# Promoting economic growth and competition through the planning system

## *Discussion paper*

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# Executive summary

This paper has been prepared to provide input into the current NSW State Government policy review of the role of the NSW planning system in the provision of commercial floorspace and the impact of the planning system on competition.

The Australian retail sector is dominated by chain retailers and also has high levels of concentration in terms of shopping centre ownership. Where concentration levels exceed 25% of the market in any sector or in ownership of centres, the ACCC has found that there is a strong prima facie case that a lessening of competitive tension will occur. Market concentration levels of up to 70% occur in some sectors of the retail market, and up to 60% in some sectors of shopping centre ownership.

## Market Dominance Test

Market dominance can be addressed by applying a floorspace dominance test. Market dominance can be measured on a catchment by catchment basis utilising gross leasable floor area. Retail catchments can be determined using commonly accepted tools and the results of regional catchment analyses, can be aggregated to review dominance on a metropolitan scale.

Setting the floorspace dominance test at a 25% level is consistent with both Australian and UK work which suggests that dominance above this level is anti-competitive. The floorspace dominance test would operate as an assessment "trigger". Developments above this level of dominance would need to undertake a net community benefit analysis according to specified criteria, which would include the need to demonstrate that competitive tension will not be reduced.

Additionally, to reduce regulation it is suggested that developments that are below 15% of the existing retail floorspace space in a centre, would not need to undertake a net community benefit analysis. Those above this level would need to meet such a test, according to specified criteria, which would include the need to demonstrate that competitive tension will not be reduced.

## Retail Lease Act Reform

Competition can also be facilitated by reforms to the Retail Leases Act to better balance the bargaining power between landlords and tenants which should lead to an overall reduction in rentals, particularly in larger shopping centres. Competition within centres with a single ownership (such a standalone regional centres) will be increased if appropriate controls exist on leases. It is suggested that consideration be given to a first and last right of refusal for a renewal of leases, and the abolisition of turnover rents.

Given the very high levels of concentration in the retail sector, the planning system has a justifiable role for managing the land use system/market to facilitate competition. This role is acknowledged and encouraged by the ACCC. Competition is an element of the net community benefit principle, which underpins the NSW planning system. The above package of measures responds to the demands of the National Competition Policy. The measures strike a balance between social and community outcomes, including the benefits of improved competition against those of the business community.

## Background

The NSW State government is engaged in a significant policy review of the current role of the planning system in the provision of commercial floorspace. A central element of that review is to determine the way the planning system encourages competition. This review is driven, in part, by a number of recent enquiries, including the ACCC Inquiry into the Competitiveness of Retail Prices for Standard Groceries (July 2008) ("ACCC Grocery Inquiry"). In short, governments are seeking to minimise the negative impacts of regulation on competition and to deregulate markets except where there is a clear net community disbenefit.

NSW has recently produced a draft Centres Policy which has sought to review fundamental principles underpinning centres of commercial and business activity and associated town planning controls. This has been complemented by a consultation paper issued by the Better Regulation Office which seeks responses to issues surrounding the role of the planning system on economic growth and competition.

## Competition and concentration

The Australian retail sector is subject to very high levels of concentration, particularly in the food and grocery sector. In addition to these high levels of concentration, which the ACCC Grocery Inquiry found reached at least 70% (page 61), there are regions where effective market dominance has been achieved by one major player.

A further area of concentration relates to shopping centre ownership. An assessment of shopping centre ownership was carried out by the Australian Retailers Association in 2008. This revealed that substantial concentration has occurred at the regional centre level, with 56% of centres controlled by Westfield. Westfield also has interests in the two centres controlled by AMP. Floorspace comparisons reveal an even greater level of concentration at the regional level, with nearly 60% of floorspace dominated by Westfield. Sub regional centres have a lower level of concentration with Centro the major owner, with 16%. At the district level concentration levels show AMP and Centro as the two major owners, having some 57% of centres (36 and 21% respectively).

The natural tendency of the capitalist firm is towards monopoly. Work in the UK (Competition Commission Guidelines 2003) suggests that a market dominance above 25% would "normally be sufficient to raise potential concerns regarding the effects of the merger on competition" noting that lower levels of concentration may also trigger concern. Within the respective markets of regional and district centres, there are two existing entities operating substantially above this level, Westfield and AMP.

It is also noted that for most items reviewed by the ACCC Grocery Inquiry, concentration by the major players was above 50% in most food sectors. That level of concentration has resulted in less competitive tension and higher prices for consumers. Attached is a schedule of the findings of the ACCC Grocery Inquiry, which summarises the key findings in this regard.

The concentration that has occurred means that it necessary to enhance competitive conditions through the intervention of government. In this respect there is the role played by Federal legislation, particularly the Trade Practices Act, however as presently drafted this Act has a limited ability to manage market concentration, particularly on a regional and sub-regional level.

This leaves the planning system as the only available and effective tool. This is acknowledged in the ACCC Grocery Review (see page 241).

# Role of the planning system

A key issue is whether justification exists for the use of the planning system to address competition issues.

The "net community benefit" underpins the notion of planning, and provides, in the context of national competition policy, justification for intervention by way of regulation in the operation of the land use system/market. Clearly, within the framework of national competition policy, the furthering of competition is an important community benefit consideration. The weighing up of positive and negative competition impacts on communities should form part of the overall assessment of planning objectives that seek social, environmental and other welfare outcomes for communities. The overall outcome for the community needs to be positive, recognising that achieving some positive outcomes may result in these being partially offset by other negative outcomes.

The key planning mechanisms to assist improve competition are the creation of a level playing field so that both incumbents and new entrants face the same regulatory environment (predominantly through land-use zoning and tools such as parking policies) and, further, to avoid the situation where single players are able to gain excessive dominance within a sub-market. Overall regulatory burdens should be minimised consistent with achieving appropriate competitive and social outcomes. Further, in terms of overall economic growth, the planning system should avoid differential treatment of different types of land use (for example residential, industrial and commercial). This is essential in order to avoid distortions in the investment market.

On this basis there is a prima facie justification for the use of planning tools to address market dominance.

# Tools to address market dominance

## *Measuring market dominance*

Planning tools, by their nature, will always be somewhat imprecise in their ability to achieve their intended outcomes. In many cases, "pure" planning principles are difficult to apply, in particular in terms of available information. This is very much the case with the retail sector where one of the key pieces of information, turnover per square metre is "commercial in confidence" information.

Even if this information were available, verification would be difficult. Accordingly, the preferable measurement tool in terms of assessing issues such as market dominance becomes floorspace. Floorspace can be measured in a variety of ways, including net selling space and, more commonly, gross leasable floor space. Whilst net selling space is probably a better overall measure, gross leasable floor space is a reasonable surrogate that is easily and cheaply available.

With respect to the determination of catchments, some issues arise. These include the spatial scale of catchments appropriate for consideration and also determining the boundaries of those catchments. There are a range of criteria for determining primary trade areas for retail centres of different size which are routinely applied as part of economic evaluations of new retail

developments. Whilst there is a degree of professional judgement involved in these determinations, results tend to be reasonably consistent.

It is suggested that catchment determination would be best undertaken by government, based on a set of criteria generally agreed with the retail industry. These would be based on the commonly accepted tools and could, it is suggested, operate usefully at the regional level. In this regard, catchments for determining market domination could be based on the primary trade area of the highest order regional activity centres with adjustments made to recognise overlapping trade areas. This would also allow easy aggregation to address markets at a broader scale, including metropolitan Sydney, the Illawarra and the Hunter. These determinations would operate in tandem with the floorspace measurement proposals contained in the draft Centres Policy.

## *Enhancing competition*

For competition to operate effectively, there needs to be consideration given to competition within centres, as well as competition between centres.

### Competition between centres

Competition between centres means ensuring that market dominance does not occur, in terms of the main retail anchors in competing centres, and in terms of the ownership of those centres, in particular planned centres. It also includes identification of appropriate sub-markets and looking at the market dominance of single retail operators within that area.

The issue with respect to competing regional centres is the issue of planned centre ownership. At the present time there is no control that would prevent a single centre owner developing and operating the majority of centres within an overall city or metropolitan catchment. On the face of it there is already a significant anti-competitive issue. The issue of planned centre ownership and competition between district and subregional centres is also of importance, noting that sub regional centres have a reasonable spread of ownership at the present time.

Competition between centres also needs to be managed in terms of avoiding unrestricted expansion of centres or the formation of new centres leading to a substantial oversupply of floorspace. This issue is further discussed in the section of this paper addressing the draft Centres Policy.

### Competition within centres

#### Neighbourhood centres

In the case of neighbourhood centres an uncompetitive environment arises where a neighbourhood centre consists of a single supermarket and "tied" specialties, e.g. liquor. It also arises where neighbourhood centres are under a single ownership.

A balanced neighbourhood centre would generally have some 30-50% of its floorspace as supermarket, providing scope for specialty stores to co-locate to assist to both improve the range of offer and improve competition. Synergistic benefits occur where a larger retail anchor provides the "drawing power" to assist specialty shopping. In this respect a supermarket anchor in the order of 850-1250 m² is adequate to provide drawing power for a smaller neighbourhood centre, whilst still allowing overall floor space of the centre to sit below the 1700-2500 m² threshhold which defines a good walkable centre. Overall consumer benefits are maximised

with centres of this size, as the need for car travel is minimised whilst still providing a competitive retail environment for most daily needs.

Larger neighbourhood centres, with sizes up to 10-15,000 m², also require consideration. For these centres, supermarket floorspace again should represent approximately 50% of total retail floorspace which would provide for at least two supermarket operators and a good range of specialty retailing and other services.

**District and subregional centres**
For larger centres, such as district and subregional centres, it is usual to expect two to three supermarkets, which, ideally, should have different operators although at the present time there is nothing to constrain multiple supermarkets in the same retail "stable" operating in a single district centre (for example a Coles and Bi-Lo).

## *Use of the floorspace measure*

The floorspace measure can be used to determine market dominance at all spatial scales. In practice, it would be expected that the focus would be on the regional/subregional level, as assessment at this scale can easily be aggregated up to cover city or metropolitan areas.

Further reinforcement for consideration at this spatial scale comes from the theory of indifference curves. In practice, once people are in their car, they are relatively indifferent to travel times up to approximately 15 minutes. This would allow access to several neighbourhood centres within a reasonable radius, and represents common driving times between regional centres.

## *The floorspace dominance test*

The suggested measure to facilitate competition is the use of a “floorspace dominance test" relating to each shopping centre ownership group and retail operator within their market.

With respect to retail operators, although supermarket concentration is often raised as the primary anti-competitive issue, the use of a floorspace dominance test should operate across all portions of the retail sector. It is noted that care is needed from a definitional point of view, as retailing follows traditional categories to a lesser and lesser extent. In particular, when looking at commodity purchases (known, predictable, routine) there is a strong move towards stores spanning multiple categories of goods. For example supermarkets now sell clothing, electrical goods, hardware items and the like and we are also seeing the emergence of USA style hypermarkets which blur the boundaries between a discount department store and a supermarket.

## Levels of market concentration

Implementation of a 25% floorspace dominance test addressing the ownership of planned shopping centres and also retail concentration within specified markets would provide improved competitive tension with respect to planned shopping facilities and also ensure that new supermarket opportunities within regional and subregional markets were largely taken up by new entrants. New entrants will ensure additional competition. The ACCC Grocery Inquiry found (at page 169) that large independent stores add competitive price tension to grocery retailing, and (at page 263) that the level of competition might be increased if large format independent stores increased in number.

### Market concentration and neighbourhood centres

A floorspace dominance test could also operate in terms of neighbourhood centres, both in terms of overall size and the composition of centres.

With respect to the overall size of a neighbourhood centre, the ideal size should be focused around the optimisation of walkability. Research varies with respect to the optimum size of a walkable neighbourhood centre however recent research undertaken by Macroplan for the Master Grocers Association Submission to the Victorian retail review (2009) (copy attached) suggests a limit of approximately 1700 m². Work carried out by Wakefield Planning in Ballarat and also for Eurobodalla Shire in NSW suggests centres can extend in size up to 2000-2500 m² depending upon the overall balance between district and local retailing. These sizes are consistent with a centre spacing of approximately 1.6 km, which facilitates an 800 m "ped-shed" - typically used as the walking radius for rail transit. Details of this work can be supplied if required.

Floorspace dominance tests could also operate in terms of centre composition. In order to ensure a good retail "mix" and to ensure competition within the neighbourhood centres, floorspace dominance tests can be used to manage the overall floor space dominance of a single retailer. Wakefield Planning conducted work in Eurobodalla Shire in NSW which established that effectively functioning centres needed at least 30% floor space as supermarket but not more than 50%. This suggests that supermarkets in the range of 850-1250 m² are appropriate to anchor smaller neighbourhood centres. This is also consistant with the ACCC Grocery Inquiry findings as detailed above. For larger neighbourhood centres (up to 10,000 m²), supermarkets of up to 2500 m² would be appropriate.

### *The floorspace dominance test as an assessment "trigger"*

A key aspect in utilising a floorspace dominance test is to ensure that there is a robust mechanism for reviewing developments that trigger the floorspace dominance test to determine whether they have a significant net community benefit or disbenefit. This avoids the floorspace dominance test being seen as an arbitrary control (such as a cap would be) but instead sees it as providing "trigger levels" beyond which specific justification in terms of net community benefit needs to be demonstrated for new development.

Above 25% market concentration, new development would have to demonstrate that competitive tension would not be lessened where proposals come forward above this prima facie level. This approach should be incorporated into the net community benefit test as a specific requirement for assessment. This is the approach adopted in UK planning legislation.

## Tools to reduce the regulatory burden

The use of trigger levels before a formal net community benefit test was conducted can also be utilised to reduce the regulatory burdens associated with new development, either by way of expansion of existing centres or by redevelopment within centres.

### *The incremental change test*

An incremental change test would establish a tool whereby development which is likely to be unproblematic in terms of net community benefit from an economic perspective can proceed "as of right" for that quantum of development, noting that there is still a necessity to assess merit aspects such as urban design, centre integration, traffic and parking and the like.

An incremental change test could operate so that a full net community benefit test would only be required for developments above a certain size. The traditional "level of attention" with respect to economic impact has tended to be in the order of 10-15%. This suggests that developments by way of expansion to the centre which fell below 15% of the current floorspace within the centre could be considered unproblematic on the basis of economic impact.

This test could also be applied when considering proposals to establish new centres within urban areas.

The incremental change test should, however, only be utilised in circumstances where the overall provision of retail floorspace is less than, say, 2.2 m² per head, assessed on a sub-regional basis. This is the figure utilised in comprehensive studies in Victoria (e.g Essential Economics work for the Victorian Retail Review) This would ensure that where areas of substantial oversupply exist, pressure is applied to utilise existing zoned land and infrastructure more efficiently prior to rezoning additional lands.

## Economic modeling and a net community benefit test

Once "trigger levels" have been achieved, either in terms of ownership concentration or retail dominance a net community benefit test should be utilised.

There has been concern expressed regarding the traditional measures of assessing retail impact. It is important, therefore, to ensure that robust and defensible criteria are utilised to assess the net community benefit, and that these are capable of objective review.

Getting the "net community benefit" test correct is therefore critical. The net community benefit test needs to examine both tangible and intangible aspects of proposals. It needs to recognise that centres are much more than the provision of retailing, but that they represent social and administrative hubs as well. Net community benefit tests need to include (but are not limited to) the following:

- Will there be a net benefit in terms of the total value of land and commercial development in the relevant retail catchment?
- Will there be any loss of capital value within a specific retail sector, or amongst competing centres so that the retail sector would be restricted in its ability to raise capital and compete?
- Will there be a net reduction in overall car travel?
- Will there be an increase in local accessibility to frequently used goods and services?
- Will new development integrate with and complement an existing centre or, if a new centre, will it not significantly undermine the viability of an existing centre?
- Are there other social implications arising from the new development?
- What are the implications for net employment?
- Will the development facilitate competition within the relevant retail catchment?

## Retail Leases Act Proposals

The domination of shopping centre ownership by a few major players has a well known and reported impact on the tenants in those centres. Those impacts are not limited to extremely high rents, they included poor conduct in relation to the renewal of leases and unjustifiable opposition to competitor developments. In addition to the above planning changes, the following changes to the Retail Tenancy Act are also suggested to facilitate greater competitive tension in shopping centre operations.

### *Turnover Rents*

The owners of shopping centres have complete knowledge of their tenants financial trading figures, because leases in these centres usually have turnover rent provisions. This is contrary to the principles of a level playing field. These provisions necessitate the provision by tenants of their financial data. Interestingly, notwithstanding the existence of turnover rent provisions in those leases, it is rare for these provisions to be triggered, because the rents are so high to begin with. The setting of rents being done with complete knowledge of tenants turnover.

It is suggested that turnover rents and the obligation to provide financial information to landlords be abolished in NSW. This would reduce over time, landlord's ability to negotiate excessively high rents with the knowledge of tenants capacity to pay. It would more fairly realign tenants negotiating position with Landlords.

### *First and last right of refusal at end of lease*

Currently landlords have an unfair advantage at the end of a lease. At the end of a lease retail tenants have no rights whatsoever to protect their business. This places landlords in an extraordinary position of strength, compounded by their monopoly position as centre owners. That strength results in supernormal rental rates being paid by tenants in shopping centres. If tenants had the ability "meet the market" at the end of a lease, the landlords position of strength would be more fairly aligned, Downward pressure on rents which would improve the ability of retailers to deliver consumer savings. This approach has been adopted in the UK.

It is recommended that all retail leases have a first and last right of refusal to a renewal at the end of any lease term. This would give tenants at the end of a lease the option to meet the market to renew their lease and introduce appropriate competition into this aspect of the retail leasing market.

The UK experience of this change has been positive. (References can be provided)

## Risks with the draft NSW centres policy

There are also various issues relating to the draft NSW centres policy which pose some risks. In particular these relate to the policy's promotion of unconstrained supply of commercial land.

As presently drafted, the centres policy would not provide any significant constraints on supply. Proposals to substantially over-zone commercial floorspace in order to lower costs of entry and reduce barriers to entry are likely to be ineffective in improving the competitive environment. In particular, the dominance of the market by several key players (both in terms of regional

shopping centres and retail operators) will significantly favour those players as compared to new entrants. This arises as a result of their financial capacity and through existing land banking.

With respect to the accommodation of market demand, it needs to be recognised that demand exists only at a price. On this basis, whilst significant over zoning may have the outcome of reducing price, this is likely to substantially undermine the embedded value in existing development. This would substantially weaken the ability of existing commercial development to compete against new development by raising capital based on existing property values. It would also create major uncertainties for the investment environment, which is based on a balanced approach to supply and demand will stop

A substantial over zoning of land within commercial zonings would also discourage redevelopment which would make more effective use of existing infrastructure and investment, particularly public investment. This includes service infrastructure but also transport infrastructure.

A further issue with this approach is the potential for a substantial oversupply of floorspace which may contribute to substantial urban blight. The risk is that new development would predominantly be replacing existing floorspace rather than utilising price signals through managed supply to balance provision of retail floorspace through a combination of refurbishment/redevelopment and new development. The American experience in this regard is instructive, in particular the move towards spatially disaggregated very large-scale car dependent retail developments. This has produced significant areas of urban blight in traditional "downtown" areas and also traditional town centres and high streets. Whilst the economies of scale have some benefits in terms of price (e.g. Wal-Mart) this comes at a very high cost in terms of loss of capital value, very high levels of car dependency and undesirable social and community outcomes associated with failed centres. These centres would struggle to pass a net community benefit test.

A final issue arises with respect to the policy is that it would operate so as to privilege commercial developments and investment as compared to residential or industrial development. This is contrary to the principle of a level playing field, which should treat land uses similarly so as to ensure that investment is best directed in a way that is productive in overall social terms.

# Summary

- To further the aims of National Competition Policy the town planning system can be utilised to improve the competitive environment with respect to retailing. This can operate through a floorspace dominance test set at 25% of the floorspace owned or managed by a single retail operator or planned centre owner.

- A floorspace dominance test can also be applied at the neighbourhood level to avoid dominance of a neighbourhood centre by a single retailer, and also to maintain neighbourhood centres at an appropriate scale to maximise walkability.

- An incremental change test can operate to reduce the burden of regulation for expansion of centres and the development of new centres.

- A floorspace dominance test or incremental change test can be used as a “trigger” for the conduct of rigorous and comprehensive net community benefit tests where proposals come forward outside the trigger levels.

- An incremental change test can substantially reduce the regulatory burden for small-scale proposals where a total floor space provision is at or below average levels.

- Reforms to the Retail Leases Act can avoid excessive use of market power by landlords leading to a more competitive overall rental environment.

- Proposals to substantially increase the level of zoned commercial land by substantial "over zoning" would produce deleterious effects in terms of both market concentration, competition, and overall community benefit.