

Observations of Morrisons on the Competition Commission's provisional decision

1. INTRODUCTION

- 1.1 This memorandum sets out Morrisons' comments on the Commission's provisional decision of 16 July 2009 ("the Provisional Decision").
- 1.2 Morrisons' main concerns with the Commission's Provisional Findings relate to its assessment of the application of the Competition Test ("the Test") to extensions, particularly small extensions of up to 300m² grocery sales area ("GSA").
- 1.3 This memorandum is divided into three sections:
- (a) Section 1 considers the Commission's approach to assessing the costs and benefits of the Test as regards extensions, particularly as regards small extensions. Morrisons considers that the Commission's approach to small extensions overstates the benefits of the Test and understates its costs;
 - (b) Section 2 addresses the appraisal of the costs and benefits of the Test in relation to small extensions. In Morrisons' view, even adopting the Commission's modelling, it is clear that the Test would not yield net benefits in relation to small extensions; and
 - (c) Section 3 considers the appropriate scope of the Test and proportionality. Given that the Test is unlikely to yield net benefits as regards small extensions, Morrisons considers that it would be disproportionate for the Test to apply in such circumstances.

2. THE COMMISSION'S ASSESSMENT OF THE COSTS AND BENEFITS OF THE TEST IN RELATION TO EXTENSIONS

- 2.1 There are three key steps in assessing the magnitude of the costs and benefits of the Test in relation to extensions:
- (a) the consumer benefits of extensions by a "strong" incumbent (i.e. one which would fail the Test by virtue of its market share exceeding 60 per cent after the extension) to adopt the Commission's terminology¹. If competitive entry/expansion does not occur or is delayed, then these foregone consumer benefits represent the consumer costs of the Test from unmet demand;
 - (b) if the incumbent were to be prevented from extending an existing store, what entry/expansion opportunity would this provide to a new entrant or an existing "weak" incumbent (i.e. one which would pass the Test as its market share would remain under 60 per cent) and what consumer benefits such entry/expansion would yield. The incremental consumer benefits of competitive entry/expansion over and above the consumer benefits arising from the incumbent's extension represent the benefits of the Test; and
 - (c) the likelihood of competitive entry/expansion occurring, and whether there would be any delay before it occurs, with this determining whether the benefits of the Test outweigh the costs.

¹ See footnote 24 on page 20.

(a) The consumer benefits of extensions by a "strong" incumbent

- 2.2 At the all parties meeting on 17 June, Tesco observed that the Commission's approach of treating extensions as reducing marginal costs did not capture the fact that extensions increased the appeal of the store both in absolute terms and due to the increase in the range of goods sold. In its memorandum of 19 June, Morrisons indicated that it agreed with this view and added that extensions directly increase output, albeit to a lesser extent than new stores.
- 2.3 Accordingly, the Commission's modelling will understate the benefits of extensions relative to new stores, and thus the adverse effects of unmet demand where it arises following a blocked extension by an incumbent not leading to competitive entry/expansion.
- 2.4 A further point is that Morrisons would expect that the consumer gains per square metre would be greater for small extensions than large extensions (the Commission has distinguished between small and large extensions according to whether they have a GSA of under or above 300m².) This is on the basis that the incremental gains per square metre in the appeal of the store (due to range and quality enhancements) and any cost savings from reduced congestion are greater for small extensions compared with larger extensions. However, the Commission derives precisely the opposite result, presumably because it adopts a quadratic cost function, with Table 3 of Appendix B indicating that the benefits of an extension by, for example, a monopoly fascia amount to £119 per square metre for a small extension but amount to £240 per square metre for a large extension (i.e. double the benefit).
- 2.5 Accordingly, the proportionate adverse effects of unmet demand where it arises due to a blocked small extension will be further understated.

(b) The entry/expansion opportunity a blocked incumbent extension would provide to a new entrant or an existing "weak" incumbent

- 2.6 The basic rationale for the Test is that, by prohibiting such extensions, benefits may be realised by the Test facilitating competitive entry or expansion which would not otherwise have occurred.
- 2.7 Obviously, unlike a new store, extensions do not remove a new site for a new store. Nor does an extension remove the scope for a new store in a different location to attract new business from those consumers who live near that location. Similarly, one store's extension does not have any bearing on whether there is suitable land available for the extension of another store.

The scope for a new entrant to open a new store

- 2.8 The Commission's assumptions as regards the opportunity for new stores provided by a blocked incumbent's expansion are stated as follows:

"... our base case assumes that, in the single fascia case, an extension of less than 300 sq metres grocery sales area would not be replaced by a new entrant. Our analysis of the 2000–2006 data shows that extensions with around 300 sq metres of grocery sales area have net sales area of around 750 sq metres. We consider that if a store above this size was prevented it would attract a new entrant store of greater than 1,000 sq metres. Our base case assumes that a development larger than the 300 sq metres threshold could attract a new entrant store of greater than 1,000 sq metres net sales area."²

²

Paragraph 8 of Appendix B.

2.9 The Commission further elaborates on this point:

*"... we note that the average size of an extension during 2000 to mid-2006 was around 1,400 sq metres, of which around 40 per cent was groceries sales area (see Table 2). This would, in many cases, warrant the building of a new large store. Moreover, a new store would be in a different location from the existing store and hence likely to attract new customers."*³

2.10 Morrisons agrees that small extensions in terms of their grocery sales area do not materially affect the incentives of another operator to open a large new store. This is because such small extensions will not materially affect the level of unmet grocery demand available for such a hypothetical new store. However, the fact that the overall extension may be larger does not reduce the level of unmet demand for groceries as the Commission appears to assume.

2.11 The Commission's observation that *"... a new store would be in a different location from the existing store and hence likely to attract new customers"* does not make small extensions exclusionary – it means that small extensions will be less exclusionary.

The scope for a weak incumbent firm to extend an existing store

2.12 Obviously, where there is a single monopoly store in a locality there is no weak incumbent store to expand. Accordingly, the Commission states that:

"... we assumed that small extensions (less than 300 sq metres) that would be prevented by the Test would not be replaced by an alternative development in a single store area..."

2.13 Where there are one or more other fascias present, Morrisons is sceptical that a small extension by a strong incumbent would appreciably reduce the incentives of a weak incumbent to build an extension. This is because a small extension by a strong incumbent would not materially affect the level of unmet grocery demand available for such a hypothetical extension. This conclusion is further strengthened by the Commission's observation that *"... our data show that extensions at larger stores (i) add less GSA and (ii) are less intensively traded than extensions at small stores..."*⁴

2.14 Whether such an expansion would be viable for a weak incumbent will depend, inter alia, on whether there is suitable land available adjacent to the store in question; the fact that a strong incumbent has the ability to expand does not mean that a weak incumbent has the ability to expand.

2.15 The Commission's model also assumes that the consumer benefits of extensions are materially smaller where they are made by strong incumbents rather than weak incumbents:

"To compare the impact of extensions from strong and weak incumbents we make the following assumption. Since our data show that extensions at larger stores (i) add less GSA and (ii) are less intensively traded than extensions at small stores, a large store's extension removes congestion to a lesser extent than a small store's extension. We reflect this by assuming that the large store's extension is smaller. In particular, we assume that the large store's

³ Paragraph 4.17.

⁴ Paragraph 83 of Appendix A.

extension is 75 per cent of the size of the corresponding extension by the small store."⁵ [Emphasis added]

2.16 Accordingly, it seems likely that the Commission's estimates of the additional consumer benefits of extensions at small stores are attributable in large part to this assumption – the weak incumbent's store is assumed to be a third larger than the strong incumbent's extension that it replaces ($1/0.75 = 4/3$ or 1.33). The Commission's approach assumes that the only benefits of an extension lie in reduced "congestion", whereas Morrisons considers that store extensions add directly to the appeal of the store, increase the range of products which the store can offer to the benefit of consumers, and increase output.

(c) *The assessment of the frequency at which the costs and benefits of the Test will arise and the likelihood of delay*

2.17 In weighing up the costs and benefits of the Test applying to small extensions, it is necessary to consider the likelihood of competitive entry/expansion occurring to replace a small extension by a strong incumbent which is prohibited by the Test.

2.18 Even taking the Commission's modelling approach as a given, the Commission appears to accept that prohibiting small extensions by a monopoly incumbent would lead to unmet demand with no countervailing benefits⁶.

2.19 As regards extensions where there are competing fascias, the Commission has sought to assess the likelihood of unmet demand by considering retailers' planned extensions:

"We compared retailers' planned extensions with (i) existing stores at mid-2006 and (ii) retailers' lists of areas they would be interested in entering, in order to assess the likelihood of competitors entering or extending in a highly-concentrated local area where an extension would have been blocked by the Test (see paragraph 5.57). Around 85 per cent of planned extensions were in areas where there was already a competitor fascia in the isochrone and around half of these areas also had another retailer that was interested in entering the area. The remaining 15 per cent of planned extensions took place in isochrones where no competitor fascia was present. In two thirds of these cases we found that another competitor was interested in entering the area."

2.20 The fact that retailers have plans to extend some of their stores, of course, does not mean that it is viable for retailers to extend all of their stores. Morrisons assumes that the Commission is not seeking to draw this conclusion, but merely that replacement extensions are "likely" in the "majority" of cases as the Commission adds that:

*"We recognize that this does not mean that retailers would necessarily, in practice, enter these areas. We also recognize that we were comparing 2009 planned extensions and lists of possible future development areas with market data from mid-2006. The results of this analysis show that, in the majority of cases where the Test limited the strong incumbent's extension, a competitor would be likely to enter or expand."*⁸

⁵ Paragraph 83 of Appendix A.

⁶ See paragraph 8 and Table 3 of Appendix B.

⁷ Paragraph 5.60.

⁸ Paragraph 5.60.

"We recognize that there might be site-specific reasons which might affect the likelihood of a weak incumbent extending to replace a strong incumbent's extension that would be prevented by the Test. However, based on the evidence that we received from retailers (see footnote to paragraph 5.62(c)), we thought that, if the weaker incumbent had the incentive to extend, they would be likely to have the ability to do so."⁹ [Emphasis added]

- 2.21 Moreover, the Test only yields benefits if the weak incumbent's extension would not otherwise occur (the Commission describes entry that would occur in any event as "routine" entry).
- 2.22 Even if it is viable for a weak incumbent to extend its store, it may not be able to do so as quickly as the strong incumbent (for example, if the weak incumbent needs to acquire additional land or faces specific operational issues associated with its extension disrupting sales at its store). As Morrisons observed in its memorandum of 15 June, given that retailers are all free to extend their stores, the fact that they have not put in a planning application before the incumbent does so (which are the circumstances in which the Test applies) means that:
- (a) it is unreasonable to assume automatically that such extensions would be as viable or rapid for rivals; and
 - (b) there will at least be significant pre-planning work that the weak incumbent is unlikely to have done.

Accordingly, in Morrisons' view, the Commission's assumption that there would be no delay whatsoever before a weak incumbent implements its own extension cannot be described as a conservative assumption.

- 2.23 This suggests that there should be some sensitivity analysis carried out to take account of delays before an existing competitor opens its extension, or to take account of the possibility that a replacement extension does not in practice take place. This is the approach the Commission applies as regards the overall application of the Test. In particular, it has modelled the impact of there being a four-year delay to replace any extension prevented by the Test (whether through entry or extension). This is the approach adopted in the next section to assess the impact of the Test on small extensions.
- 2.24 Finally, Morrisons notes that the Commission also states that "... *the Test is designed to be predictable*"¹⁰, with an important element of this being the measurement of competitors' sizes to apply the market share element of the Test. In this regard, the Commission expresses the view "*that in practice retailers will be able to measure competitor size sufficiently accurately to predict the outcome of the Test successfully*"¹¹. This is not a view that Morrisons' shares, with size assessments being difficult. The margin for error in market share assessments will be particularly large if there are several stores in a locality.

3. THE APPRAISAL OF THE COSTS AND BENEFITS OF THE TEST IN RELATION TO SMALL EXTENSIONS

- 3.1 In order to assess the costs and benefits of the Test, Morrisons has considered small extensions made by a monopoly fascia and a non-monopoly fascia adopting the Commission's modelling assumptions. For the reasons set out in Section 2, Morrisons

⁹ Paragraph 5.63.

¹⁰ Paragraph 5.51.

¹¹ Paragraph 5.51.

considers that the Commission's modelling overstates the benefits of the Test and understates its costs.

- 3.2 The figures used in this section for the annual costs and benefits of the Test applying to small extensions are the baseline calibration figures set out by the Commission in Table 6 of Appendix A. The Net Present Value ("NPV") calculations use the same methodology as Morrisons understands were employed by the Commission in its "Test base case" spreadsheet, which was forwarded to main party representatives on 23 July 2009. The discount factors applied are the same as those used by the Commission (i.e. a 3.5 per cent discount rate applied at the mid-point of each year), with such discounting being necessary to reflect that a £1 of benefits today is worth more than the same sum in the future. The time horizon of 25 years assumed by the Commission has also been applied. The calculations are set out in detail in Annex 1.
- 3.3 As regards the small extension by a monopoly fascia, no analysis at all is required to conclude that the Test yields no benefits whatsoever as this extension is not replaced. The Test would simply lead to unmet demand. Given the Commission's own estimate that this would lead to an annual benefit of £362,000 per store being foregone, this would lead to a loss in NPV terms over 25 years of £6.1 million per store (i.e. a NPV of -£6.1 million per store).
- 3.4 Turning to a small extension by a strong monopoly fascia where there are other competing fascias, the net effects of the Test depend on the likelihood of a rival's extension replacing the incumbent's extension – deducting, of course, competitor extensions that would have occurred in any event. The Commission estimates that the annual consumer benefit if the extension is built by the incumbent is £300,000 (i.e. the costs of the Test if a replacement extension is not built at all by a competitor or only after a delay) and the annual consumer benefit if it is built by a competitor instead is £381,000. The Commission's model therefore estimates that the incremental benefits of the Test if a replacement extension is built by a rival amount to £81,000 per annum, which the Commission describes as "*relatively small annual benefits*"¹².
- 3.5 The average NPV per store of the Test applying to small extensions where there are competing fascias is summarised in the Table below, which indicates the sensitivity of the average NPV per store to different probabilities of a replacement extension being built and different average delays before such a replacement extension is completed. From this Table it is clear that the Test would harm consumers unless the probability of a replacement extension is very high and is extremely high if there is any delay before this replacement is completed. If the delay was merely a year (i.e. the rival's extension took only a year longer to complete than the incumbent's in circumstances where the rival would not otherwise have built the extension), then the probability of a replacement extension arising would need to exceed 84 per cent before the Test would yield any net benefit at all.

The average NPV per store of the Test applying to small extensions where there are competing fascias

£ '000	Delay (years)				
	0	1	2	3	4
Probability of replacement					
90%	719.3	382.3	56.6	-258.0	-562.0
80%	80.5	-219.1	-508.6	-788.3	-1,058.5
70%	-558.4	-820.5	-1,073.8	-1,318.5	-1,555.0
60%	-1,197.2	-1,421.9	-1,639.0	-1,848.8	-2,051.4

3.6 Concluding that the Test would quickly prompt competitive extensions which would not otherwise occur in the "majority" of cases (as the Commission suggests overall) is therefore wholly insufficient to justify the Test applying in such circumstances. Instead, the Commission must find that the Test would quickly prompt competitive extensions which would not otherwise occur in all bar a small minority of cases. The Provisional Decision contains no factual evidence which would sustain such a conclusion. Even in this hypothetical scenario, the consumer benefits from the Test per store in NPV terms would be very low even over a 25 year period, and the risks of there being net consumer losses instead would be high.

4. THE APPROPRIATE SCOPE OF THE TEST AND PROPORTIONALITY

4.1 The Provisional Decision only considers the Test if it applies in precisely the same form as specified in the Commission's original report¹³. This is notwithstanding that all aspects of the matter have been remitted back to the Commission and specific comments have been made about the scope of the Test as regards extensions and why small extension should not be subject to the Test. The Provisional Decision fails to consider at all whether any changes to the Test would be appropriate given the Commission's assessment of its costs and benefits in various circumstances.

4.2 In its judgement the Competition Appeal Tribunal provided the following guidance as to the assessment of whether a remedy is proportionate, with these criteria being cumulative (i.e. they must all be satisfied for a remedy to be proportionate):

"the measure: (1) must be effective to achieve the legitimate aim in question (appropriate), (2) must be no more onerous than is required to achieve that aim (necessary), (3) must be the least onerous, if there is a choice of equally effective measures, and (4) in any event must not produce adverse effects which are disproportionate to the aim pursued." [Paragraph 137]

4.3 Morrisons does not consider that the application of the Test to small extensions meets these standards. First, the Commission itself accepts that small extensions cannot be replaced at all in monopoly areas, and Morrisons does not believe that small extensions have an appreciable effect on the incentives of local rivals to extend their own stores. Accordingly, prohibiting small extensions is not effective at all at generating consumer benefits and the first limb of the test set out above is not satisfied..

4.4 Secondly, by the same measure, the Test will be more onerous than required if it applies to small extensions.

4.5 Thirdly, extending the Test to small extensions will, as set out above, "*produce adverse effects which are disproportionate to the aim pursued.*" By analogy, finding

¹³ See paragraph 5.88 and 7.2.

that a drug is beneficial overall if prescribed to adults does not justify also prescribing it to children if for children its benefits are limited and the potential adverse effects are severe.

- 4.6 Accordingly, Morrisons' simple recommendation is that the Test should not apply to extensions of less than 300m². by way of an ant-avoidance mechanism, there would not seem to be any difficulty in the OFT adding together a series of de minimis extensions (over say a three year period) in appraising the suitability of planning permissions.

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