June 17, 2010

Dear Tesco Shareholder:

We are writing to urge you to vote NO on proxy Item #2, the Directors' Remuneration Report, at Tesco's July 2nd shareholder meeting. Tesco shareholders should take decisive action to address the Remuneration Committee's acute failure to link executive pay with performance and its apparent modification of previously established performance targets.[1] These failures are evidenced by the excessive compensation awarded to Tim Mason, Tesco's second highest paid executive and CEO of its floundering U.S. operations, despite the U.S. operations' dismal performance. Yesterday, leading U.K. proxy advisory service and corporate governance advisor Research Recommendations and Electronic Voting Ltd (RREV)[2] recommended voting against the Remuneration Report based on "concerns identified with both the structure of the remuneration arrangements and the decisions taken by the Remuneration Committee."[3]

As detailed in this correspondence, the Remuneration Committee awarded Mr. Mason substantially increased "performance related" emoluments in 2010 that were purportedly tied to the performance of the U.S. Fresh & Easy franchise. As a result, Mr. Mason enjoyed a £480 thousand increase in total pay, about a 13% increase over the previous fiscal year, despite an estimated loss of £165 million at the struggling U.S. venture. As we outline below, the sharp divergence between Tesco's past projections for Fresh & Easy and the venture's actual performance strongly suggests that Tesco's Remuneration Committee has "shifted the goal posts" in order to provide Mr. Mason with a pay package that no reasonable analysis of Fresh & Easy's performance could justify.

Our concern with respect to the objectivity of Tesco's Remuneration Committee is reinforced by the analysis of RREV, indicating that this critically important body was not sufficiently independent.[4] Whereas RREV's assessment ought to have motivated the Remuneration Committee to ensure that its pay decisions were warranted by the unambiguous achievement of previously disclosed performance targets, the Committee seems instead to have targeted a high pay level for a favored executive, and shifted its performance benchmarks to ensure that he would get it. This degree of flexibility in remuneration decisions undermines the alignment of executive and shareholder interests, and makes plain that Tesco shareholders must take it upon themselves to insist that generous pay increases be tied to superior performance.

The CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a coalition of U.S. unions representing nearly six million members. These funds

[1] We note that the apparent changes to the performance targets cannot be confirmed given the Committee's failure to disclose Mr. Mason's performance targets in its Remuneration Report.
[2] An affiliate of Risk Metrics Group, Inc.
[3] RREV Ltd. Recommendation, Tesco plc, 16 June 2010, page 9.
[4] In its evaluation of Tesco's governance last year, RREV found that the Chairman of Tesco's Remuneration Committee, as well as one of the five other members, did not qualify as independent according to the Combined Code. *See* Research Recommendations and Electronic Voting Ltd. (RREV) Voting Alert, Tesco plc, 17 June, 2009, page 8. RREV's recommendation for 2010 acknowledges that the lack of independence will be cured going forward when Charles Allen and Harald Einsmann step down as Non-Executive Directors at the conclusion of the 2010 AGM. *Supra*, n. 3, page 6. However, the directors' retirement does not resolve our concerns with the Committee's independence when the pay decisions in the 2010 Remuneration Report were made.

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have over $200 billion in assets and are substantial long-term Tesco shareholders. We detail our concerns below.

U.S. Performance Fails to Meet Established Targets

Despite an overall impressive financial performance globally, Tesco continues to stumble in what the company itself has described as one of its most significant new ventures: the U.S. Fresh & Easy banner. When it announced its entry into the U.S. market, Tesco projected that these operations would break even by the second half of 2009; however, actual performance has substantially lagged this goal. After reporting a trading loss of £142 million for its U.S. operations in 2008/2009,[5] Tesco has disclosed a deeper loss of £165 million for 2009/2010.[6] Cumulatively, Fresh & Easy's losses total over 1/3 of Tesco's £900 million investment in the United States.

Independent analysts have signaled serious concern over Fresh & Easy's continued poor results. For instance, MF Global UK recently noted that "the majority of the 140 [Fresh & Easy] stores are heavily loss making" and that "store openings have been cut back to only 3 per month. This means F&E remains severely sub-scale and not at all what F&E CEO Tim Mason had planned."[7] Citigroup's Food Retail analysts have asked "Should owners of Tesco be calling for a U.S. exit?" and while noting that Fresh & Easy's cash consumption is small compared to the company's resources globally, "there is no end in sight to the drag [Fresh & Easy] exerts."[8]

While many explanations for this disappointing record could be proffered, we believe the evidence suggests that managerial missteps have played a key role. For instance, external analysts estimated in a 2009 study that in at least one key market, Tesco's U.S. stores were "dead last" in affordability of the seven retailers examined, with prices approximately 30% higher than those at Wal-Mart's Super-centers.[9] This assessment of Fresh & Easy's uncompetitive pricing squares with our own analysis of the chain's disappointing sales-per-square foot. Whereas management has asserted for several years that Fresh & Easy stores average sales of $11 per square foot per week[10], Tesco's recent annual filings show and our calculations lead us to conclude that sales per square foot were actually $8.56, more than 20% lower.[11] Fresh & Easy's disappointing returns strongly suggest that the venture's troubles run much deeper than the mismatch between significant investments in distribution capacity relative to a smaller-than-planned store base[12]; rather, these losses indicate that Mr. Mason has not been able to adapt the Fresh & Easy concept to the realities of the U.S. market.

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[5] Tesco Plc. Preliminary Results 2008/9, p. 4 (avail at: http://www.tescoplc.com/plc/ir/pres_results/results/r2009/2009-04-21/2009-04-21.pdf).

[6] Tesco Plc. Preliminary Results 2009/2008/2010, p. 7.4 (avail at: http://ar2010.tescoplc.com/en/~/media/Files/T/Tesco-Annual-Report-2009/Attachments/pdf/downloads/annual_report.pdf).

[7] "Welcome to Guernsey," MF Global Equity Research UK, January 20, 2010. p.1.

[8] "Tesco: The Year Ahead Might Be Difficult Too," Citi Food Retail Report, April 21, 2010, p. 4-5.

[9] "Special Report: Wal-mart pricing report round XIX. Battle of the titans in Phoenix, Arizona," *Produce Business*, May 2009. p. 46 (avail at: http://www.producebusiness.com/Attachments/walmart-articles/walmart-phoenix-5-09.pdf).

[10] Final FD (Fair Disclosure) Wire, "Interim 2008 Tesco Plc. Earnings Conference Call," September 30, 2008.

[11] Based on sales data from the 2009-2010 Tesco Annual Report and our analyst calculations of store data provided by the company and local store openings.

[12] See Tesco, Plc. 2009-2010 *Annual Report and Financial Statements 2010*. p. 15 (avail at: http://ar2010.tescoplc.com/~/media/Files/T/Tesco-Annual-Report-2009/Attachments/pdf/downloads/annual_report.pdf financial summary).

Remuneration Practices Misalign Executive Incentives
In the face of these disappointing results, the Remuneration Committee still awarded Mr. Mason "performance related" pay specifically tied to the U.S. business. During the 2009/2010 fiscal year Tim Mason's total remuneration grew from £3.8 million to over £4.2 million, or by nearly 13%. This £480,000 increase was entirely accounted for by increases in short-term cash and preferred share awards which according to the Remuneration Committee are supposed to be tied to operational performance for which Mr. Mason is responsible. Over the past fiscal year, when Fresh & Easy's trading loss deteriorated by 18%, the short term component of Mr. Mason's performance related pay grew from £1.8 million to £2.3 million, or by 27%.[13]

The Remuneration Committee neither discloses the specific performance benchmarks it used to determine the appropriateness of these awards, nor provides a coherent narrative explanation for *increasing* Mr. Mason's pay while the performance of the business unit for which he has primary responsibility *declined*. The Committee does state that it based Mr. Mason's award on specific performance targets including "store development, sales growth, cost management and customer factors," and that it determined that "advances" made in the U.S. business justified granting Mr. Mason 65% of the potential maximum award for short-term performance[14] (up from 45% in the previous year). It is difficult to understand how this could be possible if the Remuneration Committee was working with benchmark targets similar to those that Tesco has previously laid out for shareholders: as noted above, Fresh & Easy has not come anywhere close to hitting those marks. While the Committee did determine that the bulk of global corporate objectives had been met in the previous year (including EPS and shareholder return), clearly that achievement cannot be attributed in any part to the U.S. segment.

As table below indicates, Mr. Mason is now paid well above the level of the top paid executives at Tesco's UK competitors, and even further above the level of top executives at medium-sized regional supermarkets in the United States (which are far larger than Fresh & Easy).

Name	Title	Company	Total 2010 Pay (£000's converted)
U.K. Supermarkets			
Justin King	CEO	J. Sainsbury Plc	£3,348
Stuart Rose	Chairman	Marks & Spenser	£1,765
Mark Gunter	Group Retail Director	Wm Morrisson	£1,172
U.S. Medium Supermarkets			
Jack H. Brown	CEO	Stater Brothers	£1,473
Robert F. Weiss	Chairman	Weis Markets	£1,337
Fresh & Easy			
Tim Mason	**CEO**	**Fresh & Easy**	**£4,265**

Source: CapitalIQ.

The Remuneration Committee's pay award for Mr. Mason seems to establish exactly the wrong incentives going forward. Given the significant performance issues at Fresh & Easy, shareholders should be very concerned that the executive with primary responsibility for this

[13] Tesco Plc. *Annual Report and Financial Statements 2009 &2010*
[14] Tesco Plc. *Annual Report and Financial Statements 2010*, p. 55.

venture from the outset has not only enjoyed increasing remuneration for deteriorating performance, but is in fact being paid at a level well in excess of U.K. executives presiding over much larger operations.

Our concerns are only reinforced by the current Remuneration Committee's lack of sufficient independence. In its analysis of Tesco's governance prior to the 2009 AGM, RREV noted that:

> "[Remuneration Committee Chairman] Charles Allen and Harald Einsmann have both served on the Board since 1999 and as such have now served on the Board for over ten years. … We note that Charles Allen and Harald Einsmann have served concurrently on the Board with five of the eight Executive Directors since their appointment in 1999. In light of these concurrent relationships and in accordance with the NAPF Policy, we no longer consider Charles Allen and Harald Einsmann to be independent."[15]

By failing to align the incentives of executives and shareholders, the Remuneration Committee undercuts one of the most effective mechanisms shareholders have to ensure that their interests are being served by executives and not the other way round.

We urge you to consider these matters, and to vote NO on Item #2, the Directors Remuneration Report, at Tesco's July 2nd Annual General Meeting. For any questions or further information, please contact CtW Investment Group Research Director Richard Clayton on (202) 721 6038.

Sincerely,

William Patterson
Executive Director

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[15] *Supra, n. 3.*