Implications of the Neutrality Rule:

APPLICATION TO OTHER SECTORS

Shopping malls.

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1. Network neutrality in shopping malls

In recent years shopping malls have played a major role in commercial distribution, their main activity being to put buyers in contact with retailers through their facilities. They provide an enormous amount of floor space for shops, leisure and entertainment activities and even petrol stations.

Competition among shopping malls is intense and has sparked various kinds of growth and differentiation strategies to attract visitors. These strategies foster different types of organisation and relations among mall managers, retailers who set up their businesses there and visitors, all described below:

i. **Shopping mall managers**: These are the managers of all the infrastructures that make up the shopping mall. Recurring income for shopping mall managers comes from rental fees for the different premises and revenues from advertising space sold to companies.

The success of shopping malls depends on their ability to attract the largest number of visitors which will result in more sales for retail outlets.

Attracting visitors depends on various elements. Among the most important are geographical location and surroundings, ease of access, facilities (parking, entrance) and the quality of the premises it leases (flexibility, modularity, floor plan, etc.).

Supply and quality depend largely on potential demand. Depending on its geographical location, mall managers try to adapt the quality of their facilities to the type of retailers that have leased space there in accordance with the socio-economic characteristics of the area where it is located: employment rate, disposable income and the evolution of local private consumption.

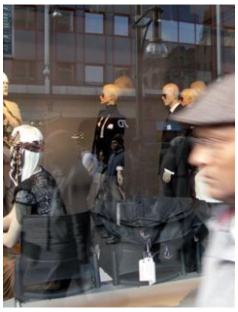
A shopping mall's drawing power depends largely on the offer of entertainment activities which may include cinemas, recreational areas and restaurants. Some opt for unique elements such as a ski slope, theme park or children's attractions to attract a greater number of visitors or a particular type of buyer.

In general terms, a shopping mall operates as a network market taking advantage of the positive externalities offered by concentrating a number of shops in the same space. The attraction of an increasing number of stores and visitors is mutually beneficial and reinforces the activity of the shopping mall and the value of its floor space. In this context, well known retail outlets play a crucial role. Without them, shopping malls would be unsuccessful in attracting a sufficient number of visitors.

ii. **Retail outlets:** These are the clients of shopping malls and their interest in leasing floor space for commercial distribution depends on how successful the mall is at attracting visitors which, as already mentioned, depends on several factors.

Several types of businesses form part of the commercial mix:

1. **Anchors or drivers**. These establishments have a strong brand image and their presence in the shopping mall attracts visitors and benefits the rest of the shops with the traffic they generate. Their presence in the shopping mall creates positive externalities for the rest of the stores as they draw in visitors. They are typically well-known brands and they have a great deal of bargaining power because without them the mall would lose its positive externalities.



1.1. **Entertainment and dining establishments**. These could be cinema and restaurant chains. Some of these act as anchors due to their singularity and drawing power.

1.2. **Brand shops**. These are businesses that sell the products or services of a particular brand which, due to its notoriety, also attracts a greater number of visitors.

1.3. **Major supermarkets**: Shopping malls are home to shops meeting everyday needs such as major supermarkets where customers can find all the essentials amongst a wide range of products at very competitive prices. Occasionally these large supermarkets use low-cost petrol stations to attract more visitors (car drivers) to the shopping mall.[1]

2. **Other shops and smaller services**: They take advantage of the positive externalities of customer traffic as their sales are contingent upon the large number of people attracted by the aforementioned businesses and the facilities provided by the shopping mall. These shops have very little bargaining power and have no other choice but to accept the lease conditions they are offered.

iii. **Visitors:** These form the axis around which mall business revolves. Shopping malls entice visitors by providing

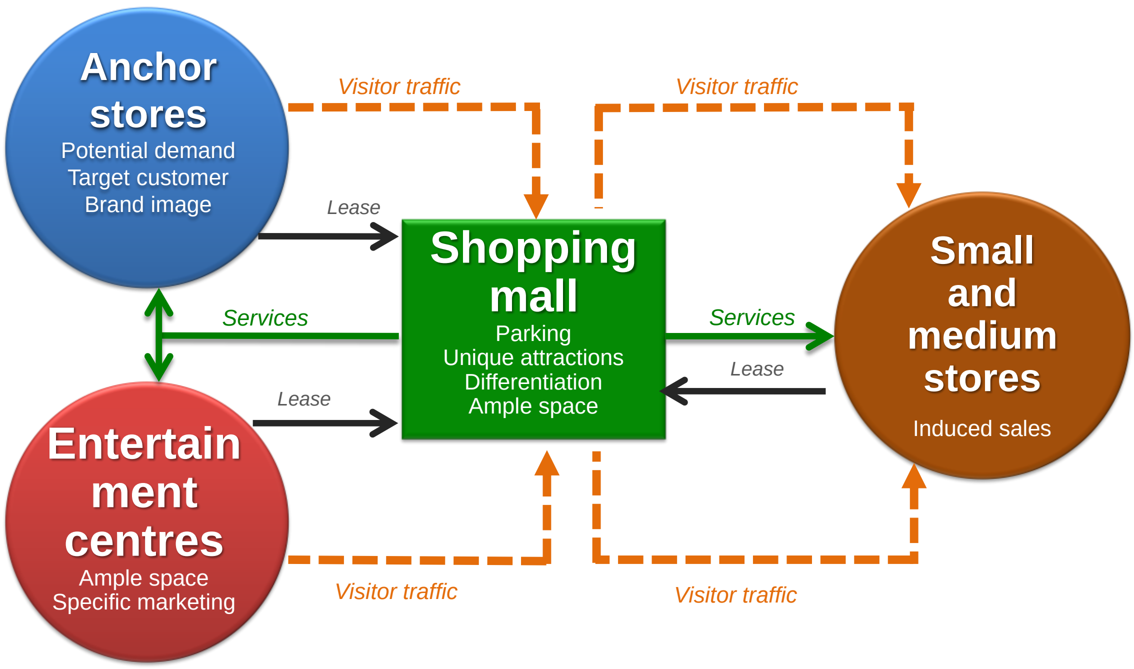
[1] The supermarket sector and how it is affected by net neutrality was already analysed. See: http://www.solchagarecio.es/es/publicaciones/estudio-neutralidad-telefonica/250-abril-sector-de-supermercados

individuals and families with "complementary" services such as free parking, discounts at restaurants or cinemas, special fuel prices, etc. This investment yields profit from the leasing of floor space to the businesses that set up their shops there.

The underlying idea is that the more visitors that come to the shopping mall the more attractive it is for retailers to lease floor space there. At the same time, the more attractive the shops and entertainment activities offered, the greater the influx of visitors. Therefore, strategies need to target both visitors and the businesses leasing commercial space.The terms of the lease have a bearing on the shopping mall's ability to draw in potential customers. Lease payments partially contingent upon sales are very attractive to shop owners insofar as they make a traditionally fixed cost at least partly variable.

Hence, the management of a shopping mall is comparable to a double-sided market to the extent that its success lies in maximising the number of economic operators willing to use it, their collective presence adding to the mall’s popularity and profit.

Figure 1: Relations between the different components of a shopping centre



Strategies employed by shopping malls in dealing with retail outlets

Leasing contracts are generally negotiated freely. Leases are typically divided into four parts:

1. **Base Rent**: this is the fixed part that the business must pay each month. It is normally subject to an annual update based on the consumer price index (CPI). Base rent is payable at the beginning of each month.

2. **Turnover rent:** calculated as a percentage of sales negotiated between the lessor and lessee. If the agreed percentage of sales (excluding VAT) exceeds the base rent, the shop owner must pay the difference. The percentage applied typically ranges from 1.5% to 12% of sales depending on the floor space and business activity in question.
3. **Service charges:** These are expenses related to shared elements and all other expenses not considered as belonging to any individual shop. These are paid in advance according to the budget drawn up by the shopping mall. They include lighting, heating and air conditioning, inside and outside cleaning, maintenance of public areas, salaries and social security contributions of mall staff, insurance premiums, property tax and others.
4. **Marketing and advertising expenses**. While these are also considered as service charges, they are treated differently as they vary over time and are likely to rise or fall depending on the mall's promotional needs. They are typically affected by the time of year and the influx of visitors.

The percentage of turnover spent on the sum of the four concepts described above is called the effort rate. It should be a factor of floor space, type of business activity and the advertising space reserved for the shop in the form of signs in the mall itself and outside billboards. The effort rate is usually between 15% and 20%.

Business strategies do not revolve exclusively around economic conditions. In fact, the differences between types of establishments in terms of the other conditions contained in the lease are more important. "Anchor" establishments and entertainment centres are given favourable conditions and more advantageous contracts. By contrast, small and medium sized outlets have less bargaining power and are forced to accept standard conditions.

Following are the most common differences in lease contract conditions:

i. **Prime real estate:** Anchor shops are guaranteed a more advantageous location ensuring a higher flow of visitors, i.e. main corridors or plazas where the most number of people congregate. Side or secondary aisles are reserved for the other businesses.
ii. **Ease of supply:** Anchor shops, especially those with high product turnover, are given best access to the loading and unloading docks, merchandise delivery passageways, etc.
iii. **Service charge discounts**: Driver businesses are often given discounts to reduce the deterrent effect that service charges could have. For example, these anchor stores are offered a weighted floor space coefficient of 0.8 while small and medium size businesses are usually assigned a weighting of 1.0.
iv. **Limitations on commercial activity**: Mall leases always include a legal clause freeing large shops and drivers from restrictions in the sale of products. In fact, these large players, especially when they are co-owners of the shopping mall, may insist on limitations being applied to the rest of the merchants. This could be the case of hypermarkets and the sale of food items. These limitations typically have to

do with establishments that could compete with their products and only permit activities that complement their business, such as banks, pet stores, travel agencies, cafeterias, etc.

v. **Limitations regarding public areas**: Shopping malls are designed to get customers to walk along certain corridors more than others. A change in corridor design for the celebration of a particular activity could affect the flow of visitors and reduce customer traffic along a given corridor. "Anchor" establishments may have a clause in their lease limiting what the mall may do in public areas that could change the normal flow of visitor traffic.

vi. **Percentage of turnover rent:** Anchor stores are often offered a much lower percentage of turnover rent than small and medium size businesses as their sales are much higher.

vii. **Marketing expenses.** In many cases, businesses that do their own advertising such as cinemas, large home stores or hypermarket chains and department stores, are treated differently from other retailers when it comes to the payment of the mall's marketing and advertising expenses.

viii. **Difference based on floor space:** mall managers set a lower rent per square meter the higher the number of square meters leased by the business. However, it is important to note that this depends on the mall's degree of modularity, i.e. its degree of flexibility in adjusting to the floor space needed by each retailer. If it is able to expand or decrease floor space according to demand, it will make more similar offers to large and small stores. In any case, small stores must usually pay a higher rent per square meter than large ones.

ix. **Discounts for unique leisure and recreation activities and restaurants.** Managers try to make their malls more attractive by offering a wide range of leisure and entertainment activities so that visitors' experience goes beyond just shopping. The aim is to get customers to return as often as possible and a good way of achieving this is to add entertainment to shopping to lengthen their stay. To that end, managers give special rent consideration to the most attractive entertainment and restaurant establishments.

x. **Price differences based on type of business**. The mall may establish different prices depending on the business the store engages in, i.e. entertainment, services, a type of product, etc.

xi. **Complementarity / degree of variety.** A large part of a mall's potential appeal lies in the variety of its stores allowing people to take care of all of their shopping needs under one roof. Mall managers try to offer the widest range of products and services so that consumers do not have to go anywhere else to purchase a particular good or service. To achieve this, they may give special discounts to those establishments that complement and enrich the range of products offered at the mall.

xii. **Differentiation based on ownership.** Some malls are also administrators of "anchor" stores such as hypermarkets. In this case, the hypermarket would not apply the same conditions to its own store as it would to the other retailers that are profiting from the sales it induces. Moreover, hypermarkets discriminate against those establishments that could compete with its products and only allow stores that complement its offer such as personal and financial services or dry cleaners in which the hypermarket has no vested interest. This is usually the strategy of hypermarkets such as Carrefour or Auchan.

xiii. **Occupancy rate:** If the mall does not achieve an acceptable occupancy rate and there is insufficient demand for space, it may lower its prices in an attempt to reach a critical mass of stores to prevent visitors from losing interest. In this case, the mall may even lease space below cost.

xiv. **Discounts for areas with less customer traffic**: Locations that are distant from pedestrian entrances (except for certain activities), cul-de-sacs, dual aisles and generally out-of-the-way areas are the worst places to set up shop and therefore are offered at a lower price per square meter of floor space.

Application of the net neutrality rule to shopping malls

Application of neutrality criteria to the shopping mall business would keep mall managers from being able to establish a lease policy and other conditions to maximise occupancy and ensure a diverse set of stores in their premises. In our definition of neutrality rules we mentioned that *"when the neutrality rule is applied, all market participants must be treated equally in terms of pricing, preferences, quality, quantity and priority".* This policy would limit the leeway malls have to differentiate and would eliminate many of the strategies designed to attract customers by enticing anchor stores to establish themselves there.

Considering that all the policies implemented by mall managers cater to the needs and preferences of consumers and that they provide many free services such as parking, play areas for children, rest areas, etc. for families and individuals in exchange for simply visiting their facilities, **the neutrality rule would be particularly detrimental to consumers as it would diminish the offer of leisure and entertainment activities, shopping and services that they enjoy today.**

The most attractive business retail outlets, the so-called anchor stores, would be hit particularly hard as they would no longer be able to benefit from differentiation strategies in terms of better prices and services offered by mall managers. Moreover, said managers would be unable to make their mall more attractive by recruiting anchor stores through the offer of more favourable lease conditions.

Since anchor stores would no longer have those advantageous clauses guaranteeing a favourable environment and visitor traffic, some would be deterred from setting up business in certain malls. Bear in mind that in addition to rent, brand name stores need to make an important investment to adapt the premises to their image. Without guarantees in terms of visitor traffic or the quality of nearby shops, some of the big stores will choose not to invest in the mall. Since it is impossible to put all shops in equally attractive locations, a neutrality rule could assign space on a first-come first-served basis which would discourage late-comers as these would be relegated to more remote parts of the mall.

Similarly, the elimination of advantages for those vertically integrated establishments such as hypermarkets would discourage the forms of organisation that have fostered diverse services under a single roof, i.e. the proliferation of different types of services complementing the large anchor store which have proven to be very advantageous and convenient for consumers. Also, malls anchored by hypermarkets would tend to disappear thus reducing the diversity of retailers available to consumers.

Another serious consequence of the neutrality rule would be its effect on leisure activities. Entertainment related businesses pay less for the marketing and advertising offered by the mall since they already spend a significant sum on their own marketing and advertising of their products. For example, cinema chains have a high advertising budget to promote their films and malls benefit indirectly from that as it draws in more visitors. Aware of this fact, mall managers offer them discounts on marketing and advertising expenses. If malls are no longer able to draw a distinction and charge entertainment businesses such as cinemas and restaurants less for marketing as they already shoulder significant advertising expense of their own, we would lose one of the main attractions drawing visitors to malls and these businesses would become more reluctant to establish themselves there.

Net neutrality would greatly hinder management as malls would no longer be able to use discounts or advantageous lease conditions to freely determine the location of shops in accordance with potential demand for their products and services. All retailers would have the same possibility of locating along traffic corridors or plazas, in cold or hot areas. Anchor stores may not be interested in settling in some areas and prefer to leave the mall to the detriment of the remaining shops (which appeared to benefit from the neutrality rule since it apparently put them on an equal footing in terms of choosing a location in the mall).

Shopping malls would also have fewer options at hand to solve low occupancy issues in times of crisis. They would have to offer the same terms to all their shops which in some cases could even result in the closure of some malls unable to cover operating expenses due to insufficient occupancy.

In this same vein, the mall would be unable to differentiate among stores based on their business activity. This would stand in the way of strategies aimed at increasing the diversification of products and services which could complement the mall's existing offer and increase visitor satisfaction.

Since the mall would be forced to give all stores the same lease conditions, it would be unable to rent the less attractive locations such as cull-de-sacs or secondary corridors or busy but unappealing areas near hypermarkets checkout counters or toilets. This would drive up the service charges of shops already up and running and could put those with lower turnover out of business.

More and more neighbourhoods are being built in areas far from urban centres and malls in these outlying areas play an important role in supplying goods and services.

For reasons of economies of agglomeration, retail outlets tend to prefer urban areas where they are closer to other shops. Shopping malls provide this meeting point for businesses outside of urban centres generating the desired economies of agglomeration. Neutrality rule interference could hinder the optimal installation of this type of infrastructure which provides services for many urban areas and, in a worst case scenario, could leave certain areas with no services.

In general, the neutrality rule would significantly interfere with the business model employed by malls and consumers would suffer the consequences in terms of poorer distribution quality and entertainment and service offerings available to individuals and families.

a) **Impact of neutrality on shopping malls:**
- Inability to implement an optimal leasing policy with different pricing per square meter of floor space.
- Inability to manage space based on occupancy, diversity and potential demand.
- Fewer instruments available to differentiate one mall from another through more or different types of anchor stores, entertainment activities or restaurants.
- Erosion of profitability due to lower occupancy rates.
- Increased operational risk due to unoccupied premises.
- Less competition, competitiveness and efficiency.
- Reduction in the number and promotion of new malls.
- Decline in total investment in infrastructure and undermining of mall-related economic activity.
- Less job creation in terms of mall maintenance and the stores occupying its premises.

b) Impact on retail outlets
- Less space to locate stores.
- Less adaptability of spaces to commercial formats.
- Higher rent.
- Less capacity to adapt to potential demand for the brand.
- Deterioration of commercial synergies.

c) **Impact of neutrality on consumers:**
- Fewer entertainment and commercial offerings at malls.
- Less varied commercial mix.
- Higher transaction costs.
- Deterioration of mall facilities.
- Increase in commercial distribution prices.
- Urban planning and organisational expectations left unmet.

Summary of business strategies that would be affected if net neutrality were applied and its impact on consumers and retail outlets.

Business Strategy	Restrictions resulting from net neutrality	Impact on consumers and businesses
Different terms regarding floor space: *Reserve busiest, high-traffic areas* *Ease of supply* *Make the use of public areas contingent upon the needs of anchor stores* *Limits on adjacent premises*	All commercial establishments must be given the same lease conditions *Discriminatory practices based on the drawing capacity of anchor stores would be prohibited.*	· Decline in the drawing capacity of anchor stores which means: · Fewer shopping and leisure offerings · Less efficient warehouse management of the most attractive shops · Fewer mall visitors.
Different economic conditions *Different turnover rent percentages* *Discounts on service charges* *Differential treatment of entertainment businesses with regard to marketing expenses*	All retail outlets pay the same rent: *Regardless of turnover, companies pay according to the same remuneration scheme*	· Higher prices paid by anchor stores making their products more expensive · Fewer shopping and leisure offerings · Popular products become more expensive
Lease terms for businesses that are part owners of the mall *Owners have no restrictions on the type of economic activity they engage in* *Owners have more favourable economic conditions*	All retail outlets must be given the same lease terms: *Discriminatory practices to round out the supply of services of hypermarkets would be prohibited*	· Discourages the establishment of malls by potential investors · Non-optimal use of space in hypermarkets · Reduces the convenience of having products and services under a single roof. · Increased transaction cost for consumers
Conditions in accordance with the objectives set by the shopping mall *Occupancy rate* *Differentiation depending on the variety of services offered to the mall*	All retail outlets must be given the same lease terms *Discriminatory practices aimed at diversifying activities and increasing occupation would be prohibited*	· Inability to adjust to changes in potential demand · Less diversification of products and services · Could cause the closure of some shopping malls · Fewer outlets serving consumers · Consumers have less access to commercial distribution

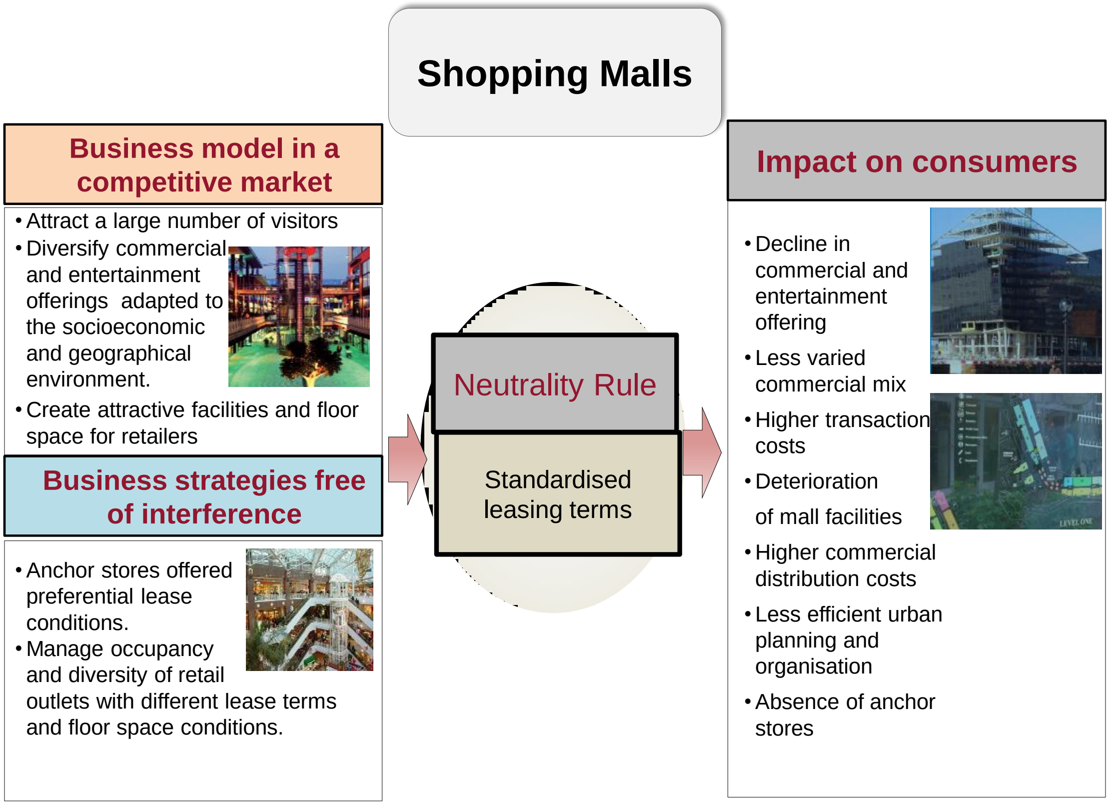
Main results and conclusions

The neutrality rule would dramatically interfere with the business model employed by shopping malls. As a result, commercial distribution, leisure and entertainment offerings and consumer access to many services would be seriously impaired.

Malls would lose the capacity to vary the terms of their rental leases which is a crucial element to attract new stores, diversify commercial offerings, manage and optimize the use of space, extract profit from facilities and develop marketing campaigns. All of this would limit their ability to vitalize the mall and attract the visitors that retailers need to boost sales. Anchor shops receive preferential treatment but their economic activity and capacity to draw in customers is what allows smaller retailers to prosper.

In all likelihood, the number of malls would decrease and consumer transaction costs would rise. Commercial distribution costs would rise and this, in turn, would push up the prices of goods and services.

Graph 2: Summary of the net neutrality rule in the shopping mall business.

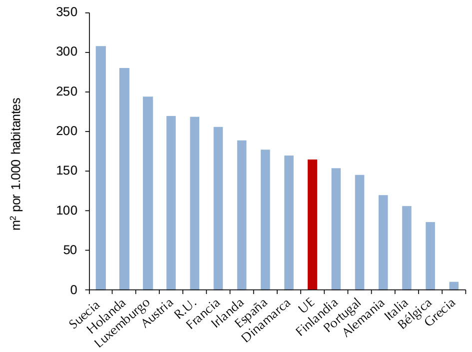


2. Annex I: Description of the business model employed by shopping malls

The number of shopping malls has increased notably in recent years, significantly increasing competition with traditional shops. This is especially the case in new urban developments where commercial infrastructures have evolved from the hypermarket model.

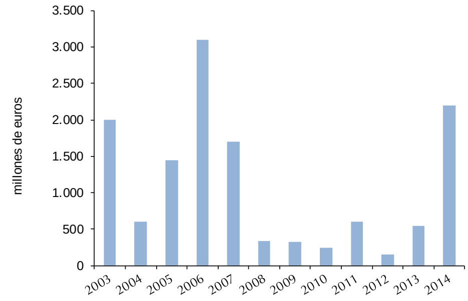
Although there was a significant reduction in investment in this segment and fewer shopping malls were opened during the years of the economic crisis, 2014 saw a resurgence of investment and the opening of new malls. Investment in 2014 was approximately €2.2 billion and 24 malls were inaugurated.

Centros comerciales. Índice de superficie alquilable (2012)



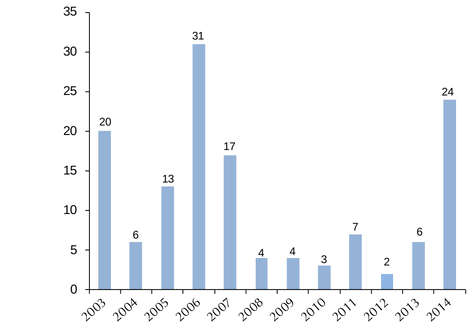
Fuente: Asociación española de centros comerciales.

Centros comerciales. Evolución inversión



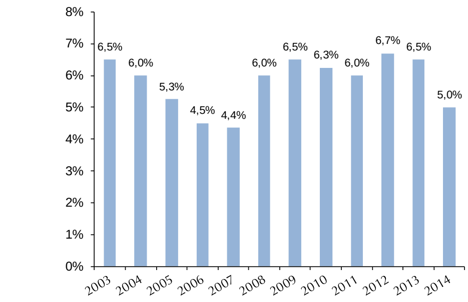
Fuente: Asociación española de centros comerciales.

Centros comerciales. Número de inaguraciones



Fuente: Asociación española de centros comerciales.

Centros comerciales. Rentabilidad



Fuente: Asociación española de centros comerciales.

i) Description of the business model, market definition

The occupancy rate is the critical variable for an adequate return in the shopping mall sector. The higher the occupancy rate, the higher the revenues. Successful management of a shopping mall hinges on matching the mix of shops and entertainment with the potential demand of the geographical area.

There are urban and suburban malls and these can be either indoor or open-air. While the different types of shopping malls did not traditionally compete with one another due to their geographic location, competition has now intensified due to changes in consumer behaviour. Consumers are now willing to travel significant distances in search of a particular shopping or entertainment offering.

Another aspect affecting the business model is the internal organisation of the mall. Premises that are distant from pedestrian entrances, or located in cul-de-sacs, dual aisles and generally out-of-the-way low-traffic areas are the least attractive places to set up shop and the rent per square meter of floor space is lower. In contrast, busier areas located along the main corridors of the mall are in higher demand and therefore their rent is more expensive.

Open-air malls are a more traditional response to the proliferation of malls, especially in urban areas. With strong government incentives, open air malls are clusters of traditional businesses joining together to achieve economies of scale that allow them to compete in an increasingly competitive environment.

ii) Description of revenues and costs and maximising revenue

The main revenue component in the shopping mall business is rental fees followed by the rental of advertising space, the latter being only marginal in comparison with space rental. Occupancy rate is the critical variable that needs to be managed to optimise return. This means that the turnover rate takes precedence over margin in the management of shopping malls.

iii) Description of discrimination mechanisms and their effect on demand, supply, efficiency and equity in the sector.

Price discrimination is employed to optimise the commercial mix in order to maximise the number of visitors and keep the occupancy rate as high as possible. To this end, it is essential to be able to offer different prices based on the drawing capacity of each mall. That is why anchor stores are typically offered more advantageous lease conditions.

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