

ANNEX 1

SUMMARY OF THE CRITERIA OF THE COMPETITION TEST

(Paragraph [74] of the Judgment)

1. A planning application for a grocery store development within a particular local area (i.e. within a 10-minute isochrone around the store to be developed) will pass the test if:
 - (i) the retailer in question would operate the developed store as a new entrant in the local area;
 - (ii) the total number of fascias in the local area were four or more; or
 - (iii) the total number of fascias were three or fewer and the grocery retailer operating the developed store would have less than 60 per cent of groceries sales area in the local area.

2. A planning application would fail the test if:
 - (i) the grocery retailer was not a new entrant in the local area;
 - (ii) the total number of fascias in the local area were three or fewer; and
 - (iii) the retailer would have 60 per cent or more of groceries sales area (including the proposed development) in the local area.

ANNEX 2

EXTRACTS FROM THE REPORT: THE OBJECTIVE(S) OF THE COMPETITION TEST

(Paragraph [115] of the Judgment)

11.25 “Even with the town centre first policy in place, for large grocery retailers with larger grocery stores we have identified 495 highly-concentrated local markets within a 10-minute drive-time and 209 stores within a 15-minute drive-time (paragraphs 6.14 to 6.19). We do not think that we can rely on this policy alone (despite the consultation paper on PPS4 and the likely amendments to PPS6) to prevent the emergence of such areas in the future or to encourage development that would increase competition in existing highly-concentrated local markets. In order to achieve this, it is our view that a specific focus on the identity of the operator is essential.”

11.26 “Overall, we find that a competition test is necessary to prevent the emergence or strengthening of a strong local market position held by a particular large grocery retailer in respect of larger stores in a local market. To the extent that this represents a ‘cap on growth’, we believe this to be necessary to prevent retailers’ positions in local markets becoming unacceptably strong. ...”

11.27 “We see the competition test remedy as an important complement to our remedies in relation to controlled land and multiple stores (see paragraphs 11.136 to 11.268). While those remedies address barriers to entry in existing highly-concentrated local markets, the competition test will prevent the emergence of areas of highly-concentrated local markets or the strengthening of strong local market positions in the future.”

11.28 “We do not consider it sufficient to rely on the existing merger control regime to prevent the emergence or strengthening of highly-concentrated local markets since the merger control regime can apply only when a grocery retailer acquires a trading store from a competitor.”

11.35 “We remain of the view that a competition test is an appropriate tool for preventing the emergence of highly-concentrated local markets and the strengthening of strongly local market positions in the future. We take the view that the other points raised by the retailers in opposition to the competition test (for example, in relation to the effect on investment, strategic behaviour, regulatory burden, uncertainty, perverse effects and regulatory ‘gridlock’) are best dealt with in the design of the test, which is discussed below.”

11.78 “The objective of the competition test is to prevent the emergence of highly-concentrated local markets in the future and to prevent the strengthening of strong local market positions held by retailers in existing highly-concentrated local markets. We do not wish to impede the development of new or existing stores where overall they are of benefit, and our aim is not to create a situation in which every local market has a certain number of competing fascias. In

particular, we do not wish to prevent new entry into an area but rather we seek to encourage it.”

11.89 “The competition test provides an assessment of concentration in a local market, on the basis of which a decision may be taken about whether a particular development, operated by a particular grocery retailer, would lead to the emergence of a highly-concentrated local market or the strengthening of a strong local market position.”

11.97 “In our view, the competition test should broadly reflect the same principles that we applied to our analysis of highly-concentrated local markets and controlled land (see Section 7). The objectives of the two are, however, different. The competition test is essentially forward looking, whereas our analysis of controlled land sought to identify existing barriers to entry in areas of high concentration.”

11.99 “In our view, when designing a remedy that will have the effect of limiting store development, we should be more cautious than when designing remedies that will remove barriers to entry and hence promote additional output or capacity and so take a more conservative approach in setting the market share threshold of our competition test.”

11.168 “We considered whether highly-concentrated markets were likely to arise in the future, particularly in light of our planning remedy. The competition test is designed to ensure that highly-concentrated local markets do not emerge in the future. However, it will not prevent highly-concentrated local markets arising through store closures or disposals of landsites, and restrictive covenants are often imposed in such circumstances.”

11.266 “We also believe that there is a significant difference between store divestitures and the other remedies we decided to pursue in relation to highly-concentrated local markets. Whilst our other remedies will ensure that grocery retailers have the opportunity to enter a market to establish a new competing grocery store in the future, store divestitures involve the transfer of ownership of an existing, trading store.”

11.267 “In Section 6 (see paragraphs 6.29 to 6.33) we identified two effects resulting from highly-concentrated local markets. The first effect relates to a lower standard of retail offer in the local markets themselves and the second relates to the weakening of those components of the retail offer, such as price, that retailers choose to apply uniformly across all the local markets in which they are present. We believe that the second of these effects will be effectively addressed by the package of remedies we decided to pursue in respect of existing and future controlled landsites (together with the inclusion of the competition test in the planning regime and the requirement on large grocery retailers to notify acquisitions of existing stores in excess of 1,000 sq metres). We decided that the gravity and prevalence of our AEC finding in relation to these markets in respect of the first effect is not sufficient to justify a divestiture remedy.”

11.268 “Divestitures would represent a significant intervention in property rights, as well as being disruptive to consumers. We do not believe that such an intervention is supported by the gravity and prevalence of the AEC we found. Moreover, we note that store development is a continuing feature in grocery retailing, with the four largest grocery retailers having expanded their UK sales area by 38 per cent between 2000 and 2007 (see Table 2 in Appendix 3.1). Given this, it is our view that removing barriers to entry in highly-concentrated local markets and ensuring that store developments do not exacerbate high concentration will be sufficient over time to address the AEC we have found in relation to highly-concentrated local markets so that there is no need for us to require store divestitures. Indeed, store divestitures in these highly-concentrated local markets would not effectively address concentration: they would constitute a very limited and one-off intervention in a large and dynamic sector. We therefore believe that the competition test and the controlled land remedies will be more effective remedies over time than would be store divestitures.”

ANNEX 3

SUMMARY OF THE PARTIES' SUBMISSIONS ON GROUND 2

(Paragraph [134] of the Judgment)

Tesco's submissions

1. Tesco submits that the Commission failed to address the benefit of the competition test and, consequently, failed to balance the adverse effects of the competition test against any beneficial effects it might have. Tesco submits that if the Commission had failed to carry out a cost-benefit analysis, then, as a matter of law, it was not in a position to decide the questions contained in section 134 of the Act. In support of this submission, Tesco refers to (i) the Commission Guidelines; (ii) the Commission's decisional practice in respect of appeals under the Energy Act 2004; (iii) guidelines published by the Office of Communications on "Better Policy Making: Ofcom's approach to Impact Assessment"; and (iv) the HM Treasury publication "Green Book: Appraisal and Evaluation in Central Government".
2. Tesco emphasises that, in its Guidelines, the Commission states that it will have regard to the principle of proportionality when deciding on appropriate remedies and in particular "will consider the effectiveness of different remedies and their associated costs" (CC3, paragraph 4.9). Tesco claims that this approach was followed by the Commission in *E.ON UK Plc v Gas and Electricity Markets Authority*, a case concerning an appeal against a decision by GEMA to direct modifications to the Uniform Network Code, which contains the arrangements for the transportation of gas in Great Britain. In reviewing the cost-benefit analysis of the energy code modification conducted by GEMA, the Commission stated at paragraph 6.157 of its decision:

"Thirdly, we accept GEMA's submission that benefits need not be quantified in order for them to be reflected in a CBA, and that non-quantified benefits may be as important, or more important, than quantified benefits. However, if a CBA is to be transparent, benefits should be quantified where possible. For the same reason, qualitative benefits should be explained clearly and in detail, so that it can fairly be seen whether there is any potential overlap between the qualitative and quantitative benefits."
3. Tesco notes that this statement was expressly approved by the Tribunal in *Vodafone Ltd v OFCOM* [2008] CAT 22 at paragraph [125].

4. Tesco also refers to the HM Treasury guidance on best practice in the appraisal and evaluation of policies and public sector projects contained in “The Green Book: Appraisal and Evaluation in Central Government”. The Green Book is a best practice guide for all central departments and executive agencies, and covers projects of all types and size. It aims to make the appraisal process throughout government more consistent and transparent. The Green Book stresses the importance of identification, quantification and monetary valuation of benefits in order to help assess more explicitly whether government proposals are value-for-money. By encouraging decision-makers to quantify most, if not all, benefits in monetary terms, the Green Book recommends a cost-benefit analysis: projects should only be approved if the present value of benefits is higher than the present value of costs. Tesco relies on the emphasis in the Green Book on quantifying and valuing benefits with the caveat of where it is feasible and practical to do so (and the costs of valuing benefits are not incommensurate with the size of the project) (see paragraphs 5.24 ff). Where it is not practicable to value benefits in monetary terms (as the Commission claims in the present case) Tesco submits that the Commission should have used the techniques suggested by the Green Book, such as estimates, scenarios or sensitivity analyses, in order to elicit approximate values (see paragraphs 5.29-5.30, 5.69, 5.72).
5. Tesco also refers to a document published by the Office of Communications on 21 July 2005 entitled “Better Policy Making: Ofcom’s approach to Impact Assessment”. Section 7 of the Communications Act 2003 provides that OFCOM must carry out and publish an impact assessment where it is proposing to do anything related to the carrying out of its functions and it appears to it that the proposal is important. OFCOM’s guidance describes how it carries out such impact assessment, in particular by quantifying costs and benefits that would flow from each proposal. As with the Green Book, Tesco draws the Tribunal’s attention to passages in OFCOM’s guidance that envisage a rigorous cost-benefit analysis, and even if benefits cannot be quantified (or it is not proportionate to quantify them), they should still be described and taken into account in making a regulatory decision (paragraphs 5.25 and 5.30).
6. Tesco submits that these sources demonstrate the sort of exercise that the Commission, acting reasonably, should but has failed to meet when evaluating proportionality in a

case such as the present. Tesco characterises the Commission’s claim that it could not quantify the benefit arising from the future application of the competition test as an “unsustainable counsel of despair”. Tesco further contends that the inability to identify or evaluate any benefit of the test is, in itself, a powerful indicator of disproportionality. As the various guidance on proportionality described above all confirm, an inability to quantify a benefit does not justify simply disregarding the issue. At the very least, the Commission should have attempted an analysis along the lines suggested by the guidance – for example, broad estimates, sensitivity analyses, scenarios – and then taken a view on what weight to attach to such an analysis. While “spurious accuracy” should be avoided, the difficulty of precise quantification does not absolve a regulator from conducting the next best assessment. The Commission’s failure to properly assess the benefits (as well as the economic costs) of the competition test means that its proportionality analysis is flawed.

7. As regards the putative benefits of the competition test, Tesco argues that the Commission cannot simply rely on its estimate of the extent to which profit margins will be reduced in those highly concentrated local areas where a new entrant opens a new store (referring to paragraph 11.397 of the Report). Instead, the benefits should be measured by reference to the benefit to consumers derived from increased competition brought about by the test on a year-on-year basis. In other words, the Commission should have calculated the reduced profit margins in those local areas where the test would be likely to block or deter store development by an incumbent retailer that would otherwise have gone ahead and a development by a new entrant would take its place. Paragraphs 18-53 of Mr Gaysford’s witness statement suggest how an analysis of the benefits of the competition test might be carried out.
8. Tesco further argues that the Commission’s analysis of proportionality of the test did not take into account the strength, robustness and scale of the AEC that it had found at the local level in certain areas. Tesco takes issue with the Commission placing limited weight on the findings of the GfK and Tesco studies. Those studies indicated that most aspects of the store-level retailer offer did not vary much across local markets. Tesco submits that the Commission’s concerns about those aspects of the retail offer which were incapable of direct measurement do not undermine the probative value of those studies. Instead Tesco claims that the Commission’s assessment of proportionality was

based on a ‘theoretical’ analysis of profit margins in highly concentrated local markets. This margin-concentration analysis failed to take into account the reality that higher store-level profit margins reflected economies of scale at larger stores, attributable to the spreading of fixed costs (in particular, staff costs) over a larger volume of sales. Moreover, the finding that high local concentrations are associated with increased profit margins is not consistent with the fact that most grocery retailers set prices nationally. Tesco similarly disagrees with the Commission’s “resort to theoretical analysis, without regard to empirical data” by finding that a grocery retailer can be expected to charge higher national prices if a large proportion of its stores are in highly concentrated local markets. Tesco submits that the uncertainties inherent in the Commission’s finding of an AEC should have been taken into account and the alleged benefits of the competition test discounted accordingly.

9. According to Tesco, the competition test inevitably produces perverse side-effects, adverse to consumer welfare, which the Commission failed to take into account. The test will provide a strong incentive for existing retailers to build smaller stores and extensions, so as to remain below the 60 per cent threshold, or to rebalance their floorspace between grocery and non-grocery sales so as to avoid being caught by the test. More importantly still, retailers will have an incentive not to enter an area of high local concentration in order to prevent a rival from passing the competition test and expanding its capacity. The Commission has failed to take this into account in its proportionality analysis.
10. Finally, Tesco argues that the Commission’s proportionality analysis fails to take into account the fact that the test will bear more heavily on some retailers (especially Tesco) than on others, and that the difference does not correspond to any difference in their practices which affect consumer welfare. In the absence of any reliable evidence that Tesco stores lower their retail offer in areas of high local concentration, Tesco submits that it is disproportionate to impose the competition test on it.

The Commission’s submissions

11. The Commission accepts that the action taken or recommended for the purpose of remedying an AEC must be proportionate. As stated in its Guidelines “the Commission

will consider the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality” when deciding what is an appropriate remedy (CC3, paragraph 4.9). The Commission Guidelines further state that if the Commission is choosing between two remedies which it considers would be equally effective, it will choose that which imposes the least cost or that is the least restrictive (CC3, paragraph 4.10). The Commission submits that, in principle, it does not seek to implement remedies which are disproportionate in relation to the AEC and any resulting detrimental effect on customers it has identified.

12. In assessing the proportionality of the competition test for planning applications, the Commission emphasises that the test forms part of a package of remedies aimed at the AEC identified. Mr Freeman’s witness statement states that the proportionality of the competition test “cannot be evaluated without taking account of the other remedies” considered and proposed by the Commission (paragraph 60). The Commission submits that its consideration of divestiture as a possible remedy is a case in point. The Commission did not require large grocery retailers to divest stores or land holdings in areas where competition is weak since they “would represent a significant intervention in property rights”. Furthermore, the Commission took the view that its package of remedies would be sufficient and proportionate in addressing its concerns about existing and future competition in local markets (paragraph 11.268 of the Report).

13. The Commission takes issue with Tesco’s argument that it should have carried out a cost-benefit analysis of the competition test. To require the Commission to carry out a cost-benefit analysis would be inconsistent with the statutory framework and place the broad and flexible principle of proportionality within an unacceptable straight-jacket. The authorities and passages from guidance cited by Tesco are not relevant to the question before the Tribunal since they do not concern market investigation references. Indeed in the case of *E.ON v GEMA* and OFCOM’s guidance, unlike section 134 of the Act, the relevant legislation expressly imposes a duty on the relevant regulator to carry out a full regulatory impact assessment. The Commission considers that the assessment required of a regulator in those cases sheds no light on the nature of the proportionality analysis required by the Act.

14. The assessment required of the Commission is not a cost-benefit analysis. The Commission maintains, in particular, that it considers the relationships between ends (a comprehensive solution to the identified AEC or customer detriments) and means (what remedy or combination of remedies would provide such a solution). In the present case, as explained in paragraphs 11.379-11.398 of the Report, the Commission was satisfied that the competition test goes no further than is necessary to remedy effectively the AEC.
15. The Commission states that Tesco also criticises it for not quantifying, or even attempting to quantify, the benefits arising in the future from the application of the competition test. Without prejudice to its primary submission that it is not required to carry out a cost-benefit analysis, the Commission also submits that any assessment of the benefit resulting from the test preventing the creation or strengthening of highly-concentrated local markets would be highly speculative. It would require the Commission to predict the level of entry or expansion in those markets where development by the incumbent retailer would be blocked by the test. Such a prediction would entail a series of assumptions regarding the number of stores to be developed, along with the size, timing, location and sequence of store developments. The cumulative effect of those assumptions tends to undermine the reliability of the prediction and would render the resulting figure meaningless.
16. The Commission disputes Tesco's argument that uncertainties in quantifying the benefit accruing from the future operation of the test could be dealt with by broad estimates, sensitivity analyses and scenarios (as suggested by the Green Book). The Commission contends that such techniques are inapt to deal with the series of unknowns facing any attempt to quantify the increased competition to which the competition test may be expected to give rise on a year-on-year basis. Applying sensitivity analyses and scenarios would only replace a single meaningless figure with a range of meaningless figures.
17. At the hearing Mr Roth accepted that it is not possible to know how quickly the benefits of the competition test will materialise. The Commission's case is that the test, together with its other chosen remedies, would over time have the desired effect of "addressing" the AECs which had been identified (see paragraph 11.268 of the Report).

In particular, given the dynamic competition in the groceries sector, the test is likely to work as quickly (or as slowly) as the number of new openings and competitor expansions. The Commission submits that it is not required to estimate precisely the time frame within which the AEC will be reduced by a specified amount. Such an approach would introduce a spurious degree of precision into the statutory test and the way in which the Commission must articulate the answers to those tests in its Report.

18. The Commission acknowledges the point made by its Guidelines that say “the Commission will give attention to the time period within which the remedy can be expected to show results” (CC3, paragraph 4.23) and that it “will tend to favour a remedy that can be expected to show results in a relatively short time period” (CC3, paragraph 4.16). Mr Roth submitted that the language of the Guidance is general in nature. It does not bind the Commission to follow the Guidance in all respects in every case. However, in accordance with general principle, the Commission was satisfied, on a reasonable and properly reasoned basis, that its chosen package of longer-term remedies should be preferred to an immediate one-off, divestiture remedy in paragraph 11.268 of the Report.
19. The Commission accepts that the estimated additional profits of £105-125 million per year currently earned by the grocery retailers operating larger stores in highly-concentrated areas is not a direct measure of the benefit which will accrue from the future operation of the competition test. The figure of £105-125 million, however, was never considered or presented by the Commission to be a measure of the anticipated benefits of the competition test. It is an indication of the scale of the local detriment arising from the existence of weak competition in local markets. At the hearing Mr Roth submitted that the figure £105-125 million per year could also be used to illustrate the annual benefit of the test in reducing the number of highly concentrated local markets. On the basis of 180 planning applications a year, Mr Roth submitted that it was reasonable to consider that 30 local markets would cease to be highly concentrated in the foreseeable future. The annual benefit of the competition test facilitating that pro-competitive development could then be estimated to be in the region of £9-10.5 million: calculated by multiplying the number of local areas by the annual £300,000-350,000 profit foregone by the average larger grocery retail outlet. This would exceed the estimated cost of the test of £6-8 million.

20. The Commission rejects Tesco's claim that the factual basis for its assessment of the AEC, in particular the effect of local concentrations on prices and other aspects of the retail offer, is subject to considerable uncertainty. The Commission's findings of the features of the market that give rise to the AEC and consequent detrimental effects on customers are challenged. In those circumstances, Tesco's disagreement with, or criticisms of, the finding of AEC cannot constitute a basis, under the guise of "proportionality", for quashing one of the remedies devised to address that AEC. Further, the Commission submits that it was entitled to place limited weight on the results of the GfK and Tesco studies; to rely on the margin-concentration analysis and to infer the broad impact of local concentration on prices charged nationally. The arguments to the contrary made by Tesco are in essence the kind of arguments which seek to substitute its own view for that of the Commission. In all the circumstances, the Commission reasonably concluded, within its margin of appreciation, that there was an AEC arising from highly concentrated local markets.
21. The Commission submits that the historical data on landsites which it had available did not provide any basis for measuring the likely impact of the competition test. The combination of changing local market conditions (as existing stores expand or new stores are built) and retailers adapting their development plan to the likely effects of the competition test means that the past is not prologue to the future.
22. The Commission denies that the competition test will inevitably produce perverse side-effects. The alleged incentive to remain below the 60 per cent threshold was relied on to support the opposite contention. The Commission submits, however, that whatever threshold was chosen, it would always remain open to retailers to expand to just below that threshold. This is not a perverse result, and is simply inherent in choosing a threshold for applying the test. Further, the Commission was entitled to place little weight on the fanciful suggestion a retailer would forgo a profitable opportunity to expand in order to prevent another retailer from expanding its capacity.
23. The Commission denies that the test will bear more heavily on some retailers, especially Tesco, than on others.

The Interveners' submissions

24. The interveners support the Commission and ask the Tribunal to dismiss ground 2 of the application.
25. Asda and Waitrose submit that Tesco's submissions in relation to proportionality are divorced from commercial reality. Tesco's case proceeds on an entirely unrealistic assumption as to how retailers will respond to the introduction of the competition test. The application of the test is not, however, difficult to understand or foresee. Retailers will not have to wait for planning permission to be refused in order to take account of the effects of the test in their planning decisions.
26. At the hearing Mr Ward, who appeared on behalf of Asda, submitted that it is inherent to the way the competition test works that its timescale is imprecise. The test works by privileging new entrants over incumbents as and when development opportunities arise. It blocks the incumbents from taking those opportunities and that way it facilitates expansion by others. The speed at which that will occur depends upon what happens in the grocery retailing market. It is perfectly rational for the Commission to say that the test will tend "over time" to remedy, or at least mitigate, the AEC it had identified; the Act does not require that the Commission should eliminate the AEC or do so within any particular time period.
27. Having referred to the extensive and transparent investigation carried out by the Commission, M&S submits that, for the most part, Tesco arguments on proportionality concern issues of complex economic assessments (both in relation to what Tesco argues should have been the alternative basis for the calculation of the cost-benefits for the competition test and its challenge to the robustness of the national and local effects of the test). M&S argues that either Tesco is seeking to re-argue points that it has already put before the Commission and which the Commission considered, but reasonably rejected; or, alternatively, it is impermissibly seeking to raise new economic arguments.
28. At the hearing Mr O'Donoghue, who appeared on behalf of M&S, submitted that the Commission's package of remedies introduces a "sea change" in the environment of competition in grocery retailing. The Commission's chosen remedies, including the

competition test, fundamentally changes the incentive and, more importantly, the ability of new entrants to compete in a more vigorous fashion than they have in the past to erode these highly concentrated local markets. He added that the Tribunal was entitled to take account of the Government's intention to replace the need and impact tests with a new test that will have a strong focus on its town-centre-first policy, and which will promote competition, avoiding the unintended effects of the current need test.

29. In relation to Tesco's claim that the Commission should have attempted to assess the benefits of the competition test, Mr O'Donoghue referred to: (i) the proposed acquisition of Somerfield by CGL in October 2008 (resulting in the unprecedented disposal of stores in 126 local grocery markets across the UK); (ii) the unprecedented financial turmoil and (iii) the media speculation that Iceland, a food retailer specializing in frozen food, may be subject to a takeover. These recent events demonstrate the dynamism of grocery retailing. In addition, they tend to cast doubt on the utility (if any) of analysing the future benefits of the test.