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Dr Richard Chadwick  
Adjudication Branch  
Australian Competition and  
Consumer Commission  
GPO Box 3131  
Canberra ACT 2601

Dear Dr Chadwick

Notification N31363

Before dealing with the specific concern and providing answers to your specific queries, there are a number of preliminary issues we would like to address.

First, as the Commission is aware, we terminated the master franchise agreement in South Australia. The Cheesecake Shop (SA) Pty Ltd, a related company to The Cheesecake Shop Pty Ltd (TCS), is now operating the master franchise on South Australia. This constitutes a change in circumstances from those described in the original notification

Second, we have reached agreement in principle with M.R.M. Pty Ltd on the early termination of the master franchise agreement for Queensland North. We anticipate signing a deed of termination in the week commencing 7 December 2009 and settling the agreement in the week ending 21 December 2009. TCS will operate the North Queensland master through a wholly owned subsidiary of R&W Traders Pty Ltd and a sister company to TCS. The company name is The Cheesecake Shop (Qld) Pty Ltd. The relevance of this will become clearer when you have read our comments under the heading "Relationship of TCS and UNS."

We believe the public benefits clearly outweigh the public detriment. In fact, we do not see any public detriment arising from the conduct.

Dealing now with the specific issues you raised under the heading -- Nature of concerns.

#### Prices

Prices are not inflated. Anecdotal comments from some franchisees are that we are very competitive. We believe we are competitive. We believe our prices are better than market in many cases. We do from time to time compare prices with competitors if we are able to get competitor price lists. Earlier in the year we compared our basket of prices to franchisees in Victoria with the prices of similar products available from two major suppliers and the cost to franchisees in buying our products. The result was that franchisees would have been significantly better off buying all ingredients from us than all from Fina Foods, a major competitor, and there was about a 1% difference in the prices of products from Victoria Farmhouse. Victoria Farmhouse does not sell the full range of goods. We attach the spreadsheets showing the analysis of prices of both competitors. You need to bear in mind that the "comparable" product in many cases is not approved product.

Because the second concern is based on a flawed assumption there is no need to comment other than to say that UNS is able to make a profit while charging market prices, and those market prices were significantly cheaper than those of Fina Foods, a major supplier.

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### Relationship of TCS and UNS

In relation to the third concern, we think there is a fundamental issue that needs to be dealt with; and if dealt with, the ACCC's concerns should disappear. If TCS was the franchisor everywhere in Australia supplying direct to franchisees the recipes, the stock rotation system, the right to use the brand and have the benefit of the brand and brand awareness, have the benefit of the training and on going assistance, and TCS supplied the ingredients, there would be no issue for the ACCC to deal with.

TCS and UNS have the same directors. UNS is effectively run as part of the TCS system. The general manager of UNS attends the TCS management meetings along with the senior managers of TCS, Kings Pantry and R & W properties. Company owned stores are operated under a separate legal entity called TCS Xpress Pty Ltd. That the various entities are structured as separate companies for liability and accounting reasons does not mean they operate independently. They do not. They operate as part of the The Cheesecake Shop Group; they are operated as one integrated business.

R&W Traders Pty Ltd, the holding company of TCS, tries to ensure that all entities operate "as one", operate as a team. It would have been possible to have UNS as a subsidiary of R&W Traders and be a sister company to TCS. However, UNS was set up differently over 10 years ago.

In looking at the concerns, we ask the ACCC to look at UNS as if it were TCS, because that is, for all intents and purposes, what it is. In fact, there is a proposal to change the name of UNS to The Cheesecake Shop Supplies Pty Ltd.

Essentially, UNS has one customer – the TCS network of franchisees. That enables UNS to keep prices low. UNS was set up to supply our franchisees. UNS does have a few other customers. Sales to those customers account for about half of one per cent of sales. If you want the detail, we can provide it.

### Packaging

Many products are packaged by the suppliers with the TCS brand. They are not repackaged. It is a common practice for manufacturers to package products they manufacture with different labels. Sometimes equivalent products can be purchased from alternative suppliers at cheaper prices. TCS will not be approving alternate suppliers. We will outline the reasons for this later in this letter.

### Changes to Authorised Ingredients

Yes, TCS does change the authorised ingredients from time to time. Whether TCS notifies franchisees before or after the change, or not at all, is a matter for TCS. Some ingredient changes do not result in any change in procedures for franchisees. We believe we notify franchisees as and when necessary.

### Deliveries

Ordering from UNS is part of the TCS system that franchisees acquire when they acquire a franchise. Our delivery system is linked to each store's ordering system, which is linked to that each store's production and sales records in the "Store Manager" system in each store. This works well for franchisees.

On line orders to UNS are via the web and utilise TCS's Intranet. TCS is able to control the whole process.

One delivery per week is a good thing. Franchisees are able to order on line. The price is calculated so that franchisees are able to see the total price for the order at the time of placing the order. The TCS system requires franchisees to order on the same day each week. They get their delivery at approximately the same time of the same day each week. Dealing with one supplier, lodging one order, receiving one delivery is extremely efficient. It is easy for franchisees. It is our system. It saves wages and allows franchisees to effectively roster staff.

Franchisees are able to check the delivery is correct. Franchisees cannot be in their stores all day every day of the week. If there are numerous deliveries franchisees will have to rely on staff to check deliveries. I understand short deliveries (due to store owners not checking that all products ordered are in fact

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delivered) accounts for a large percentage of "stock shrinkage" in retail outlets. Using UNS helps alleviate this problem.

Managing taking numerous deliveries each week from different suppliers will add a complexity to our operations that is unnecessary and will result in inefficiencies and add to the cost of running a store. It will result in franchisees spending too much time on ingredient buying, delivery and rotation rather than on selling, which is where franchisees stand to make large gains in profitability. Multiple deliveries, especially from different suppliers, will be too difficult for many franchisees.

Good franchising systems follow the "kiss" principle. Our system is simple. That is a real benefit that most of our franchisees recognise.

Franchisees are able to receive more than one delivery per week, but most should not have to. In fact, some stores, by following the system and organising production are able to order ingredients every 2 weeks. Some of the larger turnover stores in Victoria, in response to storage issues, especially for cream, do get 2 deliveries per week.

At the Qld Franchise Strategy Committee meeting on 9 November, in response to issues around thickened cream, TCS agreed to look favourably at any request for 2 deliveries per week from stores that need 2 deliveries.

### Specific questions

1. Why we require franchisees to buy from UNS, which effectively means from TCS

There are numerous reasons, some going to the heart of our system.

TCS franchisees are people with different degrees of business acumen. Many would not be able to negotiate prices with suppliers. Those franchisees would suffer significantly if UNS did not exist to do the purchasing, deal with supply issues, deal with quality control issues and complaints generally.

As stated above, it is efficient in terms of labour cost to have one on-line order placed at the same time each week, one delivery at the same time each week to check, receive and store. In any event, that is the TCS system that franchisees have acquired.

Many ingredients are shipped by suppliers into the UNS warehouse in Sydney. Nearly all ingredients from overseas land in Sydney and are delivered to UNS in Sydney where the ingredients are unloaded and warehoused. They are then transported to Victoria and Queensland for distribution to franchisees in Queensland, Victoria and South Australia.

UNS, as with all wholesalers depend on volume for profits. With greater volumes over the last year, UNS has been able to hold prices. Holding prices helped increase volume. On a strictly confidential basis, we can show you the UNS price list for the Eastern states as at 1 December 2008 and the price list as at 1 November 2009. Basically, our competitive prices resulted in increased volumes.

UNS depends on volume to negotiate prices with suppliers. Other suppliers will "cherry pick" or offer loss leaders to our franchisees. If franchisees are able to buy from other suppliers, then UNS is not able to negotiate prices for all franchisees at as low a price as possible because UNS is not able to guarantee volumes to the suppliers. If UNS stops supply, prices will rise, and franchisees will have to either suffer decreased margins or put their retail prices up to cover the

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decreased margin. The public will be forced to pay more, or franchisees will be less profitable. If retail prices rise, sales volumes will decline.

It is in TCS's interest to keep ingredient prices low. The lower the ingredient prices, the less pressure on franchisee margins. The less pressure on margins means lower selling prices, which means franchisees sell more finished product. The more franchisees sell the more royalty they pay and the more ingredients they buy. Franchisees will be more profitable if they sell more, and will get good prices for their stores when they want to sell. The more profitable the stores, the more new franchises TCS will be able to sell. The price issue has to be looked at in conjunction with continuity of supply and price takes secondary importance to maintaining quality and safety standards across the network. The ACCC will see that the processes and strategies we have implemented are consistent with and support this approach.

The ingredients that UNS sells are commodities that can have significant price variations. To ensure supply, it is sometimes necessary to lock in prices with suppliers. While this creates certainty for franchisees and they are able to budget accordingly, sometimes prices fall after UNS locks in what are good prices at the time. If franchisees are able to buy from whomever, whenever they are able to get a lower price for a particular product, then UNS will not be able to negotiate and lock in prices for the group. Needless to say, when UNS is able to lock in really good prices, franchisees buy from UNS.

The ACCC will be able to look at the movement in the world wide price of sugar over the last 2 years, and see our price to franchisees over the last year. In the last few months there has been a shortage. We have been told by our supplier that it has decided not to sell to customers who do not have contracts with it.

Guaranteed supply of ingredients such as sugar, cream and flour at reasonable prices is critical to the success of our stores. The consequences for our network of cake shops of an inability to get supply (at all or at other than reasonable prices) of essential ingredients such as sugar, cream and flour to make our cakes are unthinkable.

We cannot risk our stores not getting supply of quality assured product. We cannot have our system and all franchisee's stores being put at risk by having stores buy elsewhere. Our quality control systems work. We find out about problems when they occur. One store in Queensland has recently informed us that there is an issue with some frozen product being delivered to the store by the contractor UNS has engaged to deliver ingredients to the store. On becoming aware of the issue, UNS has advised the store that the store does not have to purchase some frozen product from UNS until UNS has solved the problem.

Suppliers change specifications of product from time to time. If franchisees buy from third parties, we will not be able to check if specifications remain the same. Our ingredient and nutritional information and labels may then be incorrect, thus creating health and safety concern, as well as quality issues.

Many of the products that we supply are unstable in the sense that they are susceptible to contamination if not handled appropriately and kept under strict temperature controls. If franchisees are able to acquire product from a myriad of suppliers, it will be too difficult for us to keep control of standards, which is essential for a franchised system. We do not have the resources to check on delivery mechanisms of all suppliers who may want to deliver individual ingredients to any or all of our 185 stores across Australia. We do not want to risk public health

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and safety. To have numerous suppliers to check on would be impossible to administer and even if we could, it would be a financial burden TCS cannot afford.

Getting the lowest price for a limited period of time with a supplier who may or may not be selling a "loss leader" and who may not have the systems for delivery that we require, is not the priority. Guarantee of supply at reasonable and not necessarily the lowest price, of quality ingredients delivered in a way that preserves the quality of the ingredients and ensures the ingredients are safe to use and produce quality cakes that are safe to consume is what is vital.

At a meeting of our Queensland Franchise Strategy Committee, the issue of compulsory buying was raised. The franchisee representatives, by majority, endorsed the buying strategy. They saw the benefits of the compulsory buying. The franchisee representative who did not support the endorsement resigned from the committee.

### 2. Review of supply arrangements

Supply arrangements are constantly under review and we have processes to ensure that this occurs.

Our UNS state managers meet monthly. At those meetings they review supply arrangements to franchisees. This includes service standards of UNS as well as price and supply issues from suppliers. Our senior management team also reviews these arrangements monthly. We have referred earlier in this letter to the review earlier this year to competitor prices.

Earlier this year we strengthened our procedures by giving one of our state managers overall responsibility for purchasing and supplier relations. This includes managing issues such as ingredient quality, supply reliability and price.

Product complaints are reviewed by State Managers individually and with the benefit of access to all complaints lodged nationally. Product complaints are coordinated nationally by the manager responsible for purchasing to see if certain product complaints are isolated incidents or whether there is evidence of a batch problem or some wider system issue with specific products or suppliers to UNS. These processes ensure we review the quality of our ingredients into store.

We have a test kitchen where we constantly test new products and ingredients. The process for changing ingredient specifications is a lengthy one. It requires testing of the ingredients, manufacturing a range of products and checking those products for quality. Occasionally, ingredient listing information has to be amended and distributed to franchisees. Some products may require laboratory testing. As an example, we have been testing various types of chocolate for the last 6 months and are just about in a position to move. The next steps are the administrative ones relating to documentation.

Our processes for testing and approving ingredients and suppliers involve coordination between UNS and the test kitchen run by TCS.

At franchise meetings around Australia, we have constantly requested franchisees to let us know the prices of ingredients being offered to them, as we can use this information to approach our suppliers to improve our buy prices. The whole network might benefit. Two weeks ago we were told a franchisee could buy condensed milk for \$10 less per box. We asked for the name of the product, supplier and actual price. I have not been given the information. If we receive the information we have the processes to review the information.

That franchisee continues to buy from the alternative supplier, and keeps secret the information that we might be able to use to help the network. The ACCC might ask why we have not received this information. It may be that the product is of an inferior quality. Unfortunately, we do not know.

We set out a few examples of how implementation of these procedures has resulted in benefits to franchisees in terms of quality, good prices and continuity of supply:

- We were given information by the network about prices charged by Bakery Sugarcraft and our purchasing manager instituted a process that resulted in significant price reductions for our franchisees.

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- We learned about quality issues (via our franchisee) with our shredded cheese. Our purchasing manager had discussions with the supplier. We changed suppliers. Before we did so, UNS had detailed discussions with the new supplier about quality issues. UNS was reassured by the new supplier that the \$1m dollar upgrade to the factory would ensure that the new supplier would not have the same quality problems that the then current (now former) supplier had. [REDACTED]
- In relation to thickened cream, UNS has had numerous meetings with our current supplier, Bulla. We have been having quality issues. Bulla has been an excellent business partner, being the supplier for over 15 years. However, price and quality has over the last year become an issue. Having said that, during a dairy shortage earlier last year, we were able to supply all franchisees as a result of the strength of the relationship with Bulla. Bulla could not supply all our needs, but gave us enough so that with minimal topping up from other suppliers, we were able to supply the network. Some of Bulla's customers did not get any thickened cream from Bulla. Bulla has told us that they lock in prices 6 months in advance. When dairy prices rose 18 months ago, our franchisees benefited from Bulla's buying policy. Conversely, when dairy prices are falling, our franchisees do not get the benefit of those prices. However, changing suppliers constantly chasing the best price will jeopardise supply in times of shortage as suppliers will support their loyal customers. TCS and all franchisees had the benefit of this last calendar year.
- In response to thickened cream being dumped into the Queensland market, we commenced negotiations with 3 national suppliers. [REDACTED]  
[REDACTED] From our discussions with alternate suppliers offering further reductions, UNS was not confident that the Queensland manufacturer would be able to guarantee supply to the Queensland network, let alone the whole of Australia.  
It is important when negotiating price to be able to offer "guaranteed" quantities. UNS can only do this if franchisees are locked into buying from UNS. UNS is changing the supplier of thickened cream. We have not signed on the dotted line yet, but we have agreement in principle with a supplier that will enable us to offer thickened cream prices to franchisees in Queensland [REDACTED]  
[REDACTED] Franchisees will benefit from the reduced prices UNS has negotiated. The proposed new supplier has indicated it will hold the price to UNS for 2 years.

### 3. Negotiation with non-approved suppliers.

Franchisees are able to negotiate prices, but are not allowed to buy from non-approved suppliers. The reasons are as stated above. Essentially they relate to safety – product handling, safe delivery systems; product quality; guarantee of continuity of supply; our freight costs will escalate if we do not maximise the quantities of ingredients sold with each delivery; and prices from suppliers will increase if volumes drop, and our prices to our franchisees will rise, putting pressure on sale prices of finished products.

We try to consent where possible to requests from franchisees to buying emergency supplies of some product, especially regional franchisees.

Recent examples of franchisees seeking approval to purchasing from alternate suppliers include:

- The [REDACTED] franchisee requested through the [REDACTED] Franchise Strategy Committee on 9 November formal approval to buy fruit and vegetables locally, cleaning chemicals other than from Jaso!, drinks from the local Coca Cola Amatil representative, candles and edible images other than through Bakery Sugarcraft, and thickened cream locally. The response was that TCS would need the request in writing (by giving us a copy of the email) so we knew exactly what we were being asked to do and it was agreed that the request would be put to the [REDACTED] master franchisee who would pass it onto TCS head office. Unfortunately, to date TCS has not received any written request.

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- At the same meeting there was a request from the [redacted] franchisee asking about a possible change from the vegetables and the bacon currently used in quiches. After much discussion, the consensus view (including that of the franchisee representatives) was that the existing ingredients were satisfactory. Accordingly, we did not take this any further.

We do not want as franchisees those who put short term price gains ahead of their long term viability, the long term viability of the system and of all franchisees by using alternate suppliers and non approved ingredients. They are not team players and if we cannot change their approach, then we do not want them in the system. At this stage a possible consequence which we have mentioned is to not renew their franchises.

#### 4. Rebates

Proper disclosure is made in Par 9 of TCS's disclosure document. While not legally required to do so, all rebates are placed in the National Advertising Fund.

#### 5. Benefits of cost savings.

If UNS supplies ingredients and the franchisees efficiently follow the TCS [baking, storage and stock rotation] systems, franchisees are able to achieve sales under the The Cheesecake Shop name and logo that result in a cost of goods of around [redacted]. This is significantly lower than industry standards. That is a significant benefit. We have referred to other examples in this letter of how franchisees have benefited from cost savings as a result of UNS being able to use volumes as a negotiating tool.

The TCS system, including the supply of ingredients, is pro - competition. Actual evidence of this is that the retail prices our franchisees charge are significantly less than the prices Michels, our major competitor, charges for similar cakes. This would not be possible if UNS charged more than a market price for the ingredients.

#### 6. Other information

In summary, we believe there are significant benefits in having one supplier, and that supplier being UNS:

- Our one order and one delivery strategy saves franchisee's time, saves wages, saves book-keeping and accountants fees,
- Franchisees only need one supplier account
- "One supplier" is an essential and integrated part of the The Cheesecake Shop system. The on line order system is part of the franchisees "store manager" system.
- It keeps our system simple and user friendly for all franchisees and for TCS
- Quality of ingredients into stores is assured.
- We know nutritional information is correct
- We know only tested ingredients are used
- There is competitive pricing
- Our system, of which the one supplier policy is a part, enables significantly lower cost of goods than the industry average

We trust this information is sufficient to satisfy the ACCC that the benefits of having one supplier to all franchisees outweigh any perceived detriments.

Yours Sincerely

David Meagher  
Chief Operating Officer  
R&W Traders Pty Ltd









