

# WOOLWORTHS LIMITED

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ACCC inquiry into the  
competitiveness of retail prices  
for standard groceries

Public submission by Woolworths  
regarding real property issues

25 June 2008

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#### Attachment A

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# 1 Executive Summary

## 1.1 Introduction

In Australia, Woolworths operates in a highly competitive take-home food and grocery retail sector, which ensures that Australian consumers benefit from a wide choice of good quality, safe, fresh food and other groceries at prices that are relatively low by world standards.

A key element of this competitive environment is the strong competition Woolworths faces when seeking and obtaining suitable free-standing or shopping-centre based locations to develop new Woolworths supermarkets and/or expand its current stores. At its broadest Woolworths competes with the full spectrum of commercial operators and others requiring land (eg commercial, residential or industrial operations). A landlord or developer has a number of choices as to how they develop land, and a development involving a supermarket is only one possible use.

More specifically, where the developer goes ahead with a shopping centre or supermarket development, Woolworths then competes with a range of supermarket operators to lease a suitable location. In addition to this demand-side competition, Woolworths faces a considerable degree of countervailing power from landlords and developers.

Woolworths understands that the manner in which supermarket operators acquire and deal with real property is being considered as part of the Grocery Price Inquiry. Specifically, Woolworths understands that the ACCC wishes to test the extent to which the real property practices of Australian supermarket operators (including Woolworths) create barriers to entry and/or impede effective competition in the grocery industry.

This submission addresses this area of the Grocery Prices Inquiry and references to Woolworths in this submission relate to Woolworths' Australian supermarket division.

## 1.2 The purpose of the submission

The purpose of this submission is to:

- examine in detail the competitive property environment in which Woolworths operates insofar as it impacts on the manner in which Woolworths undertakes its property investments; and
- set out generally Woolworths' current property practices and the role that property investment plays in Woolworths' operations and ongoing business development. In this respect, Woolworths notes that the discussion in this submission is necessarily general. Actual business practices may be adjusted both now and over time as a result of specific or changed business conditions;
- demonstrate that no compelling arguments exist for regulatory reform or legislative change specifically targeted at the manner in which Woolworths (and other supermarket operators) acquire, lease or generally deal with real property. It will be shown however that there is a compelling case for wholesale review and reform of local and state planning and development regimes.

### 1.3 The structure of the submission

This submission is structured as follows:

#### **Section 2 –**

##### **The commercial environment in which Woolworths enters into leases and/or acquires real property**

In analysing the competitive commercial environment in which Woolworths enters into leases and/or acquires property, this section outlines the approach Woolworths takes to developing new sites. Specifically, this section explores the considerable costs, delays and limitations that supermarket operators face in Australia as a result of the complex local and state planning and development structures in Australia. It calls for a wholesale review and reform of these structures. The discussion also examines the strong competitive constraint Woolworths faces when acquiring sites, when seeking to be an anchor tenant in a new centre and generally as a result of the countervailing power of landlords.

Finally, the section examines the set of retail tenancy legislation that operates to protect smaller retailers across Australia in their lease negotiations with landlords (particularly shopping centre landlords). Woolworths is, as will be explained, not able to obtain the statutory protections this legislation provides and as such relies on the commercial negotiations it has with landlords, and the terms of the lease as bargained, to protect the significant sunk investments that it makes.

#### **Section 3 -**

##### **Woolworths as a tenant**

This section examines the manner in which Woolworths enters into lease arrangements with landlords. The section examines the sound commercial reasons why Woolworths and shopping centre developers agree to include rent adjustment or exclusivity clauses in a lease. It is noted that Woolworths is not alone in including such clauses where many others, including independent supermarkets, also negotiate their inclusion.

The discussion outlines econometric analysis which shows that such clauses have no adverse effect on market structure or store level pricing, such that there is no evidence that these clauses harm either competition or consumers.

The discussion concludes with economic analysis to the effect that rental adjustment and exclusivity clauses help ensure efficient allocation of rent, space, effort and risk in the development process enabling a range of positive externalities to be produced.

#### **Section 4**

##### **Woolworths' development of sites**

This section examines the practices that Woolworths undertakes in the limited situations when it is developing land for supermarkets or shopping centres.

## Section 5

### Woolworths and its engagement with the Planning Process

This section examines the manner in which Woolworths engages with the planning process, demonstrating that the rationale for Woolworths' objections is to ensure that each of Woolworths' competitors are subject to the same planning and development obligations as Woolworths.

Concerns about the extent of delay caused by the planning and development process are, consistent with Woolworths overall position, not the result of any one party's objections, but as will be discussed, the result of current state and local planning regimes.

## Section 6

### Conclusion – is there a case for reform?

Woolworths considers that, with the exception of a broader review of planning legislation, the evidence establishes that there is no case for legislative reform related to the manner in which supermarket operators lease, acquire or obtain land.

Critically, Woolworths retained Concept Economics to conduct econometric analysis on the effect of the presence of rent adjustment or exclusivity clauses in Woolworths leases. That analysis demonstrates that these clauses:

- have no adverse effect on the likelihood of a competitor being located within the local geographic market (as defined by the ACCC that is, being within 3 or 5 kilometres) of a Woolworths supermarket;
- are not associated with a statistically significant impact on average store level prices; and
- in fact, the presence of such clauses tends to be associated with somewhat lower store level prices, but the effect is not statistically significant.

Therefore the clauses evidence no anti-competitive purpose, do not have an effect of lessening competition in any relevant market but do perform important commercial and economic functions in relation to the development of new shopping centres. The ability to negotiate and enter into such arrangements helps ensure efficient allocation of rent, space, effort and risk in the development process thus enabling a range of positive externalities to be produced.

Further, Woolworths notes that the submission to the Grocery Price Inquiry by the Bureau of Infrastructure, Transport and Regional Economics (**BITRE**) showed that customers paid higher prices for groceries in communities when neither Woolworths nor Coles were present. That is, it evidenced that grocery prices are lower where major supermarket chains are present. Therefore, Woolworths notes that reforms which would result in restraints upon the development of Woolworths or Coles' supermarkets would be likely on this evidence to cause higher, rather than lower, grocery prices for customers.

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## 2 The commercial environment in which Woolworths enters into leases and/or acquires real property

### 2.1 Introduction

This section outlines the characteristics of the competitive real property market in which Woolworths operates. The purposes of this section is to demonstrate the background against which Woolworths undertakes its property practices, ultimately underscoring Woolworths' view that the manner in which it acquires, leases and/or develops property:

- has a sound commercial and efficiency rationale; and
- is without anti-competitive purpose or effect.

The discussion outlines:

- the long term approach Woolworths takes in relation to its property holdings and investments;
- the state and local planning environment in which it operates and develops supermarkets;
- the strong competition Woolworths faces when seeking to obtain new sites;
- the role Woolworths plays as an anchor tenant for shopping centre developments and the competition it faces in this respect; and
- the strong countervailing power of landlords.

### 2.2 Woolworths' approach to site investment

Section 2.2 of Woolworths Public Submission to the ACCC Grocery Price Inquiry (**Initial Woolworths Submission**) noted that Woolworths has achieved its considerable success in part through growing its network of stores to meet the changing needs and preferences of Australian consumers. Specifically, it is noted that Woolworths:

*"opens new stores in areas of population growth and new customer demand and its preference is to open a greenfields site [to] allow it to plan its optimal store offering and layout."*

In order to proactively grow its store network appropriately in response to projected demographic changes, and respond to changes in consumer preferences and shopping patterns, Woolworths spends considerable resources identifying future opportunities for supermarket development and refurbishment opportunities. This includes considerable investment in research and personnel so that Woolworths is able to appropriately respond to the fluid retail environment in which it operates and identify gaps and future opportunities in the market.

Once an appropriate opportunity is identified, Woolworths makes a significant commitment to working, either by itself or with a landlord, to efficiently and successfully develop that site. The sunk costs Woolworths incurs in that process are considerable, including the costs incurred during the extensive planning process, as well as construction and equipment costs. Further, once the initial investment is made, Woolworths will continually be required to invest in maintaining the store environment in order to ensure that it is offering a competitive customer offering. These refurbishments, which are often part of a network-wide rolling refurbishment program, cost Woolworths millions of dollars in themselves.

As will be shown in this submission, Woolworths undertakes this considerable investment in an intensely competitive environment in which Woolworths must work hard to minimise the significant risks it is exposed to due to the long term nature of its developments and ongoing investment.

### 2.3 The effect of state and local planning regulations on supermarket development

Woolworths is aware that a number of parties giving evidence to the Grocery Price Inquiry have stated that they face difficulty obtaining access to suitable sites for supermarket development.<sup>1</sup> One identified cause of this difficulty is the local and state planning processes currently in place across Australia. Woolworths understands that many industry participants (including Coles and independent operators) have also raised this issue in a number of forums outside the Grocery Price Inquiry.

Woolworths acknowledges that the local and state planning processes and requirements in Australia invariably:

- impose some limits on the number of sites available for development of supermarkets in Australia; and
- impose considerable costs and delays in relation to the development and expansion of supermarkets (and other retail developments).

Although the United Kingdom has a substantially different planning environment to Australia (one that is arguably more constrained than Australia), it is worth noting that the Competition Commission made similar findings:

*“... the planning system, in pursuing the broad-based objectives for which it is intended, necessarily constrains new entry by larger grocery stores. It also has the effect of increasing the time for new larger grocery store entry to take place due to the need to assemble sites likely to be granted planning permission as well as the time required by LPAs [Local Planning Authorities] to consider planning applications.”<sup>2</sup>*

In this respect, Woolworths notes that it, like all supermarket operators and developers, is subject to the cost and delay associated with the planning and development process. In Woolworths' experience the process for developing a greenfields supermarket or Marketplace shopping centre development typically takes approximately 30 to 40 months, where a significant component of this process revolves around achieving appropriate development and planning approval (taking approximately 6 to 18 months).

Similarly, Woolworths faces the same difficulties as other supermarket operators face in obtaining sites where new sites may not be available due to planning and development regulations. It is therefore not accurate, as some parties have stated in their evidence, that new entrants are the only ones that have difficulty obtaining access to suitable sites.<sup>3</sup>

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<sup>1</sup> For example, the Urban Taskforce submission to the inquiry states that “access to suitable sites is a significant impediment to the entry or expansion of supermarket chains” and that “local planning and zoning laws impede access to suitable sites” (at p 3); Metcash states in its submission that “lack of access to suitable sites to expand to is the main reason why this ‘third force’ is not obtaining more market share” (at p 13); and Foodworks notes in its submission that “access to suitable sites having regard to differing State legislation and lead times to develop is complex, costly and time consuming” (at p 29) Urban Taskforce Australia, *The impact of the NSW planning system on retail competition*, 11 March 2008, p 3; Metcash Limited, *Public Submission (Part A) to ACCC grocery inquiry*, 11 March 2008, p 13; Australian United Retailers Limited (Foodworks), *Public Submission to ACCC grocery inquiry*, 11 March 2008, p 29, ACCC, <<http://www.accc.gov.au/content/index.phtml/itemId/810417>> at 15 June 2008.

<sup>2</sup> UK Competition Commission, *The supply of groceries in the UK market investigation Volume 1: Summary and report*, 30 April 2008, p 13, UK Competition Commission, <[http://www.competition-commission.org.uk/rep\\_pub/reports/2008/](http://www.competition-commission.org.uk/rep_pub/reports/2008/)> at 17 June 2008

<sup>3</sup> Above note 1.



Restrictions on access to land have created an artificial scarcity of sites which translates into a very competitive environment in which Woolworths competes with Coles and the full spectrum of independent supermarkets to obtain desired supermarket development sites. In many cases Woolworths loses those development opportunities to Coles and independent supermarket operators.

As such, Woolworths, like many other contributors to the Grocery Price Inquiry, considers that reform of local and state planning regulations is urgently required. This would remove some of the complexity, cost and delay that the current arrangements create. The need for this reform has in fact been recognised by the Federal Government in its recently proposed changes to laws to make it easier for foreign supermarket chains to establish themselves in Australia. In making these changes, the Federal Government recognised:

*“that 12 months was simply not enough time to complete all the statutory and commercial processes required to enable development to commence”.<sup>4</sup>*

Woolworths however notes that what is required is a wholesale reform of local and state planning laws where there is a complex interplay between the many state and local regulatory instruments and institutions in place across the country. Further the system, as it currently operates, impacts on the ability of *all* supermarket operators to effectively obtain sites and develop competitive supermarket offerings, not just individual supermarket operators.

Woolworths would therefore be extremely concerned if, as a result of the Grocery Price Inquiry, the ACCC:

- proposed changes to local and state planning legislation that was specifically targeted at, or disadvantaged, particular industry participants (such as Woolworths); or
- proposed changes to the respective local and state planning legislation which did not account for the need for reform of the entire local and state planning and development framework.

In this respect Woolworths specifically notes findings of the Bureau of Infrastructure, Transport and Regional Economics (**BITRE**) published in its submission to the Grocery Price Inquiry. BITRE found that

*...the presence of a major chain in a locality is likely to provide groceries at price levels broadly similar to those obtained in similar stores in the capital cities.<sup>5</sup>*

As such, Woolworths notes that should the ACCC propose changes to local and state planning legislation which specifically restrained the development of new Woolworths or Coles stores, this evidence shows that such reforms may in fact lead to higher, as opposed to lower, grocery prices for customers.

## **2.4 Woolworths faces strong competition when obtaining sites for supermarkets**

In the context of the planning and development framework discussed above, Woolworths faces strong competition when seeking and obtaining either suitable free-standing or

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<sup>4</sup> Jessica Irvine, “Labour’s deal to cut food prices”, *The Sydney Morning Herald*, 23 April 2008, <<http://www.smh.com.au/news/national/price-cuts-on-way/2008/04/22/1208742940194.html>> at 17 June 2008.

<sup>5</sup> Public submission to the ACCC grocery inquiry by the Bureau of Infrastructure, Transport and Regional Economics, 17 April, 2008, p. 9.

shopping-centre based locations to develop new Woolworths supermarkets and/or expand its current stores.

As noted above, current local and state planning and development frameworks across Australia mean that the number of sites suitable for supermarkets are necessarily limited. As a result, Woolworths, Coles and other supermarket operators are constantly examining potential opportunities to acquire and amalgamate land holdings that, pending development and other planning approvals, would be suitable for a supermarket, and possibly a shopping centre development. In terms of identifying potential development opportunities, each of Coles, Woolworths and other supermarket operators use a combination of employed and third party consultants or agents to assess and, in some cases, actively create development opportunities. In addition, developers with no alignment to any particular supermarket or retailer will also be looking to amalgamate land and develop sites which may include a supermarket offering. In addition, shopping centre developers will also be actively sourcing future development sites.

Therefore, when a site that is potentially suitable for a supermarket is identified, made available or put out to market, the level of competition to construct a supermarket at that location is fierce. At that stage, each of the supermarket operators will undertake extensive negotiations with the developer in respect of the potential supermarket offering they are seeking to put on the site. This negotiation will involve discussions of layout, retail mix (if the development is a shopping centre or will contain a number of retail offerings), required amenities, leasing and rental structures and ultimately discussions about ensuring that required returns on capital can be achieved by both the developer and the shopping centre operator.

In a situation where the land owner is merely seeking to sell the land and not be involved in the development of the centre, there will still be extensive negotiations around price and required warranties and covenants.

At the conclusion of this negotiation process, where landlords and developers are in many instances playing a range of competing supermarket operators off against one another, the developer (or landowner) will then make a decision as to the supermarket operator that best meets their requirements. Similarly, supermarket operators will determine whether or not the final terms on which the developer / land owner is offering the site are commercially acceptable.

Woolworths does not consider that it enjoys any special advantage in the processes outlined above. In this respect, Woolworths notes that developers and landlords will choose supermarkets on the basis of a range of factors including speed to market, the quality of retail offer and the range of supermarkets already in the local trading area.

In fact, demonstrative of the competitive nature of the above process, in many instances Woolworths is not successful in obtaining sites it would like to acquire.

## **2.5 Woolworths competes to be an “anchor tenant” in developments**

Woolworths understands that it has been alleged by some parties giving evidence to the ACCC during the Grocery Price Inquiry that Woolworths and Coles have a preferred “anchor tenant” status in the eyes of shopping centre or land developers.<sup>6</sup>

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<sup>6</sup> See for example: Mr E Kondouris, Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 8 April 2008, Canberra, p 27 line 32., ACCC <<http://www.accc.gov.au/content/index.phtml/itemId/813604>> at 15 June 2008.

Woolworths notes that during the session of the ACCC's public hearings at which Woolworths gave oral evidence, Counsel assisting the Grocery Price Inquiry specifically sought information regarding the role that Woolworths plays as an anchor tenant in developments (particularly shopping centre developments),<sup>7</sup> and put to Woolworths that it enjoyed a very special advantage in obtaining sites where developers considered Woolworths (and Coles) much more attractive than independent supermarkets.<sup>8</sup>

Woolworths considers that it plays an important role as an anchor tenant for shopping centre developments, in the same manner as many other non-supermarket retailers perform important roles in assisting shopping centre developers to obtain a tenancy mix and offering that is attractive to both consumers and financiers. In particular, Woolworths understands that its strong financial position and the high quality product and service offering it brings to the market do make Woolworths supermarkets, at the current time, an attractive tenant for shopping centre developers and operators.

However, Woolworths does not consider that it enjoys any ongoing special advantage over other retailers as an anchor tenant, noting that a shopping centre developer will have a preference for a tenant on the basis of a whole range of factors (including tenancy mix, size of centre, current consumer demand for a type of tenant and the ability of that tenant to drive foot traffic into the centre and in turn drive total sales in the centre).

As such, any preference for an anchor tenant will change over time. The CEO of Woolworths, Mr Luscombe, noted as much when Woolworths gave oral evidence to the ACCC on 19 May 2008:

*"The Woolworths package of convenience and fresh foods and prices and service and ambience and everything else that makes us successful has meant that our sales per square metre – in other words, the number of customers that come for a given square metre – are significantly higher than our competitors, generally speaking. If I was putting a shopping centre together, what I want is as many people coming to this shopping centre as possible because that actually gives me the opportunity to actually successfully rent out the reset [sic] of the centre, particularly to specialties, to fashion, etcetera, because they rely on passing foot traffic in the large to be successful. So insofar as Woolworths has got a proven track record of being able to run a store that has more people visited [sic] in comparison to others, then I'd absolutely accept the fact that we are a preferred tenant on the basis that we actually bring value to the centre and bring value to the other retailers in the centre. In regard to is that always the case, I'm sure that we can look back and we can find where in South Australia a couple of the Foodland guys have been preferred tenants, that in Western Australia people like Neville Garth with Advantage was a preferred tenant, that FAL with their Action stores – I query whether they're independent or part of a group – they were certainly preferred to us in Western Australia because of their local attraction. So it's not always the case that we just win hands – I mean, there's ample evidence that we miss out on a lot of property opportunities that we'd really love to get. You know, Canberra Civic Centre is a classic example where the Supabarn group won on merit."<sup>9</sup>*

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<sup>7</sup> See for example questions from Counsel assisting the Grocery Prices Inquiry, Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 19 May 2008, Melbourne, p 79, ACCC < <http://www.accc.gov.au/content/index.phtml/itemId/813604> > at 15 June 2008.

<sup>8</sup> *ibid.*

<sup>9</sup> *ibid.*

Notwithstanding the views of Woolworths enunciated above, Woolworths considers that the question as to whether Woolworths (and Coles) enjoy some special ongoing classification, or advantage, as a preferred anchor is best answered by shopping centre developers themselves.

In this respect, Woolworths draws the ACCC's attention to the evidence given by Stockland during the public hearing process. Relevantly, when asked by Counsel assisting the Grocery Price Inquiry about the identity of anchor tenants used in Stockland developments, Mr Schroder, the CEO of Stockland, noted that the list included:

*"Woolworths, Coles, ALDI, in some cases IGA, Metcash IGA. In some cases it may be somebody as small as Harris Farm, here in New South Wales, depending on what we're dealing with."*<sup>10</sup>

Mr Schroder went on to note that Stockland has the ability to choose amongst these anchor tenants and that the identity of the anchor tenant is not determinative of whether a project is able to be financed.<sup>11</sup> The ultimate decision as to the anchor tenant chosen will depend on the desired tenancy mix and format of the centre, where the anchor tenant may involve one or more supermarkets (being either a Coles, Woolworths or an independent supermarket) or in some cases it may in fact not involve a supermarket at all. For example, during the hearing Mr Schroder noted that Stockland was proceeding with a development where Harris Farm was the anchor tenant.<sup>12</sup>

In respect of the recent opening of a IGA as the anchor tenant of a retail development in Delahey in western Melbourne, Mr Neal Morgan, the owner of the IGA store stated:

*"We found it difficult to finalise negotiations due to the might of the major chains and their ability to attract the landlord's attention, but a lot has changed since then, thanks to Metcash and the growth of the IGA brand. Independents are now a force to be reckoned with and a viable alternative for most landlords."*<sup>13</sup>

## **2.6 Landowners and landlords have significant countervailing power**

In addition to the strong competition that Woolworths faces obtaining sites for supermarket sites generally, Woolworths also notes that shopping centre landlords possess significant countervailing power.

Shopping centre landlords in Australia are, in many instances, large entities with significant countervailing power in negotiating leases for supermarkets with Woolworths. Many landlords are large corporate bodies with significant interests in property and retail leasing management – for example, Westfield is the world's largest listed retail property group, with interests in 121 shopping centres that contain over 22,000 retailers in Australia, New Zealand, the United States and United Kingdom. As at July 2007, Westfield had interests in 44 shopping centres in Australia and manages 37 of these centres.<sup>14</sup> The countervailing power of shopping centre landlords arises from their size, sophistication, choice between a range of alternative lessees and landlord linkages through co-ownership or contract.

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<sup>10</sup> Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 2 April 2008, Sydney, p 45, ACCC <<http://www.accc.gov.au/content/index.phtml/itemId/813604>> at 15 June 2008.

<sup>11</sup> *ibid.*

<sup>12</sup> *ibid.*

<sup>13</sup> *Retail World*, "Supa IGA success in Melbourne's West", 6-17 August 2007, p 16.

<sup>14</sup> Westfield's submission to the Productivity Commission, *The market for retail tenancy leases in Australia*, 27 July 2007, Productivity Commission, <<http://www.pc.gov.au/inquiry/retailtenancies/docs/submissions>> at 15 June 2008.

Leases for Woolworths' supermarkets are not signed predominantly with one, or only a few, shopping centre landlords. Instead, Woolworths' supermarkets have leases with many different shopping centre landlords, with no one landlord heavily dependent upon Woolworths supermarkets as a tenant.

Further, in those cases where Woolworths has a lease with a shopping centre other than with one of the major shopping centre landlords listed above, that landlord still has significant countervailing power where:

- as a result of local and state planning and development structures there are generally limited sites available for supermarket development;
- these sites are held already, in most instances, by landlords; and
- there are a large number of supermarket operators attempting to secure a presence in those centres.

Therefore, Woolworths is not, as alleged by Metcash, in any sort of position to “leverage” its relationship with shopping centre developers to obtain sites.<sup>15</sup> Rather, Woolworths must compete strongly with Coles and independents to obtain access to suitable supermarket sites.

## **2.7 Woolworths is generally not able to rely on the statutory protections available to other retailers to protect its ongoing investment**

### **(a) The protections provided by retail tenancy legislation**

In each jurisdiction in Australia, governments have introduced prescriptive legislative frameworks for regulating the rights and obligations for the formation of leases between landlords and small-medium sized businesses<sup>16</sup> (referred to generally as **retail tenancy legislation**). The purpose of this retail tenancy legislation is to “*provide an equitable bargaining position amongst*”<sup>17</sup> landlords and lessees in shopping centres.

Whilst the exact terms of retail tenancy legislation varies across Australia, in general, each jurisdiction's legislation provides for the following range of protections for retailers located in shopping centres (and in some cases outside shopping centres). The protections variously afforded under the retail tenancy legislation sit both “inside” and “outside” the lease document, that is they operate upon the negotiation process and general interactions between the landlord and tenant, as well as requiring or prohibiting certain lease conditions. Importantly, the retail tenancy legislation provides that, where a landlord does not comply with their obligations a tenant is able to, in many instances, obtain compensation for the losses they have suffered as a result of that conduct.

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<sup>15</sup> Metcash Limited, *Public Submission (Part A) to ACCC grocery inquiry*, 11 March 2008, p 10, ACCC, <<http://www.accc.gov.au/content/index.phtml/itemId/810417>> at 17 June 2008.

<sup>16</sup> *Retail Leases Act 2003* (Vic), *Retail Shop Leases Act 1994* (QLD), *Fair Trading (Code of Practice for Retail Tenancies Regulations 1998* (Tas), *Retail and Commercial Leases Act 1995* (SA), *Commercial Tenancy (Retail Shops) Agreements Act 1985* incorporating the *Commercial Tenancy (Retail Shops) Agreements Amendment Act 1998* (WA), *Retail Leases Act 1994* (NSW), *Leases (Commercial and Retail Act 2001* (ACT) and *Business Tenancies (Fair Dealings) Act 2003* (NT).

<sup>17</sup> New South Wales Minister for Small Business, *Retail Leases Bill Second Reading Speech*, NSW, Legislative Assembly, *Hansard*, 13 May 1994, p 2641-2.

The subject matter of the protections afforded include:

- **Security of Tenure**

This includes requiring landlords to give minimum lease terms, providing for rights of first refusal for sitting tenants at the end of a lease and imposing a requirement on landlords to provide adequate notice of lease renewal and termination;

- **Specified Lease Conditions**

This includes imposing specific clauses in leases relating to methods of rent determination and review, recovery of operating expenses, compensation for disturbance and relocation and the ability of a landlord to undertake casual licensing in the shopping centre (ie allow casual short-term tenants to operate within a centre).

Specifically in respect of rent determination and rent reviews, the retail tenancy legislation:

- requires certain information about rents to be contained in lease disclosure statements;
- prescribes the scheduling of rent reviews and the basis on which rent reviews can be conducted (including specific restrictions on the frequency of rent reviews, prohibiting discretionary rent review methods and prohibiting upward only rent reviews); and
- defines “current market rent” and the process that can be employed to determine “current market rent” (involving the use of an independent valuer in some instances); and

- **Information provision and disclosure** – this includes requirements imposed on landlords relating to provision of disclosure statements to retailers as well as requiring registration of leases.

Most relevantly, shopping centre landlords are required under retail tenancy legislation to specifically disclose:

- the nature of the current tenancy mix and competitive environment in which a retailer is entering; and
- possible future changes to the tenancy mix or layout the centre.<sup>18</sup>

For example:

- in Queensland, a landlord is required to disclose to the tenant the current tenancy mix (through a floor plan diagram) and is further required to assure the lessee that the current tenant mix as shown will not be altered through the introduction of a competitor or other type of tenant. In the event that such an assurance cannot be

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<sup>18</sup> *Retail Leases Act 1994* (NSW), Schedule 2; *Leases (Commercial and Retail) Act* s30 and s157A (ACT), *Retail Leases Act 2003* (Vic) s26, *Commercial Tenancy (Retail Shops) Agreements Regulation 1985*, Reg 4 Schedule Form 1, (WA), *Retail Leases Regulations 2003* Schedule 1 (Vic), *Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998* Reg 4.4 (Tas); *Business Tenancies (Fair Dealings) Act* s19(2) and 21(2); *Retail Shop Leases Act 1994* s22 and *Retail Shop Leases Regulation 2006* s3(p) (QLD).



made then details of the proposed tenancy mix change must be provided to the tenant;<sup>19</sup> and

- in Victoria, a landlord is required to disclose the tenancy mix of the centre, advise whether or not the mix is likely to change over the course of the lease and if so, provide details of the proposed changes;<sup>20</sup> and
- in South Australia, a landlord is required to disclose to a prospective tenant the current tenancy mix of the shopping centre (through a floor plan diagram). In addition, the landlord must indicate whether any changes are proposed and if so provide details of the proposed changes, identify the processes that may be used to change or further change the mix and finally advise the tenant whether the lessor is prepared to make an assurance that the current tenant mix will not be altered to the lessee's disadvantage by the introduction of a competitor.<sup>21</sup>

The disclosure requirements expressly recognise the fact that a change in tenancy mix, which may involve the introduction of a competitor, is likely to significantly impact on a particular retailer's turnover.

It is worth noting at this point that the NSW Government is currently examining issues affecting the retail leasing industry under the *Retail Leases Act 1994*. As part of this process, the NSW Department of State and Regional Development has issued a paper titled *Issues Affecting the Retail Leasing Industry in NSW - Discussion Paper (NSW Retail Lease Issues Discussion Paper)*.<sup>22</sup> This paper has recommended strengthening the disclosure provisions canvassed above and allowing tenants certain rights of action in case of non disclosure about potential competitors being introduced, where they experience commercial harm. In particular, a proposed reform will involve:

*"increase[ing] the prominence of the question "Is the lessor able to assure the lessee that the current tenant mix as shown on the attached floor plan will not be altered through the introduction of a competitor or any other type of tenant. Yes or No and require[ing] the tenant's signature to ensure they recognise the likelihood of whether there will be the introduction of direct competition during the term of the lease. It is also recommended that there be provision for the landlord to indicate the number of competitors the landlord reserves the right to introduce."*<sup>23</sup>

#### **(b) The rationale for the protections given to retailers under the retail tenancy legislation**

In summary, the above provisions (particularly the disclosure requirement) are designed to provide the greatest degree of certainty and security to retailers operating in shopping centres (and in some cases outside shopping centres) so as to enable them to invest efficiently and securely to build their business on an ongoing basis. The terms recognise the sunk costs incurred by the retailer. In the absence of these clauses, the ability of retailers to undertake initial and ongoing investment (such as refurbishment) and incur and recover these sunk costs would be significantly diminished.

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<sup>19</sup> Queensland Government State Development Department, *Lessor Disclosure Statement*, <<http://www.sd.qld.gov.au/dsdweb/v3/documents/objdirctrl/nonsecure/pdf/2814.pdf>> at 17 June 2008.

<sup>20</sup> Retail Leases Regulation 2003 Schedule 1, *Disclosure Statement*, <[http://www.legislation.vic.gov.au/Domino/Web\\_Notes/LDMS/PubStatbook.nsf/93eb987ebadd283dca256e92000e4069/B5FABD1C80387FB8CA256E5B0021AC4D/\\$FILE/03-030sr.pdf](http://www.legislation.vic.gov.au/Domino/Web_Notes/LDMS/PubStatbook.nsf/93eb987ebadd283dca256e92000e4069/B5FABD1C80387FB8CA256E5B0021AC4D/$FILE/03-030sr.pdf)> at 17 June 2008.

<sup>21</sup> *Retail and Commercial Leases Regulations 1995* Schedule 1, <[http://www.austlii.edu.au/au/legis/sa/consol\\_reg/raclr1995342/sch1.html](http://www.austlii.edu.au/au/legis/sa/consol_reg/raclr1995342/sch1.html)> at 17 June 2008.

<sup>22</sup> NSW Department of State and Regional Development, *Issues Affecting the Retail Leasing Industry in NSW*, Discussion Paper, April 2008, <<http://www.retail.nsw.gov.au/downloads/discussion-paper.pdf>> at 15 June 2008.

<sup>23</sup> *ibid*, at [3.9.4].

Further, not only are the terms focussed on ensuring the entering of a fair bargain, they aim to protect the terms on which that bargain was entered into as they operate on an “on-going basis”. That is, they seek to protect a retailer by constraining any attempted opportunistic behaviour of a shopping centre developer / landlord (or subsequent developer / landlord) who wishes to vary the commercial bargain on which a lease was entered into through reneging on the terms of the initial lease arrangements and by providing action for compensation if such behaviour occurs.

Relevantly for this discussion however, the protections afforded under the retail tenancy legislation are limited to retail businesses of a particular size, turnover or corporate identity. For example:

- in New South Wales, Western Australia, Tasmania and the Northern Territory, retail tenancy legislation applies to retail premises (in either a shopping centre or other specified locations) up to a size of 1,000m<sup>2</sup>;
- in Queensland, retail tenancy legislation applies to certain specified businesses or any premises in a shopping centre up to 10,000m<sup>2</sup> or 1,000m<sup>2</sup> if the lessee is a listed corporation or their subsidiary;
- in the Australian Capital Territory, retail tenancy legislation applies to premises that are under 1,000 m<sup>2</sup> as well as commercial premises under 300 m<sup>2</sup>; and
- in Victoria and South Australia, there is a value based limit such that in Victoria the legislation does not apply to premises where the lease occupancy costs exceed \$1 million per annum or the premises are leased by a listed corporation or its subsidiary; and in South Australia where the rent exceeds \$250,000 per annum or where the premises are leased by a listed corporation or its subsidiary.

**(c) Woolworths does not have access to the same retail tenancy legislation protections**

In light of the above thresholds, due to both Woolworths’ position as a “listed company” and the fact that Woolworths supermarkets generally exceed the 1,000 m<sup>2</sup> threshold, Woolworths does not benefit from the detailed protections afforded to other retailers under the retail tenancy legislation. This is despite the fact that specialty retailers (many of which compete with Woolworths) generally have leases with 5 year terms (as opposed to Woolworths 20+ year leases) and have undertaken significantly less sunk investment than Woolworths, such that they are better positioned to relocate in the event that the shopping centre landlord engages in opportunistic behaviour at their detriment.

By this statement, Woolworths is not arguing that it should be captured by this legislation (with an understanding that this legislation is primarily focussed on the protection of smaller retailers). However, it is for this reason that Woolworths is concerned with ensuring that the leases it enters with shopping centre developers and landlords relevantly provide the appropriate level of protection and certainty necessary to efficiently invest in developing and maintaining its competitive supermarket offerings.

This requires the inclusion of clauses in Woolworths’ leases such as the rent adjustment clauses discussed further in section 3.4. In the absence of clauses such as these in its leases, Woolworths has no ability to protect its commercial position and prevent shopping centre owners (and often subsequent owners) from engaging in opportunistic development behaviour in the centre that would have a significant commercial impact on Woolworths.



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## 3 Woolworths as a tenant

### 3.1 Introduction

The significant majority of Woolworths supermarkets (over 97%) are located in leased premises.

A lease between Woolworths and a shopping centre landlord is a commercial bargain. It is negotiated by the relevant landlord first presenting to Woolworths its proposal regarding the terms it seeks from Woolworths' supermarkets. Woolworths then seeks assurances from the landlord in relation to amenities (such as the size and tenancy mix of the centre, access to the centre and supermarket, size of the space to be leased and the number and configuration of car park spaces) to achieve Woolworths' forecast sales volumes. This ensures that Woolworths is able to meet the rent payments included in the proposed lease and the landlord is able to justify its investment in its asset so as to validate the feasibility for the project.

The purposes of this section are to:

- outline the manner in which Woolworths enters into lease arrangements with landlords;
- examine the sound commercial reasons why Woolworths and shopping centre developers agree to include rent adjustment or exclusivity clauses in lease;
- evidence that rent adjustment and exclusivity clauses have no adverse effect on market structure or store level pricing, such that there is no evidence that these clauses harm either competition or consumers; and
- demonstrate that economic analysis shows that rental adjustment and exclusivity clauses help ensure efficient allocation of rent, space, effort and risk in the development process enabling a range of positive externalities to be produced.

### 3.2 The lease negotiation process

The process for setting up a new Woolworths supermarket within a shopping centre is a lengthy process that involves considerable negotiation between Woolworths and a shopping centre developer or landlord. The time between Woolworths commencing negotiations with a shopping centre developer and/or potential landlord and the opening of the supermarket is generally between 3 and 5 years (involving considerable cost, management time and expertise). Woolworths notes that some projects may take up to 10 years to materialise.

During that negotiation period, Woolworths will work with shopping centre developers to create a financial arrangement and relationship that allows for the ongoing and future development of the centre whilst providing each party with a suitable level of commercial certainty. In most instances, Woolworths is entering at least a 20 year lease (with further options to renew) and is looking at the long term development potential for the centre. It is important to understand that retailing is a fluid and dynamic industry that requires flexible structures and arrangements that can respond to this operating environment and appropriately place risk.

### 3.3 The components of a standard Woolworths' supermarket lease

#### (a) The terms of a Woolworths' supermarket lease

Ultimately Woolworths and the shopping centre developer or landlord will agree on lease terms relating to the operating environment that the shopping centre operator has promised to provide and maintain during the length of the lease. Where many of these clauses are interrelated in purpose and effect, it is important to ensure that no one term of the lease is looked at in isolation.

Typically, relevant conditions within lease agreements include conditions relating to ongoing availability and quality of shopping centre amenities (such as car parking and sight-lines as well as centre layout and retail mix). The purpose for agreeing on such terms, and including them in the lease, is that Woolworths (like all supermarkets) rely heavily, in terms of its trade projections, on the quality of the retail environment the shopping centre is offering customers. A failure of a shopping centre developer or landlord to deliver on these promises, where the result is a diminution in the quality and convenience of the offering to customers, will have a significant impact on Woolworths turnover. Similarly, there will be a negative impact on other retailers, particularly those retailers reliant on the foot traffic that Woolworths stores generate. In addition to the clauses described above, a key term of the lease will be the structuring of the rental arrangements between the parties.

Woolworths notes at the outset that, as with all clauses in Woolworths' supermarket leases, the rental arrangements between the parties are the result of commercial negotiations and an agreement between the parties and involves a detailed consideration by both parties of the best way to maximise ongoing performance of the supermarket and the overall shopping centre development.

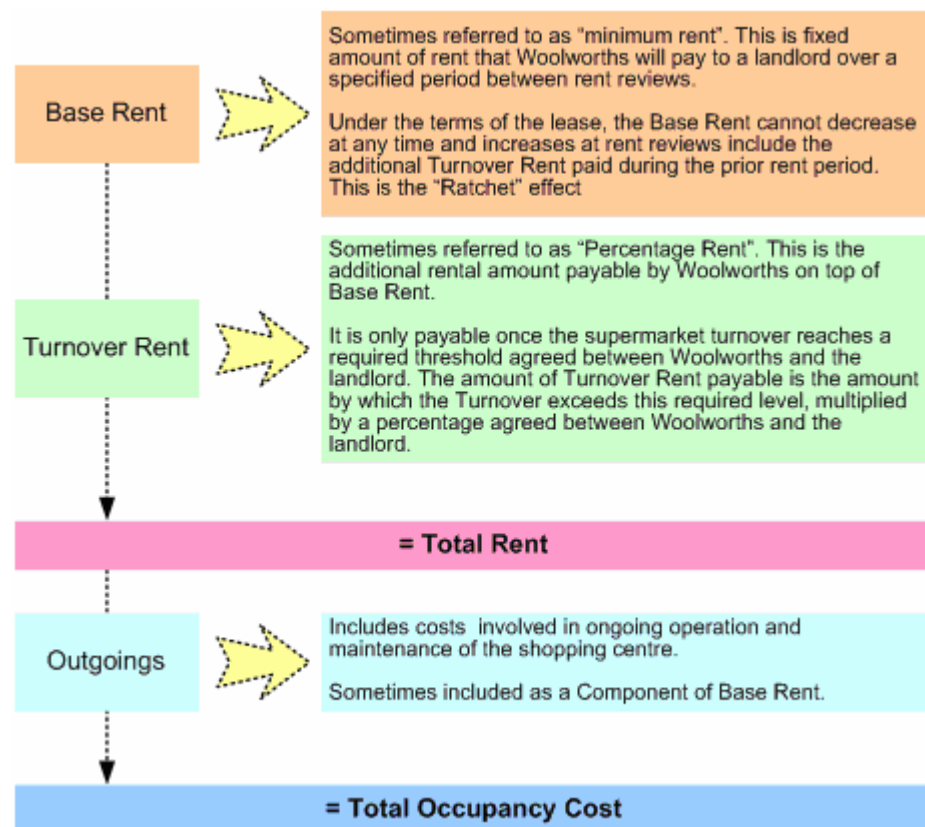
#### (b) The structure of rental arrangements in Woolworths supermarket lease

Together with wages, the occupancy costs are one of the largest fixed costs for any supermarket. In respect of leases, occupancy costs consist of rental and outgoings.

The rental structure for Woolworths' supermarket leases is one that is generally based on a combination of payment of a guaranteed base rent component (**Base Rent**) and a component which is determined with reference to the turnover of the supermarket (**Turnover Rent**).

The manner in which Turnover Rent arrangements in Woolworths leases operate is set out in Figure 1 and the discussion which follows it.

**Figure 1 - Components of rent clauses in Woolworths' standard leases**



Base Rent is the fixed (or guaranteed) portion of the rent payable to the landlord (generally payable monthly), and Turnover Rent is an additional component that is calculated as a percentage of the Woolworths supermarket gross turnover (generally payable at the end of each year, once turnover for the year is known).

At the commencement of the lease, Woolworths will pay the Base Rent and this will be the only rent payable (except outgoings, depending on the particular case) until such time as the turnover reaches the required level at which Turnover Rent is payable.

Woolworths leases generally provide for a periodic rent review. If, prior to that rent review occurring, Woolworths has paid Turnover Rent, the Base Rent payable after that rent review will increase to the average of the Total Rent (ie Base Rent + Turnover Rent) paid during preceding years.

It is important to note that the Base Rent payable to a landlord will never go down in this "ratcheting" arrangement. Therefore, if a Woolworths supermarket increases its sales turnover and performance and increases foot traffic to the shopping centre or retail site, such that the turnover threshold is met, the landlord is guaranteed increased Base Rent over time. This means that even if the Woolworths supermarket experiences decreased turnover in a period following a rent review, if the Base Rent has been ratcheted up, the Woolworths supermarket must still pay the increased rent levels.

### 3.4 The inclusion of rent adjustment / exclusivity clauses in Woolworths supermarket leases

Woolworths understands that a number of parties have made submissions to the Grocery Price Inquiry claiming that Woolworths has a practice of locking out competitors through “penalty clauses”.<sup>24</sup> The clauses in leases that parties, particularly Metcash, are referring to do not represent and should not be categorised as any form of “penalty”. They are, as will now be explained, rent adjustment or exclusivity clauses underpinned by a solid commercial rationale, without anti-competitive purpose or effect, which seek to provide commercial certainty for Woolworths and shopping centre developers and landlords.

These clauses relate to the introduction or expansion of a competitor supermarket in a shopping centre in which Woolworths currently has a supermarket presence. At a general level, the clauses operate to maintain the commercial environment in which Woolworths made its initial investment decision. More specifically:

- **Rent adjustment** clauses are lease conditions which provide for adjustment to the rent which Woolworths pays to a landlord in the event that a competitor is introduced to the centre by the shopping centre developer or landlord or an existing supermarket is expanded. These are included where the shopping centre developer or landlord has previously represented that no further supermarket will be introduced nor will the existing supermarkets be expanded.
- **Exclusivity** clauses (which are far less common) are lease conditions which provide that no further supermarket is to be introduced to the centre by the shopping centre developer or landlord, nor is an existing supermarket is to be expanded. In many instances, these clauses do not mean that another supermarket is not already in the centre. The exclusion relates to further supermarkets being introduced. These are included where the shopping centre developer or landlord has previously represented that no further supermarket will be introduced nor will the existing supermarkets be expanded.

Whilst, for the reasons set out in the following discussion, Woolworths does not consider that either the rent adjustment or exclusivity clauses are anti-competitive in either purpose or effect, Woolworths notes that rent adjustment clauses are far more common than exclusivity clauses. In this regard, Woolworths notes that only a small number of its leases contain exclusivity clauses.

### 3.5 Why do Woolworths and shopping centre developers or landlords negotiate to include rent adjustment and exclusivity clauses in leases?

The purpose of these exclusivity or rent adjustment clauses is not to “lock out” competitors. Rather, the inclusion of these clauses in the leases represents the outcome of extensive negotiations between shopping centre owners and Woolworths at the pre-development stage which are focussed on providing the required level of certainty for both Woolworths and shopping centre developers or landlords to enable the future development of the shopping centre.

As Mr Kemmler, Woolworths’ Director of Property, stated during the ACCC’s public hearing process:

*“[the clauses] actually reflects what the agreement is between the landlord and as a result of the rent and the commercial arrangement that’s been agreed between*

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<sup>24</sup> Metcash Limited, *Public Submission (Part A) to ACCC grocery inquiry*, 11 March 2008, p 13, ACCC, <<http://www.accc.gov.au/content/index.phtml/itemId/810417>> at 17 June 2008.

*the parties, it does not stop any competitor from coming into that particular trade area or that catchments[sic];”<sup>25</sup> and*

*“they legitimately protect the business arrangement that’s been agreed with the landlord. They are fairly common arrangements that exist with all supermarket operators. They’ve been in existence for around 40 years and they have not prevented or restricted the amount of supermarkets that have been established over the last period of time.”<sup>26</sup>*

Woolworths is a high volume and low margin business. Therefore, when Woolworths undertakes the cost and revenue modelling process to feed into the negotiation process, it relies heavily on assumptions about “foot traffic”, amenities and levels of competition within the centre. The introduction of a new competitor into a centre is likely to have a considerable impact on Woolworths’ projected revenue. As such, Woolworths works with shopping centre owners to create some certainty for each party about the rental impact, should the shopping centre owner enter into a lease agreement with a new supermarket. This is particularly important where, as discussed above, Woolworths leases generally contain a “ratcheting” arrangement where the Base Rent increases with turnover and does not decrease at any time during the term of the lease.

In the absence of this certainty, Woolworths (and other retailers in similar positions) would be less willing to “share” shopping centre development risk with developers. This may result in them potentially negotiating for lower rents, which may not sustain the financing of shopping centre developments, and/or bearing higher costs and risks which will put upward pressure on prices. Mr Kemmler went on to explain this dynamic during the Grocery Price Inquiry’s public hearing:

*“So if a landlord comes to us and shows us a plan, you have two supermarkets in a particular shopping centre, we make an assessment on potential sales that we can derive from one of those particular sites. If the landlord comes up to us with a shopping centre with one supermarket in a particular shopping centre we’ll make a different potential assessment of the sales. The leases and the base rent that we then negotiate with the landlord are factored around the potential sales. So what you have with a landlord is a long term relationship and a sharing of development risk between the two. So we invest fairly heavily in the shopping centre, the developer invests fairly heavily in the shopping centre and the rent that’s determined is based on the environment that the particular landlord has promised us. So once we’ve agreed on the plans we make an assessment on the potential sales. We then determine a rent that’s agreed between the parties and then we enter a lease arrangement and that lease arrangement reflects the commerciality of what has been agreed. So if the landlord has promised us that this particular shopping centre will have one supermarket and no other supermarket then that is the arrangement that is reflected in the lease.”<sup>27</sup>*

For these reasons Woolworths does not agree with comments made by ALDI in its submission that the clauses “prevents the incumbent supermarket retailer(s) facing new competition,”<sup>28</sup> nor the contention, made by Counsel assisting the Grocery Price Inquiry,

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<sup>25</sup> Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 19 May 2008, Melbourne, p 77, ACCC <<http://www.accc.gov.au/content/index.phtml/itemId/813604>> at 15 June 2008.

<sup>25</sup> *ibid.*

<sup>26</sup> *ibid.*

<sup>27</sup> Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 19 May 2008, Melbourne, p 74-5, ACCC <<http://www.accc.gov.au/content/index.phtml/itemId/813604>> at 15 June 2008.

<sup>28</sup> ALDI Stores, *Submission to the ACCC grocery inquiry*, 11 March 2008, p 10, ACCC, <<http://www.accc.gov.au/content/index.phtml/itemId/810417>> at 17 June 2008.

that these clauses go “*further than is necessary to protect the legitimate interests of Woolworths at the start of an investment.*”<sup>29</sup>

The NSW Retail Lease Issues Discussion Paper discussed above specifically addresses the significant competitive impact that introduction of competitors may have on tenants in shopping centre:

*“Tenants make a commercial decision to enter into a lease based on the current and anticipated environment. The landlord normally has control over how the competitive environment in a centre can change. However, it is generally the sitting tenants who bear the consequences of the landlord’s exercise of control. That is, the landlord can introduce competition or change the tenancy mix in such a way that the profitability of a sitting tenant is affected. This may have a significant impact on the ability of the sitting tenant to meet his or her lease obligations, especially in cases where the tenant’s lease precludes changing trading activity and focus.”*<sup>30</sup>

As such, “[i]n order to mitigate unfairness for sitting tenants where the profitability of their business is affected by the introduction of competition or changes to the tenancy mix that could not be anticipated,”<sup>31</sup> the Paper has proposed reform. Specifically it is proposed that retail tenants, in certain situations, be able to call for a review of their rent to reflect the changed business environment as a result of the introduction of a specific competitor.<sup>32</sup>

This paper, and the existing retail tenancy protections discussed in section 2.7(a), acknowledge for smaller tenants, the risk of opportunistic behaviour by landlords after the tenant has committed to its lease obligations. Given the long term ratcheting nature of Woolworths supermarket leases and the high sunk costs in fit out and equipment, Woolworths has greater investments and obligations at risk from such behaviour. However, as discussed in section 2.7, even in the event that the NSW Government decided to introduce such retail leasing requirements, Woolworths supermarkets would not be able to rely upon such statutory protections.

### **3.6 Why are rent adjustment and exclusivity clauses in leases important?**

In the event that Woolworths is not able to rely on rent adjustment or exclusivity clauses to constrain the future opportunistic behaviour of shopping centre landlords, Woolworths (or a supermarket operator in a similar situation):

- would be likely to experience considerable commercial detriment;
- would be no longer able to obtain the projected rate of return upon which it based its considerable sunk investment; and
- going forward, could not feel confident that the commercial environment in which it makes its investment is not going to be significantly changed despite representations of that sort being made by a landlord prior to the investment being made.

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<sup>29</sup> Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 19 May 2008, Melbourne, p 77, ACCC <<http://www.accc.gov.au/content/index.phtml/itemId/813604>> at 15 June 2008.

<sup>30</sup> *ibid*, at [3.9.1].

<sup>31</sup> *ibid*, at [3.9.5].

<sup>32</sup> *ibid*, at [3.9.5].



As a result of this uncertainty and the resultant commercial risk, without contractual adjustments, in the future supermarkets would be more likely to:

- seek to recoup the cost of sunk investment at an accelerated rate in order to minimise the risk it faces over the term of the lease.;
- limit the level of ongoing investment in supermarkets (both in terms of new supermarkets and refurbishment of existing supermarkets) where the supermarket operators' ability to recoup this investment is uncertain. This will likely diminish the service and convenience offering provided to customers; and/or
- be less willing to work with developers to develop new shopping centres in certain areas such that the overall level of investment in new and convenient shopping centres will decrease considerably over time. In this regard, Woolworths notes that the overall bargaining position of existing shopping centres will increase where new developers will not be in a position to finance new projects. As such, where there is an absence of shopping centre development, there will be less opportunity for supermarket operators to enter local trading areas.

This will in turn diminish the positive externalities that supermarkets, as anchor tenants, bring to shopping centres (discussed further in section 3.9) as well as making it likely that higher rental burdens and/or risk will be borne by small retailers. This is likely to result in price increases for customers and an overall decline in total welfare.

Further, and most importantly, as a result of the uncertainty for supermarket operators and their need to recoup their sunk costs at an accelerated rate, Woolworths considers that increased costs and uncertainty would place upward pressure on prices. In contrast, where Woolworths is able to agree with a landlord to include a rent adjustment clause in a lease, the commercial outcome and risk faced by Woolworths is considerably different. Specifically, Woolworths considers that the effect of the rent adjustment clause where it comes into effect, is to enable Woolworths to recoup a proportion (but not all) of the profit it loses as a result of the introduction of the new supermarket into the shopping centre. As a result Woolworths (or a supermarket in a similar position):

- are able to feel more confident that it will obtain the projected rate of return on the significant sunk investment it has made in the centre; and.
- will continue to share the risk of shopping centre development with shopping centre developers, such that efficient levels of shopping centre development will be maintained in order to respond to customer demand.

As such, the pressure to recoup sunk costs at an accelerated rate, a situation most likely to result in increased grocery prices, is minimised.

Further, the positive externalities that supermarkets, as anchor tenants, bring to shopping centres (discussed further in section 3.9) will be brought to bear such that overall welfare is maximised.

### **3.7 The inclusion of rent adjustment or exclusivity clauses in some Woolworths leases is not evidence of any market or bargaining power on the part of Woolworths**

There is no "hard and fast" rule, or distinguishable characteristic of a centre or landlord, that will determine whether a lease will have an exclusivity or rent adjustment clause. This reflects the fact that whether such a clause is included in a lease is determined as a result of each individual negotiation between Woolworths and shopping centre developers or landlords.

Further, Woolworths notes that leases which contain a rent adjustment or exclusivity clauses are widely dispersed, many with major shopping centres developers and

landlords, and are used in respect of the full range of centre types including regional, sub-regional, super-regional, major and neighbourhood shopping centres.

This demonstrates that the inclusion of such clauses should not be seen as the result of some market or bargaining power on the part of Woolworths. In this regard, Woolworths also notes that:

- each lease is individually negotiated with both parties, acting at arms length, with legal advice; and
- it is a very competitive process to obtain access to sites. Woolworths often fails to secure sites where a suitable commercial agreement cannot be met.

Further, Woolworths and Coles are not the only tenants to include rent adjustment or exclusivity clauses in their leases with shopping centres.

Woolworths notes that a number of other supermarkets, including independent supermarket operators negotiate rent adjustment or exclusivity clauses with shopping centre developers.

For example, the Supabarn Supermarket lease with the Queensland Investment Corporation has a clause that seeks to restrict the presence of other supermarkets in the Canberra Centre. The clause relevantly provides:

*"The Lessor will not grant any lease or leases of any part of the Centre for the same purpose for which the Lessee is entitled to use the Premises as at the Commencement Date namely a supermarket provided that the Lessor shall not be prevented from granting any lease of any part of the Centre for part of the supermarket business carried on by the Lessee."*<sup>33</sup>

As an independent supermarket negotiating such clauses, Supabarn is not alone, with many other independent supermarkets similarly negotiating with landlords so as to include similar provisions. Woolworths understands that a number of small operators can and do agree with landlords that such clauses represent a suitable commercial arrangement for both parties, and arrange for their inclusion into the relevant lease.

As such, it should not be concluded by the ACCC that these clauses are evidence of any bargaining or market power on the part of Woolworths. It also evidences the view of participants across the industry that these clauses provide a reasonable degree of commercial protection as a result of the investment certainty they provide to both the retailer and landlord.

### **3.8 Economic analysis demonstrates that rent adjustment and exclusivity clauses used by Woolworths do not have an anti-competitive effect in any relevant market**

Woolworths also engaged Concept Economics to consider, on the basis of statistical evidence, whether the inclusion of an exclusivity or rent adjustment clauses in Woolworths leases has had any impact on the:

- geographical market structure of Australian retail supermarkets; or
- local pricing in the markets in which the relevant supermarkets are located.

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<sup>33</sup> Lease between Queensland Investment Corporation and Supabarn Supermarkets Pty Limited (clause 28).



**(a) No impact on market structure**

Relevantly, the Concept Economics Analysis demonstrated that there was no adverse impact on market structure. Specifically:



- the presence of an exclusivity or rent adjustment clause does not appear to produce a statistically significant restraint on competition in any relevant localised market;
- the leases which contain exclusivity or rent adjustment clauses, although widely distributed, are not geographically concentrated;
- **in respect of Coles and ALDI**
  - exclusivity or rent adjustment clauses in Woolworths leases have a small effect on the probability of a Woolworths store being located in the same premises as an ALDI or a Coles (less than 1% for ALDI and less than 3% for Coles) and are therefore not economically significant;
  - the presence of rent adjustment clauses in Woolworths leases, although affecting co-location in the same centre, has no effect on the likelihood of a Coles or an ALDI being close to a Woolworths on the basis of ACCC definitions of local geographic markets, that is, being within 3 or 5 kilometres of a Woolworths supermarket.<sup>34</sup>
- **in respect of an IGA or Foodworks**
  - exclusivity or rent adjustment clauses in Woolworths leases have no statistically significant impact on whether an IGA or Foodworks is present in a shopping centre or in the 3km to 5 km radius surrounding the shopping centre;

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<sup>34</sup> As the ACCC is aware, Woolworths considers the geographic markets adopted by the ACCC are too narrow, however for the purpose of this analysis Woolworths adopts the ACCC's approach.

A summary of Concept Economics' findings is set out in Figure 2.

**Figure 2 – Summary finding as to the effect of rent adjustment / exclusivity clauses on market structures**

|   | Do Woolworths' rent adjustment or exclusivity clauses impact on whether the retailer has a supermarket in a shopping centre with Woolworths? | Do Woolworths' rent adjustment or exclusivity clause impact on whether the retailer has a supermarket in the 3 - 5 km around a shopping centre in which Woolworths is present? |
|---|--|--|
|  |   |   |
|  |   |   |
|  | <ul style="list-style-type: none"> <li>Effect on likelihood of collocation is small (&lt;1%)</li> </ul>                                      |   |
|  | <ul style="list-style-type: none"> <li>Effect on likelihood of collocation is small (&lt;3%)</li> </ul>                                      |   |

This statistical analysis supports Woolworths experience generally and the evidence given by Mr Kemmler during the public hearings responding to a question from Counsel assisting the Grocery Price Inquiry:

*"Your inference is that those clauses are preventing additional supermarkets. What we're finding since 2002, ALDI have opened up 167 supermarkets. The independents have opened quite a number of supermarkets. All of our competitors have opened a lot of supermarkets in that last 10-year period. Those [rent adjustment] clauses do not prevent supermarkets coming into a particular catchment. What they do is protect the particular trading environment that has been agreed with the landlord on a particular site."*<sup>35</sup>

In this respect, Woolworths notes that there is strong evidence that rent adjustment and exclusivity clauses do not reduce the choice available to customers nor the level of competitive activity within a local trading area.

#### **(b) No impact on pricing in local markets**

Relevantly, in addition to the absence of effect on market structure, Woolworths engaged Concept Economics to undertake an analysis of store level prices to determine if the rent adjustment or exclusivity clauses had any impact on local prices.

The results of this analysis showed that the presence of rent adjustment or exclusivity clauses in Woolworths leases:

- was not associated with a statistically significant impact on average store level prices; and

<sup>35</sup> Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 19 May 2008, Melbourne, p 78, ACCC <<http://www.accc.gov.au/content/index.phtml/itemId/813604>> at 15 June 2008.

- in fact, the presence of such a clause tends to be associated with somewhat lower store level prices, but the effect is not statistically significant.

### **(c) Conclusion of economic analysis**

On the basis of the fact that the rent adjustment and exclusivity clauses utilised by Woolworths have no impact on:

- local market structures and the presence of competitors; or
- store level prices;

there is no evidence that these rent adjustment and exclusivity clauses harm either competition generally or customers.

### **3.9 Rent-adjustment clauses promote efficient contracting between shopping centre developers or landlords and anchor tenants and generate positive externalities**

In addition to the above analysis, Woolworths also engaged Concept Economics to analyse the competitive, and assess the existence of any pro-competitive, effects of the rent adjustment and exclusivity clauses employed by Woolworths. The full analysis undertaken by Concept Economics is set out in **Attachment A** to this submission.

In summary, Concept Economics notes that:

- economic literature shows that anchor stores generate positive externalities by drawing customer traffic into a shopping centre, benefiting not only its store but also others in the centre;
- rental adjustment clauses help ensure efficient allocation of rent, space, effort and risk in the development process. They assist developers to secure the large, sunk cost investments by anchor tenants in an environment of uncertainty;
- greater government intervention should be approached cautiously as there is no convincing evidence that these provisions materially lessen competition in the retail grocery market; and
- prohibiting or limiting the use of rental adjustment clauses would lead to an inefficient allocation of risks in the development process, thus increasing costs and reducing welfare in the long-term. Furthermore, higher rental burdens and/or risk borne by small retailers may result. Thus any purported pro-competitive benefit obtained by prohibiting or limiting these clauses would be offset by harms to competition.

As such, Woolworths considers that there is no established economic basis for the ACCC to limit or restrict the use of rent adjustment or exclusivity clauses by Woolworths or any other supermarket operator.

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## **4 Woolworths development of sites**

### **4.1 Introduction**

Woolworths leases over 97% of its supermarket sites. However, Woolworths will at times seek to develop its own sites. These developments may take the form of free standing supermarkets or they may be part of a larger shopping centre development by Woolworths (eg Marketplace developments). Woolworths may also at various times need to acquire land surrounding existing Woolworths sites in order to improve an already

existing Woolworths store which is deemed to be less than optimal for the catchment that store can potentially serve.

- This section addresses the practices that Woolworths undertakes when it is developing land for supermarkets or shopping centres.

#### **4.2 The process for developing a supermarket site is a lengthy process**

As discussed in section 2.3, local and state planning and development regulations mean that the development process for a new supermarket site (or shopping centre development) is both a lengthy and costly process.

Where Woolworths is seeking its own development options, Woolworths seeks to be proactive about obtaining development sites in the medium to long term to enable new store openings. Woolworths will acquire land, or work with a developer to acquire land, in areas where it believes there is a need to increase Woolworths store representation, where an existing store is over-trading, or where there is substantial projected or planned population growth in areas which require a supermarket.

#### **4.3 Woolworths acquisition of land for supermarkets**

Woolworths understands that its practice of obtaining sites on a proactive basis has been categorised by some parties giving evidence to the Grocery Price Inquiry as Woolworths securing or “entrenching” prime sites in order to prevent competitors obtaining access to sites.<sup>36</sup> Woolworths further understands that the Competition Commission considered whether UK supermarket chains were engaged in such practices, which it termed “landbanking”.

Woolworths notes that these allegations concerning Woolworths’ conduct are unfounded.

Relevantly, Woolworths notes that the Competition Commission examined whether supermarket operators were engaging in blocking or “land banking” practices. In conclusion, the Competition Commission found that:

*“...grocery retailers are engaging in the holding of undeveloped land (or landbanking) as a strategy to impede the entry by rival grocery retailers into local markets. The distribution of land holdings held by grocery retailers shows that these are, in the main, in areas where the grocery retailer does not have a strong presence. The four largest grocery retailers are taking longer to develop land into stores than has been the case in the past, and while this may be consistent with a landbanking strategy, it may also be explained by other factors such as time preparing planning applications. Finally, holding land undeveloped as a land bank seems a relatively expensive means of controlling land for the purposes of*

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<sup>36</sup> Allegations were raised regarding “land banking” by Franklins (in its written submission to the Inquiry), Tasmanian Independent Retailers (during its public hearing in Hobart on 10 April 2008), and Superbarn Supermarket Group (during its public hearing in Canberra on 8 April 2008) Franklins Pty Ltd, *Response to ACCC inquiry into the Competitiveness of retail prices for standard groceries Volume 1*, 11 March 2008, p 10; Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 10 April 2008, Hobart, p 47 (Tasmanian Independent Retailers); Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 8 April 2008, Canberra, p 4 - 11 (Tasmanian Independent Retailers), ACCC <<http://www.accc.gov.au/content/index.phtml/itemId/813604>> at 15 June 2008.

*impeding competitor entry compared with other means of controlling land, such as leasing land to third parties or selling it with a restrictive covenant.”<sup>37</sup>*

In addition to “land banking” concerns, Woolworths noted that a number of parties have alleged that Woolworths imposes restrictive covenants on land, in order to block competitor supermarkets obtaining land.<sup>38</sup> This was an issue also canvassed by the Competition Commission.

The Competition Commission was concerned about supermarket operators acquiring land suitable for supermarket development and then selling it, but subject to a restrictive covenant which prevented it being used as a supermarket in the future.<sup>39</sup>

In respect to Australian conditions:

- Woolworths understands that restrictions related to accessing land suitable for property development are even higher in the United Kingdom;
- Woolworths seeks to be proactive about obtaining development sites in the medium term to enable new store openings. Woolworths acquires land in areas where it intends to increase its representation, and will look for areas where there is substantial population growth and new centres are proposed or planned in the future;
- there is, as noted above, a need to acquire land (on a forward looking basis) due to the length of time required (as a result of planning restrictions etc) in order to develop and open a supermarket site; and
- ultimately, Woolworths believes that retailers such as itself (being low margin and high volume businesses) cannot afford to acquire and hold sites merely to restrict competition, or to impose restrictive covenants, as distinct from acquisition for the purpose of enabling the development of new Woolworths’ stores.

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## 5 Woolworths and its engagement with the Planning Process

Woolworths notes that another issue the ACCC is considering during the course of the Grocery Price Inquiry is the manner in which Woolworths and other supermarket operators engage with the planning process. Woolworths understands that the specific concern being raised by the ACCC in this regard is that objections being made by market participants to new developments increases the cost and delay involved for new entrants and therefore raises barriers to entry.

Woolworths notes that the Competition Commission in considering the same issue in the United Kingdom, found that:

*“In conclusion, objecting to competitors’ planning applications does not appear to be particularly widespread or a significant matter of concern in terms of barriers to entry or expansion.”<sup>40</sup>*

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<sup>37</sup> UK Competition Commission, *The supply of groceries in the UK market investigation Volume 1: Summary and report*, 30 April 2008, [p 142, 7.81], UK Competition Commission, <[http://www.competition-commission.org.uk/rep\\_pub/reports/2008/](http://www.competition-commission.org.uk/rep_pub/reports/2008/)> at 17 June 2008.

<sup>38</sup> Above note 37.

<sup>39</sup> Above note 37.

In respect of the current Grocery Price Inquiry, Woolworths advises the following:

- Woolworths only objects to proposed developments where it believes there are sound planning and development reasons for such an objection;
- the rationale for Woolworths' objection is to ensure that both Woolworths and its competitors are subject to the same planning and development obligations when undertaking their respective commercial operations;
- in any event, Woolworths rarely objects to new developments (this can be seen from the limited number of objections Woolworths has made in recent years) whereas Woolworths' competitors have lodged a number of objections to Woolworths' developments in recent years; and
- Woolworths does not consider there is any evidence to show that its objections to new developments impose costs and delays significantly above those that are already necessarily incurred as part of the current planning and development process.

As noted in 2.3, the local and state planning environments in which all supermarket developers operate mean that that new store development is a lengthy process. It is a process that Woolworths, as well as all other supermarket operators are subjected to and must operate within.

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## 6 Is there a case for reform?

As well as addressing the need for wholesale reform of the current local and state planning and development frameworks in Australia, this section also examines some of the proposed property and development related reforms the Commission has noted it may be considering during the course of the Grocery Price Inquiry.

In short, but for the overall reform noted above, Woolworths considers there is no case for any specific legislative reform or policy change in respect of the property practices of supermarket operators.

Woolworths further notes that regulation inherently increases costs and should only be introduced where its benefits will substantially exceed its costs. Moreover, the onus of demonstrating that the benefits exceed the costs needs to be borne by the proponents of the regulation. For the reasons set out below, the proposed reforms do not meet this criteria.

### 6.1 There is a case for wholesale reform of the local and state planning and development frameworks across Australia

Woolworths considers that the issues raised by parties in the Grocery Price Inquiry about the ability of supermarket operators to efficiently and effectively access and develop stores, to a considerable extent, are the very same issues that have been raised by parties, including Woolworths, for a number of years. That is, there is a need for wholesale reform of local and state planning frameworks in Australia, where the arrangements currently in place:

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<sup>40</sup> UK Competition Commission, The supply of groceries in the UK market investigation Volume 1: Summary and report, 30 April 2008, [7.64], UK Competition Commission, <[http://www.competition-commission.org.uk/rep\\_pub/reports/2008/](http://www.competition-commission.org.uk/rep_pub/reports/2008/)> at 17 June 2008.

- unnecessarily restrict the amount of land available that could be suitably used for supermarket development; and
- create significant cost and delay for supermarket operators and shopping centre developers seeking to develop new sites. Indication of this cost and delay was given in section 2.3. As discussed, in Woolworths' experience it typically takes approximately 30 to 40 months to develop a supermarket, 6 to 18 months of which is taken up by the planning and development process.

Woolworths notes that all supermarket operators in Australia are subject to, and must operate within, this regulatory environment, not just specific retailers.

For this reason, Woolworths sees no case as to why reform of local and state planning and development frameworks should be done in a way that necessarily or specifically disadvantages one operator over others, in particular the major supermarket operators. Such an approach would not only distort the competitive environment in which supermarket operators currently operate, but also impose a significant commercial detriment on the parties and undermine the overall objective of wholesale reform by adding unnecessary regulatory complexities.

## 6.2 Independent supermarket operators are growing rapidly

Despite claims being made by independent supermarket operators to the Grocery Price Inquiry that they are constrained in their growth due to an inability to access and develop sites, independent operators have, and continue to experience significant growth in recent years. The facts speak for themselves:

- with 1,288 stores (418 of which are SupaIGA and 717 are IGA), Metcash noted in its most recent results that it was experiencing "continued strong new store growth" and has significant new store openings, conversions and refurbishments in the last financial year (55 new stores, 24 extensions and 96 refurbishments). It is planning to open 39 new stores in financial year, in addition to 47 extensions and 96 refurbishments.<sup>41</sup>
- Foodworks introduced 30 new stores in the 12 months to July 2007 (16 of which were new to industry),<sup>42</sup> recently announced that it had identified more than 950 new store sites around Australia and has plans to launch new and/or redevelop 300 stores within its network. In respect of this growth, the Foodworks CEO notes *"What you are seeing now is an independent supermarket revival."*<sup>43</sup>
- Drake Foodmarkets, South Australia's largest independent supermarket owner/operator, is in the process of developing five greenfields supermarket sites between the Gold Coast and the Sunshine Coast.<sup>44</sup> These are in addition to the recently developed 3,200 m<sup>2</sup> supermarket in Angle Vale a proposed new development at Port Lincoln.<sup>45</sup>

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<sup>41</sup> Metcash, Company Results – Financial Year ending 30 April 2008, p 19  
<[http://www.metcash.com/site\\_files/s1001/files/Apr08\\_Full\\_Year\\_Results\\_Pres\\_-\\_final.pdf](http://www.metcash.com/site_files/s1001/files/Apr08_Full_Year_Results_Pres_-_final.pdf)>.

<sup>42</sup> FoodWorks, "Media Release – Independent retail FoodWorks advances in NSW market", 11 July 2007.

<sup>43</sup> FoodWorks, "Media Release – FoodWorks reveals forecasted targets and their planned strategies to achieve them", 30 August 2007.

<sup>44</sup> *FOODweek*, "Drake strengthens Queensland foray", 7 December 2007, p 9.

<sup>45</sup> *Retail World*, "Drake, Foodland retailers surge in SA", 6 August 2007.



### **6.3 The leasing arrangements employed by Woolworths do not have an anti-competitive effect in any relevant market**

In its evidence to the hearing, this submission and its attachments, Woolworths has demonstrated that the leasing arrangements it employs have a sound commercial rationale, and that there is no evidence that these practices (including specifically rent adjustment or exclusivity clauses) harm either competition generally or customers.

In this regard, rent adjustment and exclusivity clauses reflect the terms of the commercial negotiation between Woolworths and landlords with the purpose of providing an appropriate level of certainty for both parties so that they can make their respective significant sunk investments and to enable the future development of the shopping centre.

Woolworths has also provided the ACCC with econometric evidence which demonstrates that rent adjustment and exclusivity clauses have no impact on:

- local market structures and the presence of competitors; or
- store level prices.

Further, Woolworths has provided the ACCC with economic literature and analysis which demonstrates that the rent adjustment and exclusivity clauses bring about considerable positive externalities.

The significant negative impact that would occur should the ACCC seek to constrain the operation of these clauses on either a prospective or retrospective basis is considered below.

### **6.4 The potential reforms are likely to have a significant negative commercial impact on Woolworths**

During the course of the Grocery Price Inquiry, the ACCC indicated it may consider a number of reform proposals including:

- a requirement that any new lease entered into by, and/or any new supermarket development involving either a Woolworths or Coles would be subject to a competition test;<sup>46</sup>
- a restriction on the use of rent adjustment and exclusivity clauses on either a forward looking or retrospective basis;<sup>47</sup> and
- limiting the ability of major supermarket operators to object to the development of new supermarket sites.<sup>48</sup>

In relation to each potential reform Woolworths submits that, but for a wholesale review and reform of the local planning and development legislative processes, the evidence

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<sup>46</sup> Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 19 May 2008, Melbourne, p 93 (Woolworths); 12 May 2008, p 82 (Westfield); ACCC < <http://www.accc.gov.au/content/index.phtml/itemId/813604> > at 15 June 2008.

<sup>47</sup> **G Samuel** "What would you say to the following propositions? I will take each in turn. The first is that there should be a prohibition – let me go back. The first is that any restrictive covenants contained in any of the leases you've got would no longer be enforceable after a certain date." Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 19 May 2008, Melbourne, p 91 ACCC < <http://www.accc.gov.au/content/index.phtml/itemId/813604> > at 15 June 2008.

<sup>48</sup> Transcript of Proceedings, *Grocery Prices Inquiry Hearing*, 19 May 2008, Melbourne, p 92-3 ACCC < <http://www.accc.gov.au/content/index.phtml/itemId/813604> > at 15 June 2008.



does not support a case for legislative reform related to the manner in which supermarket operators lease, acquire or obtain land.

More importantly, Woolworths considers that in each instance, the proposed recommendations will cause increased cost, delay and uncertainty.

Further, as noted above, analysis submitted by BITRE to the Grocery Price Inquiry showed that customers paid higher prices for groceries in communities when neither Woolworths nor Coles were present. That is, grocery prices are lower where major supermarket chains are present. Therefore, Woolworths notes that reforms which would result in restraints upon the development of Woolworths or Coles' stores, such as those proposed by the ACCC, would be likely on this evidence to cause higher, rather than lower, grocery prices for customers.

#### **(a) Addition of competition test to current development regulation**

As described above the current local development and planning processes are complex, lengthy and costly. Additional mandatory regulatory processes to be applied should therefore be approached very cautiously.

Section 50 informal merger clearance reviews occur in relation to substantial acquisitions engaged in by Australian corporations. In contrast, lease arrangements are entered into in the every day, ordinary course of business of Woolworths and other supermarket operators. Requirement of mandatory ACCC competition review of such frequently entered into commercial arrangements would impose a significant additional regulatory procedure in commercial and economic circumstances not analogous to the existing section 50 reviews. It would, as noted above, also create significant additional cost for both Woolworths and landlords and the uncertainty it would create around new developments would make it considerably more difficult for shopping centre and land developers to finance new developments.

If an additional requirement of mandatory review were only to apply to some supermarket operators, eg to Woolworths and Coles only, this would skew the intense competitive process in which parties negotiate to acquire land and enter into leases.

#### **(b) Restricting the use of rent adjustment and exclusivity clauses**

Woolworths has illustrated through empirical and statistical analysis that there is no evidence that the use of rent adjustment or exclusivity clauses harm either competition generally or customers. These arrangements have a sound commercial rationale which facilitates efficient allocation of rent, space, effort and risk in the development process enabling a range of positive externalities to be produced.

Woolworths would be significantly concerned if legislative restrictions were to be placed upon the ability to enter into such lease protections. As identified above, smaller retailers are currently provided such protections legislatively. Prohibition upon Woolworths and Coles being able to negotiate such protections, where commercially appropriate in view of sunk investment and long term risk, would seriously undermine the ability to reach sensible, commercial arrangements with landlords and developers. It would further only aggravate the economic distortion resulting from the current restrictions on retail development associated with planning and land use controls.

Woolworths would be even more concerned if retrospectively there were to be limits upon the extent to which existing rent adjustment clauses or exclusivity clauses could be enforced. Such an approach would selectively interfere with the current bargain between landlords and supermarkets, the basis upon which both parties have made significant commercial investments. Woolworths would likely suffer significant commercial detriment as commitments to rent increases through the ratchet effect would have no condition or

exception if turnover subsequently reduced as a result of opportunistic behaviour by a landlord.

As an example, placing a limit upon the time in which such clauses could be effectively enforced would be commercially detrimental. A proposal to limit the operation of the clause to some arbitrary time period for all leases regardless of the individual commercial circumstances in which the lease was negotiated (eg requiring that such clauses could only be effective for 5 years) would ignore both the ratchet effect upon the rent and the fact that supermarket operators do not just make one single investment at the beginning of the life of a new store. Supermarket operators, like Woolworths, are required to refurbish and make significant ongoing investments in the supermarket site throughout its entire life. These ongoing investments are, in the same manner as new store investments, dependant on supermarket operators being confident that the deal they have struck with the landlord is certain. Further the turnover projections on which it has based these new and ongoing investment are dependant on Woolworths not being detrimentally impacted by the opportunistic introduction of new supermarket into the centre.

Woolworths cautions against the findings and actions of the UK Competition Commission being taken as support for similar findings and action in the Australian context. Firstly, it is important to note that those findings related to restrictive covenants and exclusivity clauses, no consideration was given to rent adjustment clauses. Secondly, there are considerable differences between UK and Australian land practices, in particular there are greater limitations upon the availability of suitable land and sites. Finally, the limited economic analysis undertaken by the Competition Commission failed to effectively account for the positive economic effects of the exclusivity clauses it was reviewing. Woolworths engaged Concept Economics to examine the extent, and the manner in which, the Competition Commission undertook detailed economic analysis of these clauses. The full analysis is set out in **Attachment A**. In summary, Concept Economics observed that:

- almost no formal analysis appears to have been conducted regarding the underlying purpose of such provisions, their effect on competition, the role of contracting incentives and constraints in the presence of retail demand externalities or the risks of opportunistic behaviour in the development process;
- no allowance was made, or analysis conducted, of the *ex ante* harm to competition likely to arise from proscribing or artificially limiting the terms on these clause
- while the Competition Commission noted in passing the anomalies and distortions likely to arise from singling out large grocery retailers for this sort of remedy, it made no attempt to assess the impact of these distortions in practice; and
- importing policy remedies from the United Kingdom to Australia may prove very costly for particular groups of consumers, given the significantly different competitive environments and retail development challenges in the two countries

**(c) Restricting the ability of supermarket chains to object to new development**

Woolworths notes that the delays and costs created by the local and state planning and development processes impact on all participants in the supermarket sector. As discussed previously in this submission, the evidence of the taking of planning objections does not indicate any systemic abuse of the planning process.

It is Woolworths' submission that what is required is an overall review and reform of the local and state planning and development regulatory processes.

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## Attachment A —

### *Concept Economics – Economic Analysis of lease conditions*

**concept economics**



**PUBLIC REPORT**

# **ECONOMIC ANALYSIS OF LEASE CONDITIONS**

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## 1. ECONOMIC ANALYSIS OF LEASE CONDITIONS

Securing the long-term presence in shopping centres of anchor stores (including large supermarkets such as Woolworths) is vital to the retail development process. In particular, the relevant economic literature shows clearly that anchor stores generate positive externalities by drawing customer traffic not only to their own store, but also to other stores in a shopping centre.<sup>1</sup>

In this context, rental adjustment clauses form part of the complex set of long-term contracting arrangements which landlords and anchor tenants use to ensure the efficient allocation of rent, space, effort and risk in the development process. They provide an important mechanism by which developers secure the large, sunk cost investments by anchor tenants in an environment of uncertainty, where future actions are not fully observable and are difficult to contract over.

These provisions should not be seen as anti-competitive exclusivity clauses. This is all the more the case as there is no convincing evidence that such clauses materially lessen competition in the retail grocery sector. That fact underscores the need for caution surrounding greater government intervention in retail tenancy arrangements.

Any attempt to prohibit or otherwise limit the use of rental adjustment clauses based on some arbitrary 'rule of thumb' would likely impact negatively on the development process to the ultimate detriment of consumers. More generally, such a limitation would lead to an inefficient allocation of risk between developers and anchor tenants, increasing costs and reducing long run welfare. Beyond the possible negative impact on retail development, a further consequence (albeit unintended) may be higher rental burdens and/or risk borne by smaller retailers compared with the current retail tenancy situation in Australia. In this sense, even if competition were stimulated "ex post" by the removal of these clauses, it would be even more adversely harmed "ex ante" (Klein 1980).

### 1.1. RETAIL DEMAND EXTERNALITIES

So-called 'retail demand externalities' are created from customers who are drawn to a shopping centre by an anchor tenant retailer and who then shop at the smaller, non-anchor tenant retailers. As a result, the retail sales of smaller, non-anchor tenants increase when an anchor tenant retailer is present in a shopping centre. Ghosh (1986, p. 91) has described the impact of these externalities as follows:

*Realizing that the low-order store benefits substantially from associating with it [the high-order store], the high-order store may claim part of the excess revenue [to the low-order firms] as subsidies or side payments. In practice, such side payments often take the form of rental subsidies. Developers of shopping centers offer land parcels to high-order stores – typically "anchor" department stores – at rates substantially less than those available to lower-order stores.*

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<sup>1</sup> In addition, the economic literature supports the general proposition that exclusive contracts can have legitimate business purposes, and have the effect of promoting competition and efficiency (see, for example, Posner 1976, Bork 1978, Inness and Sexton 1994, and Rasmusen, Ramseyer and Wiley 2000).

Both the size of the anchor tenant and anchor tenant image have been identified in the literature as important to customer draw (Eppli and Benjamin 1994). An early survey study by Stanley and Sewall (1976) found that stores whose chains have strong favourable images can draw customers from longer distances than can similar-sized stores representing a chain that is perceived as mediocre. Nevin and Houston (1980) also found evidence that anchor department stores are an important shopping centre draw, and perhaps the primary reason customers choose one shopping area over another.

Empirical studies have sought to estimate the effects of anchor tenant size and image on non-anchor tenants in shopping centres. Eppli (1991), for example, found that for shopping centres with high fashion image anchor tenants, non-anchor tenant sales increase by US\$35 to US\$123 per square foot. Applying a market expansion potential model to the same database, Eppli and Shilling (1993) found that in regional shopping centres with greater quantities of space devoted to anchor tenants there are higher non-anchor tenant sales for eight of nine merchandise types, with an average increase in sales of US\$83 per square foot for centres with a higher concentration of anchor tenants.

Pashigian and Gould (1998) found strong empirical support for the externality hypothesis with an increasing presence of anchor stores generating higher sales of non-anchor stores. Shopping centre developers internalise these externalities by offering significant rent subsidies to anchors and by charging rent premiums to other tenants. They estimated that anchors receive a per foot rent subsidy of no less than 72 per cent that which non-anchor stores pay.

## 1.2. EFFICIENT CONTRACTING BETWEEN SHOPPING CENTRE DEVELOPERS AND ANCHOR TENANTS

A failure to internalise the benefits of the anchor stores would imply too little space allocated to anchors and a failure to generate all the returns to their activities at the margin. Gould, Pashigian and Prendergast (2005) show that shopping centre contracts are written so as to internalise these retail externalities through an efficient allocation and pricing of space, and an efficient allocation of incentives across stores.<sup>2</sup>

In general, though to varying degrees, the success of each store depends upon the presence and effort of other stores and also on the effort of the developer to maintain the shopping centre. Externalities are efficiently internalised by: (1) subsidising the rent of stores (usually anchor tenant stores) who generate traffic (and sales) for other stores (with a premium charged to stores who primarily benefit from the retail externalities); and (2) creating contractual provisions which align the incentives to induce optimal effort by the developer and each shopping centre store according to the externality generated by each store's effort.

Gould, Pashigian and Prendergast show that contracts are designed to allocate shopping centre space efficiently in that, on the margin, sales from an additional square foot of anchor space are equal to those from an additional square foot of non-anchor space. Specifically, although sales per square foot for anchors are US\$133 less than those of non-

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<sup>2</sup> This result is based on a data set containing the rent, sales and contractual provisions of more than 2,500 stores in large US shopping centres.



anchors, an extra square foot of anchor space is predicted to increase sales of non-anchor stores by roughly US\$120 through externalities, eliminating almost all the difference.

A key insight, however, is that externalities are created not merely by the anchor stores locating in the shopping centre. Rather, there are a multitude of unobserved actions taken by stores which affect not only their own sales, but also those of other stores through the traffic that they bring to the shopping centre. The developer depends on each store owner to exert effort not only to maximize their own store's profits, but also to generate more traffic to other stores as well. In the case of anchor stores, externalities are generated by actions such as marketing campaigns, maintaining cleanliness, product variety, and so on (Gould, Pashigan and Prendergast 2005, p. 419).

Simultaneously, the success of a shopping centre depends on how the developer maintains the centre over time – keeping it clean, refurbishing it as required and ensuring an appropriate mix of stores so that the centre remains competitive with rival shopping centres.

In the context of what economists describe as a 'two-sided agency' or team production problem, a simple fixed rental contract cannot be relied on to align incentives efficiently. The contract, therefore, needs to be structured in circumstances of uncertainty where actions are not fully observable and are difficult to contract over.

Shopping centre lease contracts provide the rules for parties to structure their future relationship. In general, parties will have competing alternatives both at the formation stage and within the relationship and the choice of rules will depend on the anticipated outcomes.

As suggested by Goldberg (1980), the choice of rules will also reflect three significant facts about the world: first, people are not omniscient; their information is imperfect and improvable only at a cost; second, as the relationship unfolds there will be opportunities for one party to take advantage of the other's vulnerability, to engage in strategic behaviour, or to otherwise behave opportunistically; and third, the parties cannot necessarily rely on outsiders to enforce the agreement cheaply and accurately.

### 1.3. RISK, INVESTMENT AND RENT ADJUSTMENT CLAUSES

Anchor tenants must undertake a range of large, long-term investments that are sunk and do so in circumstances where the ultimate performance of the shopping centre is uncertain. From an economic perspective, therefore, long-term shopping centre lease contracts are a mechanism for risk reduction and distribution between parties, providing a system of incentives and constraints affecting future actions by both the anchor tenant and the developer.

Once investments are made, the anchor tenant faces both developer risk and competitive risk and it is both commercially reasonable and economically efficient that the original contract terms take account of these risks.

As noted from the analysis by Gould, Pashigian and Prendergast (2005), there is the risk that the developer will not maintain the centre's common amenities in a way that ensures its future success. This type of risk is essentially an example of what economists refer to as 'hold-up' risks.

There is also a risk of the developer undermining the anchor tenant's ability to recover its sunk costs by reneging on an initial commitment concerning the competitive environment in the shopping centre. Simply put, an anchor tenant will be reluctant to incur the initial investment without some assurance of subsequent rewards. Other things equal, the firmer that assurance, the more attractive the investment. An efficient way to manage this competitive risk is a rental adjustment clause whereby rental levels are structured in contingent terms – for example, the rental level is made contingent on whether the developer exercises an option to seek the location in the centre of another supermarket.

In this context, it is important to note that shopping centre contracts with anchor tenants are negotiated at a time when ultimate outcomes in terms of the shopping centre are uncertain. In particular, competing entry creates an obvious risk of truncation of returns. More specifically, should the centre succeed, the anchor tenant may find its share of the “up-side” removed by competing entry, while still being entirely exposed to the “downside” should the centre fail. Seen in this light, exclusivity clauses provide a form of insurance that shares the risk; moreover, they are likely to do so more efficiently than could a fixed rent level alone. In effect, the clauses amount to an additional instrument (above and beyond the rent level) that can be targeted at the specific risks of opportunism, while retaining the desirable incentive properties – emphasised by Gould, Pashigian and Prendergast – of the rental contract.

The presence of these clauses may be one reason why rental subsidies to anchor tenants in Australia appear significantly lower than those found in US shopping centre leases. Previous public inquiries into the retail sector in Australia have heard that small retailers are likely to pay roughly three times the rental per square metre paid by anchor tenants.<sup>3</sup> While broadly consistent with the presence of retail demand externalities, the data examined by Gould, Pashigian and Prendergast suggest that rental subsidies for anchor tenants in the US are greater by a significant order of magnitude.

They found, for example, that, on average, anchor stores occupy more than 58 per cent of the total leaseable space in the shopping centres yet pay only 10 per cent of total rent collected by the developer. Describing this rental subsidy as ‘astounding’, the authors concluded that it ‘can only be explained by the vast externalities created by anchor stores’ (Gould, Pashigian and Prendergast 2005, p. 411).

Indeed, according to their data, the overwhelming majority of anchor tenants (73 per cent) pay zero rent. At the same time, 76 per cent of anchor tenants in the US were found do not have percentage provisions in their contracts (commonly referred to as overage provisions in the United States) making them eligible to pay additional rent above the base rent if a certain threshold of sales is reached.

These results appear to be in marked contrast to the terms and conditions which apply to an anchor tenant such as Woolworths in Australia where a shopping centre contract invariably includes a combination of base rent and percentage rent (whereby if sales increase a higher rent is paid), plus periodic rental reviews whereby the increase in the percentage rent is converted into the new base rent.

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<sup>3</sup> See the report by the Joint Select Committee on the Retail Sector (1999), chapter 5.

#### 1.4. PUBLIC POLICY AND COMPETITION ISSUES

For reasons set out above, rental adjustment clauses form part of a framework of efficient contracting through which an anchor tenant is provided with a degree of certainty that the landlord will not alter the ground rules on which a large initial investment was based. Given that those clauses are struck through commercial negotiation in a context where all parties have multiple alternatives, the onus is on those seeking to demonstrate some adverse impact on social welfare to do so.

Clearly, a rent adjustment clause is not an 'exclusion clause' in the sense that the landlord/developer can still exercise the option of expanding the shopping centre to include new tenants (in this case a supermarket). Rather, the evidence above suggests that these clauses need to be viewed in the context of complex contracting arrangements in a long-term relationship.

In addition, there may often be reciprocal obligations on the anchor tenant which reflect the developer's interest in ensuring the most profitable allocation of space in the shopping centre. Suggestive of this, a major supermarket centre landlord has stated in an earlier public inquiry that:

*When we write an anchor tenant lease, on a large number of occasions it will define the range of products that are offered there ... The worst thing for us is to build a new centre and because the range of products offered within the existing supermarket we cannot lease up the specialty shop space because they just cannot compete. So we are very mindful of that. It is a case of striking the right balance between the two and ensuring there is no overlap. It is no good for us as the landlord having empty space in our centres.<sup>4</sup>*

Given the obvious public benefits that accrue from the development process, this further highlights the need to consider individual clauses or rental provisions within a wider context of efficient management and distribution of risk. The initial commitment and major investment decision by the anchor tenant is often vital to the viability of the overall retail development in certain locations (particularly in non-metropolitan areas).

Again, this point has been made from a landlord's perspective such that:

*Anchor tenant leases act as a catalyst for retail development in rural Australia. Without an anchor tenant committed to a long-term lease, any proposed major retail development will flounder. ... Not only are they renting a very large area of space ... they are spending quite a considerable amount of money on the inside of their property... It [lower rent per square metre to anchor tenants] is reflective of the relative contributions: the length of the lease – obviously, a 20-year lease with a credit quality tenant who has the financial security to honour the obligations of that lease over the long term – the area, the amount of money they invest in the centre themselves and the marketing dollar that they bring.<sup>5</sup>*

<sup>4</sup> See evidence from Mr Mark Baillie in the report by the Joint Select Committee on the Retail Sector (1999), chapter 5.

<sup>5</sup> *Ibid.*

## 1.5. ANTI-COMPETITIVE EXPLANATION UNNECESSARY AND COMPLEX

Although economists invariably analyse anchor tenant contracts in “efficient bargain” terms, the suggestion has been raised in the course of this Inquiry that the clauses at issue may reflect the market power of Major Supermarket Chains (MSCs), and more specifically Woolworths, being used to an anti-competitive purpose.

However, it is difficult to understand why Woolworths, even assuming it had the market power at issue (which is not the case, as shopping centre developers could turn to other anchor tenants, including stores other than supermarkets), would choose to use that market power to obtain clauses of this type. Indeed, the theory that exclusivity clauses might be used to preserve market power relies on complex and arguably implausible mechanisms (as will be explained below). In contrast, the efficiency explanations given above seem more compelling. Further, actual practice suggests there must be an efficiency rationale for these types of clauses since:

- MSCs that clearly have no material market power obtain similar terms and conditions with shopping centre developers; and
- the shopping centre developers in some cases have imposed restrictions on the MSCs, including Woolworths, that either forbid the MSC from opening a new store within a certain area, or which impose a rent review penalty.

Proponents of the view that exclusivity clauses represent substantial market power must explain two difficulties:

- First, why would the signing MSC have substantial market power while negotiating with the shopping centre developer (that is, *ex ante*), but need to protect that power *ex post*, after it has established operations in the shopping centre? After all, to say the MSC has substantial market power *ex ante* is to say that *ex ante* other retailers cannot make the shopping centre developer an offer that would force the MSC with market power to give up some of its monopoly rents. Yet, if an exclusivity clause is needed to protect the MSC with market power from *subsequent* entry, then that implies that somehow that MSC would no longer have such market power *after it has established itself*, that is, exactly when it would be even harder to beat. This is especially so given the established MSC's rents typically are, in part, dependent on the MSC's total sales. Thus, for the entrant to increase the shopping centre developer's profits through *ex post* entry, it would have to either increase total sales at the shopping centre (since any sales taken from the incumbent merely change who pays the developer rent) and/or pay a higher percent of sales to the developer than the incumbent. At the same time, the entrant would have to expect to earn sufficient net revenues to cover the large sunk costs of establishing its own store, while competing with an incumbent. While all this may be possible, it seems implausible that an entrant capable of achieving this would be unable to provide a greater *ex ante* constraint on the MSC said to have substantial market power. In short, if an exclusivity clause is to protect or extend market power, it must be explained why competition would be stronger *ex post* than *ex ante*.

- Second, why, if the MSC has substantial market power, can it not directly obtain market rents through monetary terms in the lease arrangement? This is especially reasonable given that the parties typically engage in relatively complex forms of financial payments involving both lump sum and rental payments, where rental payments can in part be, and often are, set as a percentage of sales. For example, an MSC with substantial market power could call for lower (perhaps even negative) rental payments relative to those it would pay if it had no such power. Moreover, such arrangements would be far less likely to draw regulatory attention.

It also cannot be argued that exclusivity clauses are intended to trade short-run income against uncertain long-run income where growth in the market or a misstep or a competitive development might make future entry possible in the absence of the exclusionary contract. This story fails on the standard grounds that buyers such as the shopping centre developers would not sign contracts that required them to forego the potential of obtaining future competitive bids, without compensation that would make the contract unattractive to the excluding retailer. Indeed, shopping centre developers and competing retailers have excellent incentives to sign their own long-term contracts that would defeat any particular retailer's attempt to engage in forward-looking foreclosure. Moreover, it is not clear why the MSC would choose to ensure its monopoly rents on the basis of a bet that may or may not pay off *ex post*, when instead it could *ex ante* force, for example, low rents.

That said, the economic literature has shown that anticompetitive exclusion might be affordable, when among other things, 'firms in the industry must be able to operate only at or above some efficient scale' (Rasmusen, Ramseyer and Wiley 2000, p. 310; see also Aghion and Bolton 1987 and, extending this, Rasmusen, Ramseyer and Wiley 1991). In the present case, a successful retailer of groceries (whether an MSC, a discounter like ALDI, or a smaller general grocery store like IGAs) may have to command a certain number of shopping centres, and/or, allowing for endogenous economies of scale, a certain percentage of the market. Thus, an MSC with substantial market power might use exclusivity clauses to prevent other firms from gaining the scale required to compete more effectively. Such action (to the extent it is possible, which will be discussed below) may be more probable if shopping centres where retailers can locate do not frequently become available.

Despite this, nothing in the literature has overturned the basic proposition that, as Rasmusen, Ramseyer and Wiley (2000, p. 310) put it, quoting Judge (now Justice) Stephen Breyer, 'exclusive dealing "often" serves legitimate business purposes', and consequently:

*[t]he theory [of anticompetitive exclusion] does not support outlawing exclusive dealing on a per se or summary basis. If a legal prohibition is justified at all, any sensible legal test would have to be far more discriminating.*

### 1.5.1. Anticompetitive exclusion is implausible in Australian shopping centres

If anticompetitive exclusion is to be possible, then as Rasmusen, Ramseyer and Wiley 2000, p. 310) argue:

*the victims...—customers or suppliers—must expect that the exclusionary tactic will succeed, and be unable to coordinate their actions to defeat the tactic...*

*An excluding firm in this situation can buy naked exclusion affordably [in contrast the standard intuition expressed by Posner, 1976 and Bork, 1978] because it can scare victims into selling cheaply; no single victim can stop the exclusion by itself, so no single victim has any bargaining power.*

Thus, Innes and Sexton (1994) and several others (see their footnote 2) show that when buyers can merge, vertically integrate, form coalitions, and contract with entrants the possibility that exclusive dealing is anticompetitive is narrowed or eliminated. Indeed, Innes and Sexton (1994, p. 566) find that in some cases 'exclusionary contracts actually prevent inefficient entry from occurring and need not deter efficient entry'. Similarly, Segal and Whinston (2000) show that anticompetitive exclusion cannot succeed when negotiations are simultaneous and discrimination is impossible.

In summary, anticompetitive exclusion can only occur when buyers and competing sellers are essentially powerless, and so buyers can be convinced that if they do not accept the offered terms they will simply have no one to purchase from. This hardly seems to characterise shopping centre developers (the buyers in the present circumstances) or retailers (notably those such as Coles, ALDI and the IGAs). As a result, Woolworths is in no position to effect anticompetitive exclusionary contracts.

For example, all of the large shopping centre developers operate many shopping centres (see Table 1). As a result, one of these larger shopping centre suppliers can unilaterally prevent Woolworths from successfully engaging in anticompetitive exclusion by merely being willing to contract with third parties such as Coles, ALDI and the IGAs. Moreover, developers have strong incentives to encourage rivalry among retailers, and this is heightened if there is any prospect that a single powerful retailer might be able to anti-competitively exclude so as to railroad them into dealing with a monopolist. Similarly, retailers, most notably the larger more sophisticated players, such as Coles, ALDI and the IGAs, can readily seek out large developers with competitive offers to ensure they are not excluded from the market. Further, these, and indeed all, retailers have good incentives to do so.

Consequently, it is common for developers to engage in committed relationships with different retailers from one shopping centre to the next.. Such multiple commitments only make it harder for a single player like Woolworths to exclude other retailers.



**Table 1: Larger shopping centre developers**

|                                   | Centres      | GLA (millions sq m) | Australian shopping centre assets managed (\$billion) |
|-----------------------------------|--------------|---------------------|---|
| Westfield                         | 43           | 3.4                 | 20.4  |
| CFS Retail property trust         | 24           | 1+                  | 8.9   |
| GPT Group                         | 17           | n/a                 | 5.8   |
| Stockland Trust Group             | 40           | 0.9                 | 3   |
| Centro Properties Group           | 120          | n/a                 | 1.2   |
| AMP Capital investors             | 43 (incl NZ) | n/a                 | 7+  |
| Macquarie Countrywide Trust       | 77           | 0.4                 | 1.2   |
| DB RREEF Trust (DRT)              | 6            | n/a                 | 0.9   |
| Bunnings Warehouse Property Trust | 51           | 0.7                 | 0.7   |

**Sources:** Westfield Group Annual Report 31 December 2005, CFS Retail Property Trust (CFX), 30 June 2006 Annual Results, Michael Gorman – Fund Manager, 17 August 2006; GPT Retail Overview December 2006; Stockland Property Portfolio December 2006; Centro Properties Group Annual Report 2006, AMP Media Release, 11 October 2006, “AMP Shopping Centre Fund continues strategic growth”; DB RREEF Trust Annual Report 2006; Bunnings Warehouse Property Trust, Annual Report.

It is important to note that shopping centre development is oligopolistic and relatively concentrated. Approximately 30 firms control just over half of total shopping centre floorspace,<sup>6</sup> however, ownership is not evenly spread over these 30 firms (see Table 1), and, in any case, it is likely firm concentrations are higher in many regions and sub-regions. Additionally, there are entry barriers associated with planning restrictions that protect existing operators. Moreover, many of the developers are very large and sophisticated businesses, including in terms of their expertise in dealing with development processes. Finally, shopping centre development is not merely difficult to hide, but rather is often widely advertised. As a consequence, developers, it can be assumed, are in a position to observe Woolworths contracting and to analyse its impacts on the market, including whether Woolworths is using exclusive dealing as a means of maintaining or extending any market power it might have at their expense.

<sup>6</sup> Shopping Centre Council of Australia. <http://www.propertyoz.com.au/scca/HTML%20Pages/Research.htm> (viewed 10 June 2008).



It is also the case that if the rival retailers that are to be excluded have made credible commitments to entry or continued presence in the market, then exclusion may become impossible and in any case less profitable. Such commitments make exclusion less possible because buyers (in this case, shopping centre developers) know that for at least the commitment period, they do not have to accede to any exclusionary contract. Such commitments make exclusionary behaviour less profitable, even if it can succeed, because buyers 'will not sign exclusionary contracts with the [excluding party] without a bribe' to compensate them for the higher prices they would endure under that contract for the period over which they could obtain lower prices from rivals (Rasmusen, Ramseyer and Wiley 1998, p. 5).

In practice, as already noted, shopping centre developers and competing retailers can and do credibly and publicly commit to ongoing operations over broad geographic regions (since any development requires both the developers and retailers to incur substantial sunk costs). The result is few if any of these players could be expected to exit over any short period (or if they did, existing competitors or new entrants could operate their assets). As a result, if Woolworths could plausibly engage in anti-competitive exclusion (and the preceding suggests that is simply implausible) it would have to pay the developers to give up the benefits of extant competition. Such payments would not only make it less likely that such action could be profitable, and hence worth pursuing, but would make it more likely that the developers would recognise they were being manipulated into creating a monopolist, allowing them to avoid this fate.

Such shopping centre developers are unlikely, for several reasons, to be convinced that all their peers are going to sign an exclusionary contract that has the anti-competitive effect of raising their costs, and so they really have no option but to also sign such a contract.

In conclusion, the theory that exclusivity clauses serve an anticompetitive purpose seems without basis and for several reasons:

- It is implausible that Woolworths would have substantial market power *ex ante*, but not *ex post*.
- Even if Woolworths did have substantial market power *ex ante*, but not *ex post*, it would be more straightforward, and less risky in regulatory terms, for Woolworths to simply use its *ex ante* market power to obtain low (possibly negative) rents. After all, market power can only be used once, in the sense that any advantage gained in one dimension of a contract will be traded-off against outcomes in another. Were it the case that *ex ante* Woolworths had and was using the market power at issue, it is difficult to see why it would use it in a way that raised regulatory risks to obtain a speculative benefit in terms of rent renegotiation clauses, as against the assurance of obtaining a lower rental regardless of outcomes (Gerber 1988).

- In any case, anticompetitive exclusion seems entirely implausible. Under ordinary circumstances, no buyers would be willing to give up competitive prices without compensation that would make the cost of obtaining the exclusive deal prohibitive. While a particularly powerful seller, when faced with extremely weak and uninformed buyers, might be able to force such a deal, there is nothing about the market in which retailers and shopping centre developers work that would make such an outcome possible. Woolworths faces competition from a range of other large, sophisticated and well-informed retailers, and equally makes offers to shopping centre developers with similar characteristics.
- Rather, a more natural explanation is that exclusive dealing clauses assist in reducing transactions costs in the context of complex, long-term relationships in which the need of each party to incur substantial sunk costs exposes the parties to the risk of opportunistic conduct.

To pursue the efficiency argument further, it is worth noting that in terms of the efficiency analysis, little turns on the form of the relevant provisions, and more specifically, on whether they are cast as a property clause (a right to refuse the co-location of a competitor) or as a liability clause (a right to a stipulated adjustment in payments in the event of the co-location of a competitor). In effect, the sole difference between these clauses is in the vesting of the relevant decision rights (in the one, the developer holds the right, while in the other, the right is vested in the tenant); indeed, in theory, all the work done by the one could be done by a suitable re-definition of the other.<sup>7</sup>

As a general matter, one would expect the property right formulation to be used where it would be difficult to determine the rental adjustment that would leave the tenant whole in the event of competitor co-location, where the tenant was more risk-averse than the shopping centre developer or, more generally, where the shopping centre developer has an informational advantage (for example, in assessing the likely consequences of competitive entry) and the clause acts to protect the tenant from that advantage. In this sense, exactly the same types of efficiency gains will flow from the alternative formulations, with each formulation being used where it maximises the gains the parties jointly make from the contract.

Analysis conducted by Concept Economics further supports this view. It finds that contracts with an exclusivity or rent adjustment clause have no statistically significant effect on prices. There is a small effect on the probability of co-location of ALDI and Coles with a Woolworths store, with the presence of an exclusivity or rent adjustment clause reducing the probability of an ALDI or Coles being co-located with a Woolworths by one and three percent, respectively. However, this structural effect dissipates rapidly (over a distance of 3 to 5 km). No effect was found for IGAs or Foodworks. Thus, it seems improbable that such leases serve any anticompetitive purpose.

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<sup>7</sup> This is simply a standard result of the Coase theorem. The standard reference on the difference between property and liability clauses is Calabresi and Melamed (1972).

In short, the natural interpretation of these clauses is as the outcomes of bilateral bargaining aimed at maximising the economic value to the parties of development opportunities. Society gains by having specialisation in the property development function relative to the function of operating supermarket chains and other anchor tenants. However, the separation of the ownership of these activities that is the inevitable result of that specialisation creates transactions cost issues that are resolved through complex contracts. Those issues arise from the need to protect the parties' respective sunk investments while providing them with incentives to undertake value-enhancing activities (that is, the activities which maximise the joint value of the assets to the parties). This is what the contracts do, adapting their form and content to the varying circumstances in which they are entered into.

As with other such contracts, it would be incorrect to confuse what may seem like restrictions on competition *ex post* as comprising competition and efficiency at the time when the sunk investments are being entered into – which is the relevant perspective for competition analysis. For exactly the same reason, seeking to increase competition *ex post* would simply deter competition and reduce efficiency *ex ante*, as it would reduce the scope for development to occur and cause society to forego the benefits it brings.

## 1.6. FINDINGS OF THE UK COMPETITION COMMISSION GROCERIES MARKET INVESTIGATION

The sorts of contractual arrangements discussed above appear to have attracted added interest in the context of this Inquiry as a result of the investigation by the UK Competition Commission (CC) into competition in the UK retail grocery market. While the CC found that, overall, consumers are receiving the benefits of competition in that market, it also adopted a number of measures aimed at improving competition, including 'action to prevent land agreements which can restrict entry by competitors'.<sup>8</sup> Among the remedies adopted by the CC were the following:

- Large grocery retailers will be required not to enforce or seek the enforcement of any existing exclusivity arrangements identified in the report where those arrangements have been in place for more than five years from the date of the report.
- Large grocery retailers with a strong local market position in a highly-concentrated local market may be required not to enforce certain exclusivity arrangements in that local market which may restrict grocery retailing or have equivalent effect and which were not notified to the CC.
- Large grocery retailers will be required not to enforce or seek the enforcement of other exclusivity arrangements after the longer of five years from the date of this report or five years from the date the grocery store benefiting from the exclusivity opened.

A number of points can be made concerning the analysis underpinning these remedies and why they do not necessarily provide a model for this Inquiry to replicate:

1. The CC adopted what appears, at best, to be a partial and cursory treatment of the economics of these provisions. Almost no formal analysis appears to have been conducted regarding the underlying purpose of such provisions, their effect on

<sup>8</sup> See Competition Commission, 'Groceries Market Investigation – Final Report', News Release, 30 April 2008.

competition, the role of contracting incentives and constraints in the presence of retail demand externalities or the risks of opportunistic behaviour in the development process. For example, virtually the only discussion along the lines of sections 1.1-1.3 above appears to be a passing reference at paragraph 7.94 of the Final Report of the Competition Commission (2008, p. 145) to the effect that: 'We [the CC] were told that once a grocery retailer had agreed to open a store within a development, other tenants followed more readily and thus a commitment from a grocery retailer facilitated the letting of other units'.

2. No allowance was made, or analysis conducted, of the *ex ante* harm to competition likely to arise from proscribing or artificially limiting the terms on these clauses. As the analysis above highlights, seeking to increase competition *ex post* is likely simply to deter competition and reduce efficiency *ex ante* (this being the appropriate perspective for competition analysis) by reducing the scope for development to occur to the benefit of consumers.
3. The CC adopted a somewhat curious (and convenient) approach to identifying the issues where it felt equipped to make analytical assessments. Thus, for example, it acknowledged explicitly: (a) that in some cases developments may not have proceeded without the grocery retailer obtaining an exclusivity arrangement; and (b) that the availability of these arrangements were likely to have been relevant in the negotiations of the terms on which the retailer participated in the store. When it came to specific remedies, however, the CC concluded that it would not be possible for a government body to readily distinguish between exclusivity arrangements which underpin investment and those which do not. While perhaps reasonable in itself, the CC felt less constrained by analytical modesty in determining (based on very little evidence) that five years provided the appropriate amount of time for future exclusivity arrangements applying to large grocery retailers.
4. While the CC noted in passing the anomalies and distortions likely to arise from singling out large grocery retailers for this sort of remedy, it made no attempt to assess the impact of these distortions in practice. Indeed, given the lack of formal analysis of the competitive impact of these provisions, a strong case can be made that the remedy proposed by the CC in curtailing the contractual freedom of grocery retailers (as opposed to all other land users) represents a disproportionate response to the alleged anti-competitive impact of these provisions and, as such, is contrary to the CC's own stated guidelines (Competition Commission 2008, p. 181). The imposition in some cases of a retrospective remedy on contractual arrangements already entered into by supermarkets on the basis of legitimate expectations of a particular operating environment is a particularly unfortunate feature of the approach taken by the Competition Commission.
5. Finally, importing policy remedies from the United Kingdom to Australia may prove very costly for particular groups of consumers, given the significantly different competitive environments and retail development challenges in the two countries. It seems reasonable to assume, for example, that any attempt to impose a blanket restriction or artificial five-year time-limit on certain clauses is likely to impact most severely on retail developments which are already risky from a benefit-cost perspective. In particular, the risk of a chilling effect on the growth of large supermarkets in parts of rural and regional Australia, where population density is relatively low, must be judged to be quite high, with fewer large supermarkets being established than would otherwise have been the case

(see evidence cited on p. 5). This seems particularly relevant given the evidence presented to this Inquiry by the Bureau of Infrastructure, Transport and Regional Economics (2008) that: (a) the presence of a major chain store in a locality is likely to provide groceries at price levels broadly similar to those obtained in similar stores in the capital cities; (b) up to half of Australia's non-metropolitan population is living outside a centre where they have ready access to a major chain store; and (c) the average price premium in stores in these locations is 17 per cent above the average major chain store.

## 1.7. NEED FOR CAUTION IN REGULATION

The need for caution in introducing new regulation and greater government prescriptiveness into the area of retail tenancy leases has been made forcefully by the Productivity Commission in its recent draft report on *The Market for Retail Tenancy Leases in Australia*. It concluded, inter alia, that:

- The market for retail tenancies is dynamic and complex, with an amalgam of large and small businesses participating as landlords and tenants;
- State and Territory retail tenancy legislation is highly prescriptive and has grown in volume (with a total volume of legislation now some 700 pages across all jurisdictions);
- Aspects of the legislation have constrained the market, lowered productivity and added to compliance and administrative costs; and
- In an environment where the market is working reasonably well overall, further prescriptive legislation would not achieve improved outcomes.

The broad assessment by the Commission was that 'the market is operating effectively – hard bargaining and varying business fortunes should not be confused with market failure warranting government intervention to set lease terms and conditions. Generally, there is competition by landlords for tenants and by tenants for retail space, with more desirable tenants and shopping locations able to negotiate more favourable lease terms and conditions' (Productivity Commission 2007, p. xxix).

The alternative scenario is to make it the province of government (whether in terms of a general 'rule of thumb' or on a case-by-case basis) to define what constitutes a 'legitimate' rental contract that efficiently allocates rent, space, effort and risk. There is little evidence to suggest that government agencies are equipped with the sort of knowledge required to make such assessments.

It is likely that among the consequences (albeit perhaps unintended) of new government intervention in this area would be some retardation of the development process below the level that is socially optimal. It is hard to see how this could be of any long-term benefit to Australian consumers. There is also some risk that prohibiting one specific type of contract provision may have the consequence (albeit unintended) of smaller retailers paying higher rental subsidies and bearing greater risk to ensure anchor tenants continue to make large, sunk cost investments in an environment of increased uncertainty.

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