

NO LOCAL INCUMBENCY ADVANTAGES (4 DECEMBER 2006)

1. INTRODUCTION

1.1 It has been suggested that local incumbent retailers (retailers who already have a store in a particular locality) have an advantage over entrants (retailers not present in that locality) in acquiring and developing sites, and hence that there is a local incumbency advantage. We believe that there are five possible ways in which incumbency advantages could arise in theory.¹ However, this paper shows that none of these hold in practice.

2. KNOWLEDGE AVAILABLE IN THE MARKET

2.1 This suggestion was made in the Barker Review: “*the complexity of the planning system promotes insider-power, as incumbent firms are able to exploit their knowledge of the system when making applications and objecting to proposals from competitors*”.² There is no evidence for this view. There is no area of the process which requires specialised local knowledge that is not available in the market.

- (a) **Finding sites.** Retailers use buying agents to scour the property market to find properties that may be of interest. There are hundreds of different buying agents available. Buying agents openly advertise their services in publications such as *Property Week*, *Estates Gazette* and *Retail Week*. Retailers will themselves advertise their need for sites in the same publications, to ensure that buying agents are informed of their property objectives. We have a central site acquisition team that interacts with the buying agents and does not rely upon insights from local stores.
- (b) **Developing a site for retail use.** All the skills necessary can be purchased in the market. Such skills include architects to design the site and quantity surveyors to understand the costs of the development.
- (c) **Site valuation.** All the skills required – for sales forecasting and investment appraisal – are non-proprietary and readily available. There are external consultants that can help with sales forecasts. Investment appraisal models use standard discounted cashflow techniques.
- (d) **Planning system.** Retailers use external town planning consultants to help them make their representations, as well as using the knowledge in our central site acquisition team. There is no advantage in trying to develop relationships with planning officers. Local planning authority personnel (both members and officers) are required to act in an unbiased way in the assessment of any individual planning application. Council officers are required to abide by a code of professional conduct and council members are required to abide by the recommendations of the Nolan Commission.

¹ Some of these hypotheses were put to Tesco by the Competition Commission (CC) others in main and third parties' submissions on the CC website.

² Barker Review, paragraph 1.22 (see also paragraph 5.13).

2.2 If a retailer did not have the skills that it wants in-house, there is an active labour market through which people with the necessary skills can be hired. Several senior property staff have recently moved from us to Wal-Mart/Asda and Sainsbury.

2.3 To explore whether there is an advantage empirically from a local presence, we have looked at whether our existing presence in a local area helps us to forecast sales more accurately. The evidence shows that it has not - where we have had an existing presence there has been no statistically significant improvement in sales forecasts.

2.4 Moreover, there are some sources of incumbency disadvantage. A key disadvantage is the impact of lobbying activities on the political appetite for development.

3. LOCAL ECONOMIES OF SCALE ARE IMMATERIAL

3.1 It could be argued that there are local economies of scale which would allow existing retailers to develop new sites close to existing stores more profitably. For example, there could be distribution economies that result in clusters of stores being more efficient to operate, or management structures that cover a local area so that these overheads can be shared. This is not the case. There are no material local economies of scale.

3.2 With regard to distribution, each of our depots typically delivers to a large number of stores, which cover a wide area of the country. There is minimal incremental benefit to having a new store in a particular area. In any case, distribution services can be sought on the open market from providers such as Excel, Wincanton and Eddie Stobart.

3.3 With regard to local management, we have area management teams which cover an area much wider than the isochrones that the CC has previously used. The extent of this management tier is extremely small and as such are not a material cost with respect to any local economies of scale.

4. BIDDING INCENTIVES DO NOT FAVOUR INCUMBENTS

4.1 It has been suggested that incumbents have an incentive systematically to overbid for sites compared to a new entrant in order to preserve their existing position and profits. This suggestion is based on results from simple theoretical economic models and not supported by evidence. However, adapting these models to the situation of the grocery retail market shows that predictions of incumbency advantage do not hold. This finding is supported by empirical evidence.

4.2 If the incumbent could use a site more efficiently or gain more sales from it than an entrant, then the incumbent would be expected to win the site. This is simply the property market at work. The first theoretical incumbency advantage argument relates to the danger of cannibalisation if the entrant wins the site, potentially giving the incentive for the incumbent to outbid the entrant to avoid this cannibalisation. This approach is too simplistic. If the incumbent wins the site, it will cannibalise the sales of its own stores in exactly the same way. Only if the entrant would cannibalise the

incumbent more than the incumbent would cannibalise itself would there be an incentive to outbid the entrant (other things equal).

4.3 This theory is not supported by the evidence. On a like-for-like basis, a new Tesco store cannibalises an existing Tesco store more than does a rival store. .

4.4 If anything, there is an “incumbency disadvantage” – we are less likely to bid for sites in areas where we have existing stores. This is shown by an analysis of where we have opened new stores. From 2003-2006, a majority of our new “one stop” stores were introduced into areas where there was no existing Tesco.

4.5 It has also been suggested – using a very simple theoretical economic model – that a new entrant would increase the competition in a local area and reduce prices. The incumbent’s desire to keep the entrant out would be strengthened by this factor. However, this argument has no practical relevance to the grocery retail industry.

(a) First, we operate national pricing, and so price levels are unchanged whether or not there is a new entrant.

(b) Second, the theoretical economic model on which these arguments are based (see paragraph 4.9 (b)) relies on specific assumptions which do not hold in the grocery retail market. Standard models only predict that this situation exists for the case of existing monopoly areas. We do not believe that there are any Tesco stores which have a local monopoly position.

4.6 There is no evidence that we have an incumbency advantage in bidding for sites. The arguments that have been presented are not theoretically robust and do not hold in practice.

5. ACCESS TO FINANCE IS AVAILABLE TO ALL

5.1 It has been suggested that access to finance gives incumbents an advantage, since only they can take on large and complex developments. This argument does not appear to be relevant to local incumbency since it is not clear why an existing position in a local area would provide better access to finance. However, even if this suggestion was a concern more widely, we do not think that it is realistic.

5.2 Grocery retailers are sufficiently large to be able to access finance from their own resources on the capital markets. For instance, Wal-Mart/Asda has a credit rating of AA, Tesco A(+) and Sainsbury BBB. All these are “investment grade”. Other grocery firms such as Aldi, Lidl, Waitrose, Somerfield and Morrison have turnovers of several or tens of billions and are similarly unlikely to find it difficult to find finance.

5.3 For those retailers who choose not to purchase sites themselves, there is a strong and active commercial property market with developers who can and do finance and then lease stores to new entrants. These developers are highly capable of assembling sites and carrying out complex activities such as site decontamination. Access to finance for these developers is unlikely to be a problem. For example, British Land has a credit rating of BBB.

5.4 It is important to distinguish the ability to raise finance from the desire to do so. The extent to which a retailer would choose to raise finance in order to expand its development opportunities depends on that retailer's wider strategic objectives and anticipated performance in the retail market. A retailer with relatively poor expected return on capital employed from its grocery retail operations would struggle to justify raising capital for further investment in growth.

5.5 For instance, we believe that Sainsbury neglected the property market for a number of years. However, as Sainsbury has started to improve the operation of its stores, it has discussed re-entering the property market³. An article in Property Week (7 November 2006) stated that: “[Sainsbury CEO Justin] King... reflected that Sainsbury's had been 'off its game' for too long in retail property. It did not open a new store between April 2004, in Seldson near Croydon and Cheltenham this autumn, a situation King never wants to see repeated again. It now wants to grow by 5% or 750,000 sq ft a year... Sainsbury's is now shaking up its property activities, and King revealed that so far it has plans for 14 new supermarkets and 50 convenience stores for 2007-08. It has also spent £725m since September 2004 on refurbishment”.

6. THE PLANNING REGIME IS APPLIED EQUALLY TO ALL

6.1 It has been suggested that both the need test (meaning the policy requirement set out in PPS6 at paras. 3.8-3.11) and the vitality and viability test (part of assessing retail impact as set out in PPS6 paras. 2.34-2.38 and 3.20-3.23) inherently favour incumbent retailers in the acquisition of additional sites. We do not think that either test provides an incumbency advantage. This is because all the key aspects of the planning regime, including the need test, are applied equally to all retailers and do not benefit incumbents over entrants.

6.2 To provide further detail, there have been two arguments made in relation to whether the need test favours extensions over new stores.

- (a) It has been argued that the sales density applied to new extension floorspace is only 40% of that applied to new stores and so less “need” is required. This happens because the sales density of extensions is lower than that of new stores. When making a planning application for an extension, an incumbent retailer will take this into account. A new store taking up the same amount of need would be treated identically by the need test.
- (b) It has also been argued that once an extension has been granted on the basis of 40% sales density, that extension counts as having 100% sales density when it comes to assessing the need available to a subsequent store. This does not appear to be correct. We are not aware of this situation ever having arisen. We have checked 34 planning objections we have made since 2003 and have not made this argument in any case. If the Local Planning Authority had ever suggested this, the applicant could simply point to the assumption made in the previous planning decision – whose records are in the public domain. This issue is also a matter of fact and evidence and is open to question on any individual planning application.

³ J Sainsbury press release 2 August 2006: “Sainsbury acquires stores from Somerfield”.

6.3 The application of the need test is a matter of fact and evidence. It is open to question and demonstration as part of the planning process in any case. It is not a policy or legal assumption or presumption.

6.4 It has also been argued that the vitality and viability test (as set out in the Retail Impact Assessment) is more easily passed by extensions rather than new stores since their trading patterns are more easy to predict. This is incorrect. Local planning authorities and their town planning consultants are experts at assessing this test and we are aware of no evidence that it is easier to assess extensions rather than new stores. Even if the test was easier to assess, it would not necessarily make the test easier to pass – it may equally make it more difficult.

6.5 For completeness, it is important to note that we have submitted⁴ that the planning regime (and the need test in particular) provides a source of unnecessary complexity and cost for business – a concern which is quite distinct from the alleged competition concern which is being discussed here, namely that the planning regime results in an incumbency advantage. The subjective nature of the needs test makes it difficult to assess and makes navigation through the planning process more difficult. So abolishing the needs test is something worth looking at.

7. CONCLUSION

7.1 This paper shows that there is no source of local incumbency advantage. There is nothing to stop entrants and incumbents “competing on the merits” for any new sites that arise, which would allow the consumer to decide the right balance of stores in any area.

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⁴ We see the main adverse effects in the current regime as delay and increased costs arising out of inefficiencies brought about by complexity.