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## Competition Commission Inquiry Response to Tesco's Position on Geographic Market Definition

### Summary

This paper reflects Sainsbury's views on Tesco's approach to geographic market definition addressed in the CC's recent Working Paper on Market Definition (published in May 2007). Sainsbury's commissioned RBB Economics to review the Tesco model and their conclusions are set out in a separate paper (to be published on the CC's website).

Sainsbury's believes that the CC's approach to geographic market definition is consistent with the standard "SSNIP test" approach set out in the guidelines of the CC, as well as the competition agencies in the EU and the US. The CC has sought to gather a range of evidence and undertake a series of analyses to understand the actual behaviour of customers and retailers, in order to draw inferences about market definition.

However, Sainsbury's disagrees with Tesco's approach, which applies a single, highly theoretical quantitative model that requires the use of a number of simplifying assumptions that do not reflect the realities of grocery retailing. Tesco claims, based on its analysis, that the relevant geographic markets are at least 30 minutes' drive time wide. This result is contrary to the weight of evidence assembled by the CC in this and previous inquiries, and the assumptions invalidate Tesco's findings.

### Sainsbury's View on Market Definition and the SSNIP Test

One of the key aspects of the Inquiry is the definition of the relevant geographic market, which provides the framework within which to assess competitive constraints. The CC's guidelines note that:

*"The generally accepted conceptual approach to market definition used in many jurisdictions is the SSNIP Test (also known as the hypothetical monopolist test). The Commission will adopt this approach wherever it is feasible to do so."*<sup>1</sup>

The SSNIP Test is a universally-accepted framework for market definition and the preferred approach to defining geographic markets. However, as noted by the CC in its guidelines:

*"...it is generally not possible to apply the SSNIP test in any direct sense, that is to say actually observing a 5% increase across the products concerned and identifying the consequences ... Given this, it is usually necessary for the Commission to infer, from whatever information is available or can be collected, what the likely outcome of the SSNIP test would be. This can then be used to determine market definition."*

A range of information should be examined to predict how customers would actually react to a SSNIP. A quantitative model, such as that constructed by Tesco, would have value as one piece of evidence, but only if the simplifying assumptions required to make quantification possible do not distort or disregard important aspects of customer or retailer behaviour.

### The CC's Methodology

In the past, the CC has considered a number of different types of evidence, including a review of the catchment areas used by retailers in their business planning; a consumer survey aimed at identifying customers' willingness to travel to visit alternative supermarkets; and a discrete choice model that econometrically estimated cross-elasticities between stores.

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<sup>1</sup> Paragraph 2.2, Market Investigation References: Competition Commission Guidelines, June 2003

The CC has, for the purposes of this Inquiry, also undertaken a margin-concentration analysis and a store entry analysis, which use information on the actual behaviour of customers and retailers to predict the likely outcome of a SSNIP test.

This methodology is consistent with the CC's obligations under the Enterprise Act.

### **The Tesco Model**

In response to the CC's Emerging Thinking, Tesco has published a paper on the definition of the geographic market in which it presents a SSNIP analysis based on a quantitative model. This model attempts to predict customers' response to a 5% price rise – that is to say, whether individual customers would switch to an alternative store, and whether this would make the imposition of the price rise profitable or not.

The model submitted by Tesco uses two simplistic quantitative drivers to predict how customers would behave in the event of a 5% price rise. The first driver is the increased cost to individual customers caused by the price rise, based on an assumed range of basket sizes. The second is the incremental cost of travel if the customer were to switch to an alternative store. Customers are therefore assumed initially to choose their closest store, and to decide whether to switch away from that store in response to a SSNIP based solely on the cost of travelling to their second closest store.

Tesco claims that the model demonstrates that grocery retailers compete in markets which are at least 30 minutes' drive time wide and that the geographic market may, as a result, be national.

The modelled assumptions do not reflect the reality of grocery retailing and ignore the many qualitative factors that customers consider in choosing where to shop, including customers' perception of the overall offer, the size of the store, the facilities provided, familiarity with layout and other factors.

RBB found that a number of the assumptions made may be expected systematically to bias the results towards overly wide geographic markets. These are explored in more detail in RBB's separate paper and summarised below.

#### ***Failure to account for price flexing***

Tesco's quantitative model assumes that prices, quality, range and service are, and will remain, the same in every store. This assumption, which is not justifiable on the facts of the grocery industry, is critical in driving Tesco's finding that the geographic market is at least 30 minutes' drive time wide. The introduction of price/offer flexing into Tesco's quantitative model would lead to significantly narrower markets than claimed by Tesco. In the case of the Brixton example cited by Tesco, RBB's analysis shows that the extent of the market falls from 30 to no more than 15 minutes' drive time, and that the number of competing stores falls from more than 45 to six.

#### ***Failure to include smaller baskets***

Tesco has assumed that only those transactions representing more than 60% of a household's average weekly grocery spend are one-stop shopping transactions. Tesco does not attempt to model the remainder. On this basis the model disregards half of the transactions made at grocery stores, accounting for around a quarter of turnover. Tesco asserts, without justification, that these excluded sales will exhibit identical behaviour to those included. However, it is reasonable to assume that these customers would behave very differently due to their smaller basket sizes.

#### ***Over-simplification of travel cost***

Tesco's model assumes that the entire population of the UK faces an equal cost of travel, the value of which is derived from an undisclosed internal study. This contradicts the standard intuition that customers' value of time will rise with their income. As grocery expenditure will also generally rise with income, the most valuable customers will be the least likely to switch in response to a SSNIP. Tesco's assumption of a single cost of travel will therefore generate a bias towards more customer switching and therefore wider markets.

## **Conclusion**

Tesco's model is underpinned by unrealistic assumptions. Sainsbury's therefore believes that Tesco's findings must be disregarded in favour of the array of other information gathered by the CC, which is consistent with the observed behaviour of customers and retailers.

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