business drivers. According to the annual report, “The new corporate structure enables the businesses to better compete in their respective markets by enabling them to make independent financing and business decisions”.⁵ This change is claimed to “maintain competitiveness and achieve their business goals.”

Industry background

Shopper Trends⁶ characterises the Australian grocery industry as one of low growth. During 2003, Aldi (the German grocery discounter) made a significant impact in the Victorian market with “nearly one in five Victorian households ... (having) made at least one shopping trip to one of Aldi’s 13 stores in the seven months to December 2003”. Aldi was successful in gaining market share not only from other discount supermarkets, but also from the majors such as CML and Woolworths.

This market is clearly in its maturity phase and has been impacted by the overall economic landscape. Until 1997, there had been little in the way of major innovation in Australian grocery retailing. However, then came the establishment of Woolworths Plus. “This involved an attempt to expand

customer loyalty through offering discounted petrol to Woolworths' supermarket customers. Although technically in breach of the (Australian) Trade Practices Act^ϕ, Woolworths successfully applied to the ACCC for an exemption".⁷ The Australian Competition and Consumer Commission is a national law enforcement agency and was set up in 1995 by the Commonwealth Parliament to protect the rights of consumers and businesses. It does this by encouraging vigorous competition in the marketplace and enforcing consumer protection and fair trading laws, in particular the Trade Practices Act.

Objectives of the alliance

As illustrated by the Woolworths-Caltex alliance, companies can secure competitive advantage by building relationships with partners, and exploiting their joint competencies.⁹ Therefore, the creation and effective management of business networks becomes critical to success. Firms enter alliances for competitive reasons. Alliances allow firms to gain economies of scale in production and marketing; they can also overcome regulatory barriers and facilitate access into new markets. The ultimate objective is to develop a mutually advantageous arrangement, often with the specific goal of strengthening market share.¹⁰

The success of any alliance depends heavily on effectively matching the capabilities of the participating organizations and on achieving the full commitment of each partner to the alliance. The benefits and the trade-offs in the alliance must be favourable for each of the partners¹⁰. It isn't unusual for one party to an alliance to gain more than the other.

^ϕ The *Trade Practices Act 1974* prohibits conduct known as third line forcing. Third line forcing conduct involves the supply of goods or services at a discount on condition that the purchaser acquires a second good or service from another supplier. While third line forcing is prohibited by the Act, it can be "notified". Notification provides immunity from court action by the Australian Consumer and Competition Commission (ACCC) or any other party in respect of the notified conduct, until or unless the ACCC intervenes to revoke that immunity. Shopper docket discounts are a form of third line forcing, which is prohibited under the Act. Immunity can be sought for this conduct by way of the notification process, which requires companies engaging in third line forcing conduct to notify the ACCC of the conduct⁸.

CML and Shell formed a “strategic alliance”, with each firm retaining its autonomy, and the alliance being for a particular purpose i.e. the discount fuel offer. A strategic alliance is a collaboration leveraging the strengths of two or more organisations to achieve strategic goals¹. The participating organisations contribute and adapt needed assets and competencies to the collaboration and these assets or competencies are maintained over time. The results of the collaboration add strategic value and contribute to a viable venture that can withstand competitive attack and environmental change. This appears to be a good description of the CML-Shell partnership.

The objectives of the alliance are clearly stated by CML: “When fully implemented the alliance is expected to add more than AU\$3B in annual sales to CML each year for 20 years”¹¹. According to CML, the partnership is designed to drive retail sales for CML. “Coles Myer’s extension into petroleum and convenience store retailing will complement our existing grocery retail business, create and drive sales, and reward customers for shopping with us” according to CML CEO, John Fletcher¹². CML indicated that they expected a general uplift in supermarket sales of approximately 2% as a direct result of this alliance. With Australia’s retail fuel market being one of the world’s most competitive, there is little benefit for CML from fuel sales alone (see Table 2).

CML hoped to capitalise on the opportunities offered by affluent, time-poor consumers who enjoy the convenience of buying premium-priced packaged foods at service station points of sale.

One analyst suggested “The development of Woolworths Metro and Coles Express ... provide a vehicle for Woolworths and Coles to expand into market segments which to date have been dominated by franchised convenience stores” such as 7-Eleven.”⁷ These two shop fronts are convenience store formats. Coles Express units were developed at Shell outlets participating in this scheme.

Customers do not receive the discount fuel offer by shopping at Coles Express. Payment for fuel, however, does require entry into service station-located Coles Express outlets. CML hoped that this experience would drive customers back to other CML outlets such as Coles supermarkets.

For Shell, the alliance objective is to increase throughput, leading to an improvement in profitability. In addition, there were other benefits derived from the buying power of the alliance. “Petrol industry sources say the deal is (for CML) to buy their fuel from Shell at 1c below the terminal gate price (TGP), the market price. A study of capital cities over the past four months has shown that the price Shell is selling at is 2c below TGP. This means CML is making a 1c loss per litre”¹². The alliance therefore allowed Shell to maintain favourable selling prices on its forecourts.

Table 2: Coles Myer Express Site Analysis¹²

Profit / Loss per Coles Express-Shell Alliance Site	\$K Monthly	\$K Annum Per
Rent	(20)	(240)
Operational (Wages, electricity, other back-office)	(18)	(216)
Petrol discounts	(13)	(156)
Profit (Coles Express)	24	288
Net Profit (Loss) per site	(27)	(324)

Table 2 shows that when an average of 85% of customers buy fuel at the co-branded outlets using the discount voucher, this leads to a loss of \$324,000 per outlet p.a. for CML. This is a sum that CML has to recover from additional retail sales through the network of stores offering the discount voucher.

Customer value

The alliance aims to create customer value by delivering extra benefits and reducing costs for customers.

Coles takes a broad view of customer costs. The most evident form of cost reduction was at the bowser. The offer consisted of 4c per litre discount off the standard price of fuel when customers spent \$30 or more at Coles Supermarkets, or other participating CML outlets. Shoppers redeem their discount voucher, within a 4-week validity period, at a selection of participating co-branded Shell-Coles Express outlets as a reduction in the price of fuel paid at the pump on presentation of the voucher. By mid-2004 there were nearly 600 participating co-branded outlets across Australia, located in close proximity to the supermarket outlets in urban areas, thereby reducing search costs for customers. Likewise, participating service stations are generally located on major thoroughfares and are prominently marked with the offer. Shell's annual report noted that as "more than 80% of CML supermarkets are within 5km of a Coles Express site, the alliance enables CML customers to receive a discount on fuel in many locations around Australia"⁵. The alliance also reduced customers' concerns about fuel quality by making considerable reference to its Shell-branded fuel product as "Quality Fuel". This was at a time when ethanol contamination of fuel has been widely reported in the press.

The fuel discount offer was "part of the three-pronged CML loyalty program which included a much improved FlyBuys offer and the new Coles Myer Source MasterCard"¹⁷. This provides a significant point of differentiation from the Woolworths offer.

FlyBuys is Australia's biggest customer loyalty program. A magnetic stripe, card-based program, it offers rewards for shopping at some of two dozen of the best known stores and services in Australia including CML outlets, First Choice Liquor Superstores, Best Western, EziBuy, Jetset and Travelworld. For every \$5 spend two points are credited to the customer's FlyBuys account. The Coles Source MasterCard offers a number of benefits to customers including no annual fee, up to 62 days interest free on purchases, 0% of balance transfers for a period of 2 months and double dipping on FlyBuys points. FlyBuys members can earn a total of 4 FlyBuys points for

every \$5 spent at participating CML stores when they use the Coles Myer Source MasterCard. According to CML's John Fletcher, the fuel discount, FlyBuys and Coles Source MasterCard "are compelling loyalty programs in their own right but we also have the unique flexibility of being able to connect them in different ways to delight our customers".¹⁴

The discount price is prominently displayed at participating retail and fuel locations. AC Nielsen, the market research organization, has investigated buyer behaviour and reported that "effective fuel discount offers appear to be encouraging consumers to switch stores compared with other factors such as a wider variety of products offered by competing stores, or higher levels of out-of-stock in the usual store".⁶ According to Shell, the alliance is a great match of retail and petroleum industry expertise which provides a very attractive consumer offer...and is a pro-competitive initiative which will extend the availability of fuel discount offers to more consumers".¹² The ACCC has acknowledged this viewpoint, but has also stated that the competitive situation will be periodically reviewed⁸.

There had been some concern that successful alliance-based value adds such as the Coles-Shell and Woolworth-Caltex offers may ultimately lead to diminished competition in the retail fuel market, as petrol giants Caltex and Shell come to dominate the market, forcing out the independents due to shrinking margins. The RACV (Royal Automobile Club of Victoria) has suggested that these alliances will also place pressure on rural fuel outlets. In the long-term the RACV is concerned that a number of service stations would close, particularly the independent stations in the cities, and maybe the less profitable ones in country areas.¹⁸

The Sydney Morning Herald carried a story that also set out the depth of concern. "Down the track, and without competition, consumer groups fear prices will rise again, unchallenged. In Australia, that risk is heightened by the concentration of the market to a duopoly where Coles Myer and Woolworths control 77% of packaged grocery sales. A report by Deutsche

Bank this year found Australia had the most concentrated food grocery market in the world, even when compared with countries with smaller populations”¹⁹.

How the allies are organised to achieve their objectives

The CML-Shell alliance is horizontal in scope, with a collaborative relationship existing between the two companies at the same level within their respective distribution channels. It is intended to be a long-term relationship, with considerable investment having been made by both parties, and strategically important to both companies. “CML has purchased the rights to operate Shell’s core retail property network of service stations across Australia. CML is now responsible for operational management of all Alliance sites including staff management, operational compliance and store and product range. Shell is the exclusive supplier of fuels to sites that are branded both Coles Express and Shell.”⁵ The contribution of CML to the alliance is site operating rights, stock, plant and equipment, and its retailing experience. Shell is contributing access to its properties and fuel, and its intellectual property.

Pump prices are set by CML. The fuel sites are co-branded Shell and Coles Express, and provide CML with a new business opportunity through the convenience stores. Low growth in the grocery environment makes this an attractive proposition for CML, providing a channel for higher margin and potentially premium-priced segments such as prepared meals. “CML leases the sites, running the fuel business itself and giving Shell a guaranteed payment for the leases”.¹¹

The alliance encountered significant legal issues, with Minter-Ellison acting for CML with a “multi-disciplinary team of 170 lawyers to bring this project to fruition”.¹¹ The issues included “structuring, negotiating and documenting the alliance with Shell, obtaining clearance for the transaction from the ACCC...preparing ‘third line forcing’ notification...entering into long term fuel supply agreements with Shell and structuring complex

property rights arrangements for all the petrol stations involved”.¹¹ Additional considerations were “intellectual property law, including the negotiation and documentation of a unique trademark sub-licensing and co-branding arrangement”.¹¹

This arrangement differs fundamentally from that of its major competitor: “Woolworths has the benefit of encouraging supermarket sales but is not in the fuel business itself. It has 300 Woolworths Plus petrol outlets and recently signed a deal with Caltex for another 140 outlets. The deal with Caltex is based on Caltex retaining operational control and receiving a commission paid by Woolworths based on volume and convenience store sales”.¹²

Some analysts believe that the CML-Shell alliance provides a greater benefit to Shell than it does to CML, with the risk translating into a downgrade in CML stock, based on the perceived risk and increase costs. The overall strategy is for CML appears to be the development of a powerful network position that will offer a sustainable competitive advantage.

Measuring the alliance’s outcomes

A number of changes were implemented simultaneously at CML. “Coles’ new advertising campaign, store refurbishments and a continued focus on range combined with the early impact of the fuel discount scheme - all started to pay dividends in 2003, with growth in its shopper base, trip frequency and average basket size producing [market] share growth”⁶. The CML shareholder discount scheme, considered costly by CML, was also diluted over the same period and finally terminated at the end of July 2004. This was expected to have generated a one-off surge in business before the cut-off date. It was therefore difficult, if not impossible, for CML to measure the unique contribution of the alliance alone. However, a number of analysts gave their views on how the alliance may have impacted on CML, using a number of metrics:

- Credit rating - “the structure of the Coles petrol arrangement is very different from that of Woolworths; and, due to the higher costs and risks associated with the Coles-Shell deal, the credit rating agency Standard and Poor’s downgraded its rating of Coles Myer from BBB+ to BBB”¹¹. This was as a result of the increased liabilities that exist for Coles in assuming lease payments from Shell sites.
- CML Revenue - “Coles Express is expected to generate more than AU\$3 billion per annum in fuel and convenience store sales”¹⁷, albeit with the fuel sales being unprofitable.
- CML Earnings per share - With higher food and liquor sales “the impact from these initiatives will be earnings per share positive in FY 2004”¹⁷.

In its 2004 Annual Report, Shell’s Oil Products business declined in 2003, with EBIT of AU\$183M in 2003 (2002: AU\$202M)⁵. According to Shell, “The underlying growth in profitability associated with successful start-up of the Coles Myer alliance and the strengthening refinery margins was masked by a combination of one-off credits in 2002 and accounting write-offs in 2003”.⁵ In addition, “The Alliance with Coles Myer exceeded Shell’s expectations and we expect to see the full benefits in our 2004 results”.⁵

Commentary on the alliance

“The execution of this transition has been one of the best I have seen, and was driven by an alliance based on strong relationships, and unwavering customer focus, and sound commercial decisions. In my opinion, we have created Australia’s most compelling fuel and convenience offer” (John Fletcher, CEO, CML in Shell’s Annual Report 2004.⁵)

Fletcher’s comments were echoed in a joint CML/Shell press release: The “Shell-Coles Myer Alliance was successfully implemented, resulting in overwhelming customer response to Australia’s most compelling fuel and convenience offer”.¹⁷

The Age newspaper reported that: “The highlight of the sales figures was the AU\$17.97 billion reaped from supermarkets and liquor stores, up 8.5% and powered by the loyalty offer of discount petrol at Coles Express/Shell petrol stations. In its first year, Coles Express sales totaled AU\$3.18 billion, including AU\$1.28 billion in the final quarter when the network was operating in all states. After eliminating sales from new stores, food and liquor, annual sales rose 6.2% in the July quarter, marking possibly the strongest same-store sales figures in the retailer's history.”²²

In a BRW article analyst Charlie Aitken stated that the alliance lifted “Shell’s fuel sales up 30% in 2003, which drove their national market share from 17% to 22%…… This is the greatest deal ever for Shell. It got rid of its retailing risk and has potentially doubled its national market share in a period of unprecedented refiner margins. This is not a win-win deal.”¹²

In another report: “Retail giant Woolworths released its annual profits today (23rd August 2004). The net result after tax is an improvement of more than 12 per cent to nearly \$700 million. But the undisputed grocery king of recent years is under assault on several fronts. Rival Coles Myer's high stakes foray into petrol has hit Woolies hard. Independents are uniting to fight the majors, the Federal Government has said no to supermarkets taking on pharmacies and the Opposition says it would stop the big grocers buying up smaller stores. They're famous for the way they've grown, but where do our two big retailers turn now if they're to achieve the growth they've promised shareholders?”²⁵.

Conclusion

The alliance was formed at a time of intense competitive pressure from a new entrant (Aldi) and an existing competitor with a strong customer value proposition. The fact that the offer (on face value only) matched the competitor offer as a “cents per litre discount” and achieved considerable success is testament at least in part to the strength of the alliance, and the additional value offered through FlyBuys and CML MasterCard. It is

important however to recognise that a number of other measures to attract and retain customers were implemented by CML at around the same time, and that it is difficult, if not impossible to quarantine the results from the alliance alone. For Shell, it appears that the alliance has been an outstanding success, with a substantial increase in market share.

For the customer, it appears, at least for the moment additional customer value has been delivered by the CML-Shell alliance. What is certain is that these alliances will ultimately lead to the demise of some independent fuel outlets and supermarkets. Will this ultimately lead to a reduction in competition and increasing prices for fuel and groceries for Australian customers?

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