

GROCERIES MARKET INVESTIGATION

**PROVISIONAL DECISION ON THE REMITTAL OF THE COMPETITION
TEST BY THE COMPETITION APPEAL TRIBUNAL**

INTERIM RESPONSE OF J SAINSBURY PLC

EXECUTIVE SUMMARY

Sainsbury's initial response to the CC's provisional decision on the remittal of the competition test by the Competition Appeal Tribunal (the "Provisional Decision") is set out below.

1 New stores

Sainsbury's is supportive of a competition test for new stores, which will prevent consumption of scarce land by incumbents to preclude entry or expansion by potential rivals. We believe that the CC's provisional findings with respect to new stores accord with Sainsbury's own business experience, and that the application of the proposed competition test¹ ("the Test") to new stores is likely to result in benefits for consumers.

However, Sainsbury's continues to believe that there will be a need for discretion in the application of the Test by the OFT. While a mechanistic application of the Test would provide the OFT (and retailers) with an initial view of whether there are competition concerns, Sainsbury's remains of the view that, in the event of a failure of the Test, the OFT will need to balance the need for transparent criteria with the need for a level of discretion to avoid perverse outcomes.

2 Extensions

The CC has provisionally concluded that the Test "would deliver a positive value to consumers when the reduction in consumer welfare in the short term is set against the longer-term benefit of increased competition when entry or expansion occurs"². Its base case estimate, using a market model that seeks to estimate the size of the benefit and cost that the Test would produce, is that the net benefit of the Test when applied to extensions³ will be £1.5 billion in NPV terms⁴. A key assumption underpinning this conclusion is that the Test will, of itself, cause rivals to a strong incumbent to enter or expand without significant delay.

Sainsbury's strongly disagrees with the CC's assumptions and findings regarding the application of the Test to extensions, which we consider are flawed in three fundamental respects.

¹ As set out in the CC's Final Report of 30 April 2008.

² Paragraph 8, Summary of Provisional Decision.

³ For the purpose of this response, the phrase "extensions" includes mezzanine developments and on-site replacement stores, in line with the CC's approach in the Provisional Decision.

⁴ Table 4, Appendix B, Provisional Decision.

2.1 Blocking incumbent extensions will only facilitate rival entry or expansion in exceptional circumstances

The CC asserts that “where development by one retailer is prevented, we expect competitors to undertake replacement developments”⁵. The CC’s chain of argument for extending the Test to include extensions assumes that in every case⁶ where an extension is blocked, that prohibition will facilitate either new entry or extension by a smaller incumbent that would not otherwise have taken place. The CC further assumes that such entry or extension will take place without significant delay.

This assumption is flawed in two respects.

2.1.1 The CC substantially overstates the availability of suitable sites for rival entry or expansion

First, the CC pre-supposes the availability of a suitable site for a rival development, and the ability to obtain planning permission for such a development. This assumption overlooks the significant space availability and planning restrictions that characterise the UK grocery market, which are not considered in any detail in the Provisional Decision⁷.

Sainsbury’s has provided evidence illustrating the challenge of finding suitable sites.

2.1.2 The CC’s assumption regarding facilitated entry or extension is not internally consistent

Second, the CC overlooks the reality that a rational potential entrant (or potential extender) would take into account likely reactions by the strong incumbent. Once the rival has made its investment (whether new entry or extension) the strong incumbent may then extend as it originally planned⁸. But if such an extension would render unprofitable the rival’s expansion – as the CC assumes – then the rival may not make that investment in the first place. Conversely, if the rival does enter or extend knowing that the incumbent may then extend its store, it is likely that the rival would have expanded anyway, irrespective of the Test. In short, either the assumed facilitated expansion will not occur, or would have occurred anyway.

The constraint on suitable site availability and the internal inconsistency dramatically reduce the relevance of the Test when applied to extensions, such that it is likely to facilitate entry or extension by a rival only in exceptional circumstances. Sainsbury’s own analysis indicates that, far from occurring in 100% of cases, there was scope for facilitated entry that would not otherwise have taken place to occur in around 5% of these instances. This is significantly lower than the 61% threshold at which the CC has found that the Test ceases to produce net benefits⁹.

⁵ Provisional Decision, paragraph 4.10.

⁶ With the exception of grocery extensions less than 300 sq m. We note also that the CC has subjected this assumption to sensitivity testing, which we discuss further in the following sections.

⁷ The CC states at paragraph 5.63 of the Provisional Decision that “we thought that, if the weaker incumbent had the incentive to extend, they would be likely to have the ability to do so”, citing a number of isolated statements in support of this assertion.

⁸ As its market share would have been reduced by the rival’s entry or expansion, thus enabling it to pass the Test.

⁹ Table 4, Appendix B, Provisional Decision.

2.2 Extension by a strong incumbent will not generally dissuade routine entry or expansion

The CC's rationale for including extensions in the Test is that extensions permit an incumbent to accommodate demand that could otherwise be served by a new entrant or by a weaker incumbent via an extension to its store. The CC's analysis assumes that all extensions by strong incumbents preclude routine entry or extension by rivals (i.e. investments that would have occurred anyway), and therefore that every extension by a strong incumbent will tip profitable alternative developments into unprofitability.

This assumption substantially overstates the sensitivity of retail stores' revenues and profitability to rivals' extensions. Sainsbury's has provided the CC with analysis that indicates that extensions by incumbent stores have a relatively minor effect on the viability of surrounding stores.

Sainsbury's therefore believes that, where suitable sites are available, rivals' decisions to enter or extend will be materially affected by incumbents' extensions in exceptional circumstances only.

2.3 The CC's model relies on *ad hoc* assumptions and is not robust

Even if (contrary to Sainsbury's view), the CC's assumptions regarding facilitated and routine entry are considered plausible, Sainsbury's has also found that the CC's modelling of extensions is not robust to reasonable changes in the assumptions employed.

In particular, Sainsbury's has found that the CC's results are entirely dependent upon the assumption that facilitated entry or extensions will be between 33% and 100% larger than the blocked extensions. This assumption that competitors enter with larger stores / extensions is inconsistent with the assumption that the blocked extension accommodates all residual demand in the local market and thus precludes routine entry. It is therefore logical to consider an assumption that blocking an extension only facilitates entry or extension of a similar scale. Applying this alternative assumption to the CC's market model reverses the finding of net benefits from the Test. The sensitivity of the model to reasonable changes in the assumptions casts further doubt on the robustness of the claim that the Test (as applied to extensions) gives rise to net benefits for consumers.

3 Conclusion

3.1 New stores

Sainsbury's is supportive of a competition test for new stores, which will prevent consumption of scarce land by incumbents to preclude entry or expansion by potential rivals. We believe that the CC's provisional findings with respect to new stores accord with Sainsbury's own business experience, and that the application of the proposed competition test¹⁰ ("the Test") to new stores is likely to result in benefits for consumers.

3.2 Extensions

Sainsbury's strongly disagrees with the CC's assumptions and findings regarding the application of the Test to extensions.

¹⁰ As set out in the CC's Final Report of 30 April 2008.

3.2.1 The model and accompanying assumptions are flawed

As set out above the CC's analysis is seriously flawed in a number of respects. Applying the Test to strong incumbents' extensions will not, of itself, increase the scope for competition in highly concentrated areas (because shortage of demand is not typically a constraint on rival entry or extension); nor will it remove the main impediment to such increased competition (which is the constraints on suitable sites). Sainsbury's own analysis clearly indicates that, if the Test were applied to extensions, benefits to consumers would be generated only in very exceptional circumstances.

In short, applying the Test to extensions would be beneficial only in a "Goldilocks" scenario in which suitable sites are available and demand conditions are "just right". Rather than serving to increase local competition in 100% of cases, as assumed by the CC, the evidence reviewed by Sainsbury's suggests that the Test is likely to result in blocked extensions being replaced by alternative developments in fewer than 10% of cases. This is significantly below the 61% critical likelihood at which the CC's market model predicts zero net benefits from the application of the Test to extensions.

Furthermore, the CC's modelling of extensions is not robust to reasonable changes in the assumptions employed.

Sainsbury's therefore strongly disagrees with the CC's provisional decision (in so far as it applies to extensions) that "the impact of the Test was likely to be substantially positive in terms of our quantitative assessment of benefits and costs in particular local areas."¹¹

3.2.2 Unquantifiable benefits are minimal

Sainsbury's also disagrees with the CC's assertion that the application of the Test to extensions would generate significant unquantifiable benefits.¹² Of the three potential benefits identified by the CC, two (namely, inter-store variety and consumer ability to switch in response to higher prices) would be limited to the rare circumstance in which a blocked extension is replaced by a new store. The third potential benefit is somewhat speculative as it is not necessarily likely that blocked investment would be diverted to alternative grocery developments.

3.2.3 Consumers will be harmed

Finally, the CC provides little support for its statement that "we did not expect the costs of the Test to be significant or to outweigh the benefits that we have not been able to quantify".¹³ It is clear from Sainsbury's analysis that application of the Test to extensions will create substantial costs through preventing those stores that do serve areas of high concentration from improving the facilities and intra-store variety available to those consumers living in areas in which there is limited scope for new and existing rivals to provide similar improvements.

The inclusion of extensions in the Test would therefore result in cost to consumers by restricting quality, range and service, in addition to limiting the operating efficiency of the retail sector and constraining the efficiency of land use (in particular in urban areas) contrary to government policy. Furthermore, the inclusion of extensions within the Test would likely treble the administrative costs for the planning authorities, the OFT and the

¹¹ Paragraph 10, Provisional Decision.

¹² Paragraphs 5.12 to 5.18, Provisional Decision.

¹³ Paragraph 7.2, Provisional Decision.

industry (given the number of applications that would be likely to require notification to the OFT compared to new stores).

3.2.4 The Test should not be applied to extensions

Sainsbury's has provided strong evidence that entry into concentrated markets will not be facilitated by the application of the Test to extensions, other than in exceptional circumstances. Rather, the Test would only serve to deny customers the benefits provided by extensions. Sainsbury's therefore strongly believes that the Test should not be applied to extensions.