

## CINEWORLD/CITY SCREEN MERGER INQUIRY

### Cineworld and Picturehouse Response to Provisional Findings

#### 1. Introduction

- 1.1 Cineworld and Picturehouse agree with many of the conclusions in the Competition Commission (the “CC”) provisional findings report issued on 20 August 2013 (the “**Provisional Findings**”). In particular, the parties welcome and strongly endorse the CC’s provisional conclusions that the merger is unlikely to lead to a substantial lessening of competition (“**SLC**”) in respect of 18 of the 21 Picturehouse cinemas.
- 1.2 This Response focuses on those aspects of the CC’s provisional conclusions with which the parties disagree, specifically in respect of the merger’s impact on competition in the local areas of Bury St Edmunds and Cambridge. The Response is structured as follows:
- 1.2.1 First, the parties discuss a number of general issues in respect of the CC’s approach to its analysis of the competitive effects of the merger; and
- 1.2.2 Secondly, the parties provide further specific observations in relation to the effects of the merger in Bury St Edmunds and Cambridge<sup>1</sup>.
- 1.3 The parties believe that, following consideration of this Response, the CC will be able to be satisfied that no SLC will arise in Bury St Edmunds or Cambridge.

#### 2. General issues

- 2.1 The parties consider that two general issues in the Provisional Findings require reconsideration by the CC:
- 2.1.1 First, the CC has not given proper weight to the differences between the cinema offering of a multiplex operator such as Cineworld and the cinema offering of Picturehouse; and
- 2.1.2 Secondly, there are certain weaknesses in the CC’s methodology for assessing the competitive effects of the merger such that the CC’s conclusions in relation to the conditions of local competition in the relevant areas are unreliable.
- 2.2 With respect to **differences between the cinema offerings of multiplex operators and of Picturehouse**, the parties’ position has consistently been as set out in paragraphs 6.2 and 6.36 of the Provisional Findings, which is that the high level of differentiation between the two types of cinemas means that they serve different audiences and face different competitors. Cineworld’s rationale for the transaction was and remains to enable it to diversify the group’s offering and to reach a new and growing segment of cinema-goers –

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<sup>1</sup> The parties have not made further specific submissions in relation to Aberdeen, but would note that their concerns in relation to general issues as set out in this Response apply equally to Aberdeen.

neither Cineworld nor Picturehouse viewed the transaction as one competitor acquiring another. The views of consumers that Picturehouse and Cineworld are different are reflected in the responses from Picturehouse customers in particular to the Provisional Findings<sup>2</sup>.

- 2.3 The parties are disappointed that the Provisional Findings place little weight on these differences between the businesses, and instead in effect adopt the views of Cineworld's competitors (Vue and Odeon) and Picturehouse's (Curzon), as set out in paragraph 6.3 of the Provisional Findings. [§<].
- 2.4 The parties acknowledge that the CC has presented evidence from its survey and price-concentration analysis. However, as discussed below, the parties have concerns over the robustness of the survey evidence and the CC's interpretation of the price-concentration analysis. Indeed, properly assessed, the CC's price-concentration analysis is consistent with the parties' views on the extent of competition between them.
- 2.5 Combined with the evidence previously presented on the very different offerings of Cineworld and Picturehouse (as experienced by the CC during the site visits), the parties consider that any evaluation of the strength of the competitive constraints exerted by the parties on each other should conclude that there is insufficient evidence of a likely SLC in Bury St Edmunds or Cambridge.
- 2.6 With respect to **weaknesses in the CC's methodology**, the parties consider there to be specific problems relating to both the CC's over-reliance on its own survey results and its under-reliance on the results of the CC's price concentration analysis, which are consistent with the parties' view that Picturehouse does not materially constrain Cineworld, and, more generally, that Cineworld and Picturehouse do not materially compete with each other.
- 2.7 The parties also consider that the CC has erred in its entry impact analysis with respect to Bury St Edmunds and in this Response we set out substantive new evidence with respect to the CC's entry impact analysis in Cambridge.
- 2.8 The parties have been advised by Compass Lexecon with respect to these economic analyses, and the assessment set out below and in Section 3 (Bury St Edmunds) and Section 4 (Cambridge) has been reviewed and approved by Compass Lexecon.

### **CC survey**

- 2.9 The CC's customer survey (as discussed in Appendix D of the Provisional Findings) is central to its evaluation of the alleged closeness of competition between Cineworld and Picturehouse. In particular, it is relied on in the Provisional Findings for evidence of customer switching between the parties and underpins the CC's calculations of diversion ratios and GUPPIs. However, the parties submit that external evidence indicates that the

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<sup>2</sup> With respect to Cambridge, see for example the following news story: *3,000 sign petition to save Cambridge Arts Picturehouse in just five days*, Cambridge Evening News, 3 September 2013 (available at <http://www.cambridge-news.co.uk/Cambridge/3000-sign-petition-to-save-Cambridge-Arts-Picturehouse-in-just-five-days-20130903060110.htm>).

CC's survey is unreliable with respect to implied gross margins and (based on the entry event analyses in Bury St Edmunds and Cambridge) diversion ratios.

- 2.10 The parties' advisors have previously submitted comments on the CC's survey methodology. Among other points, Compass Lexecon stated that:

*"When a survey measures a variable that is known from actual data, the measurement of that variable based on the survey can be used to indicate the reliability of the survey."*<sup>3</sup>

- 2.11 Compass Lexecon have noted that the responses to the CC's survey question on price changes can be used to generate implied gross margins for the parties based on the Lerner condition. These implied gross margins are very different from the parties' actual gross margins. This inconsistency between the stated preferences from the survey and the actual data casts doubt on the reliability of the CC's survey results.

- 2.12 The Provisional Findings note this concern and acknowledge that the hypothetical nature of the price increase means that the customers' preferences with regards to switching may not have been accurately stated<sup>4</sup>. However, the CC concludes that this does not directly affect the calculation of diversion ratios.

- 2.13 This, however, misses the main point of concern. The CC's survey produces only certain variables which can be tested against actual data. When the stated preferences with regard to these variables are found to be unreliable, this casts doubt on the other stated preferences found by the survey, including those which cannot be directly tested against other sources.

- 2.14 Further, if the analysis of entry impact in Bury St Edmunds is not discarded (see the discussion on this in Section 3 below), then the results of this analysis are also at odds with the stated preferences from the CC's survey. This is an additional reason for treating the CC's survey results with caution.

- 2.15 The comments above on these specific issues form part of a more general concern, namely that the CC's assessment of the competitive effects of the merger depends heavily on evidence of stated preferences (the CC's survey) while discarding economic evidence, i.e. evidence based on revealed preferences (the price-concentration analysis and the entry impact analyses).

- 2.16 The parties' criticisms of aspects of the CC's economic assessment therefore raise a broader issue as to the role of such economic evidence in the Provisional Findings. The CC has stated that, in reaching its conclusions, it has had regard to the strengths and weaknesses of each type of available evidence and made its evaluation in the round<sup>5</sup>.

- 2.17 However, the parties consider that the CC has deviated from this approach by excluding several important pieces of evidence on revealed preferences from its assessment of

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<sup>3</sup> Compass Lexecon *Diversion Ratios*, 16 July 2013. Quoted in Compass Lexecon *Comments on gross margins and diversion ratios obtained from the CC's survey results*, 23 July 2013, footnote 2.

<sup>4</sup> Paragraph 6 of Appendix D of the Provisional Findings.

<sup>5</sup> Paragraph 6.53 of the Provisional Findings.

competitive effects, such as the parties' actual gross margins and the evidence from Bury St Edmunds discussed above, as well as the CC's price-concentration analysis. This evidence indicates that the CC should not rely on its survey as demonstrating an SLC arising from the combination of Cineworld and Picturehouse.

### ***Price-concentration analysis***

- 2.18 The CC's price-concentration analysis (as discussed in Appendix C of the Provisional Findings) raises a number of significant issues, some of which are either ignored or, in the parties' view, misinterpreted in the Provisional Findings.
- 2.19 The CC has carried out a price-concentration analysis based on average ticket prices of Cineworld<sup>6</sup>. The CC has cited the results of this analysis as evidence supporting its findings on geographic markets.
- 2.20 In Appendix C of the Provisional Findings, the CC has also noted the results of an extension to the CC's analysis submitted by Compass Lexecon on 22 July 2013, which found no significant relationship between the number of independent/art-house fascias in the local area and Cineworld's prices. This is consistent with the parties' view that Picturehouse does not materially constrain Cineworld, and, more generally, that Cineworld and Picturehouse do not materially compete with each other. However, the CC has not referred to these results in the main body of the Provisional Findings.
- 2.21 The parties consider that it is not justified to use the main results of the CC's price-concentration analysis to support the CC's findings on geographic market definition but ignore the implications of Compass Lexecon's extension for product market definition. The results of the extension to the price-concentration analysis should have led to the conclusion that, in general, Picturehouse cinemas do not operate in the same product market as Cineworld.
- 2.22 In addition to market delineation, the results of Compass Lexecon's extension to the price-concentration analysis also inform the assessment of the competitive interaction between the parties, and should therefore have formed part of the evidence examined by the CC in its assessment of the competitive effects of the merger.

### ***Conclusions on general issues***

- 2.23 The parties submit that the following key conclusions should be drawn from the discussion above:
- The Provisional Findings have placed insufficient weight on the demonstrable differences between Cineworld and Picturehouse's businesses – differences which make an SLC inherently unlikely.
  - Data on revealed preferences derived from the CC's survey is inconsistent with actual data – which indicates that the survey is unreliable. In assessing whether an

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<sup>6</sup> The CC has also presented results based on Picturehouse prices but has described these as indicative and has not relied on them for its findings - see Appendix C of the Provisional Findings.

SLC is likely the CC should therefore place little reliance on diversion ratios and GUPPIs derived from the survey.

- The CC's price-concentration analysis, incorporating Compass Lexecon's extension, should have led to the conclusion that, in general, Picturehouse cinemas do not operate in the same product market as Cineworld.

### 3. Bury St Edmunds

3.1 The CC sets out at paragraphs 6.70 to 6.76 of the Provisional Findings its potential concerns in Bury St Edmunds. The parties consider that the CC has erred in rejecting the results of the entry event analysis for Bury St Edmunds, which provides strong evidence of the limited competitive interaction between Abbeygate Picturehouse and Cineworld Bury St Edmunds.

3.2 The CC expressed concerns regarding Compass Lexecon's entry analysis<sup>7</sup>. With regard to the analysis of the entry of the Abbeygate Picturehouse into Bury St Edmunds in February 2010, the CC stated that:

- since the entry of the Abbeygate Picturehouse was not a *de novo* entry, the increase in revenue observed at Cineworld Bury St Edmunds may be due to the fact that "*the Hollywood Cinema, which operated prior to Picturehouse Bury St Edmunds opening, was a closer competitor to the Cineworld cinema than the current Picturehouse is*"<sup>8</sup>; and
- the comparator set used by the parties based on all Cineworld cinemas should have excluded Cineworld Bury St Edmunds itself.

3.3 With regard to the second concern expressed by the CC, the parties agree that the comparator set should have excluded Cineworld Bury St Edmunds. However, as noted by the CC<sup>9</sup>, this does not have a material impact on the results of the analysis.

3.4 With regard to the first concern expressed by the CC, the parties would make the following points:

3.4.1 First, it is odd that the CC reject the analysis on the basis that the Abbeygate Picturehouse is a more distant competitor to Cineworld compared to the Hollywood Cinema. If this is true, then this should have informed the CC's findings on the competitive effects of the transaction in Bury St Edmunds.

3.4.2 Secondly, while the Abbeygate Picturehouse was not a strict *de novo* entry, it achieved roughly double the box office revenues of the Hollywood Cinema during the first year of operation and roughly triple the box office revenues of the Hollywood Cinema during the second year<sup>10</sup>. Given this significant change

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<sup>7</sup> Compass Lexecon *Cinema entry analysis*, 24 June 2013.

<sup>8</sup> Paragraph 26 of Appendix F of the Provisional Findings.

<sup>9</sup> Paragraph 27 of Appendix F of the Provisional Findings.

<sup>10</sup> Paragraph 6.82 of the Provisional Findings and paragraph 125 of Appendix G of the Provisional Findings.

in revenues, the parties consider that it forms a high quality natural experiment for testing the diversion ratio from the Abbeygate Picturehouse to the Cineworld.

- 3.4.3 Thirdly, as noted by the CC, the methodology used to estimate the implied diversion ratio from the Abbeygate Picturehouse to Cineworld Bury St Edmunds takes into account the pre-existing level of sales at the Hollywood Cinema.
- 3.5 The parties therefore consider that the CC's basis for rejecting the entry analysis on Bury St Edmunds is not valid. On the contrary, the CC has overlooked significant evidence for limited competitive interaction between Abbeygate Picturehouse and Cineworld Bury St Edmunds, as shown by the fact that the Abbeygate Picturehouse grew its customer base and the overall market without stealing business from Cineworld Bury St Edmunds, implying a negative diversion ratio from Cineworld to Abbeygate Picturehouse.
- 3.6 Indeed, since the entry of the Abbeygate Picturehouse, both it and Cineworld have continued to grow their box office revenues, with 2013 year to date increases of [x<] % at Abbeygate Picturehouse and [x<] % at Cineworld.

### **Conclusions**

- 3.7 In summary, the parties consider that the following factors indicate no SLC in Bury St Edmunds:
- As with other cinemas, the unreliability of the CC's survey means that the CC should not rely on diversion ratios and GUPPIs derived from that survey.
  - Compass Lexecon's extension to the CC's price-concentration analysis indicates that, in general, Picturehouse does not materially constrain Cineworld.
  - The entry analysis on the Abbeygate Picturehouse has not been undermined by the CC's criticisms, and shows that Cineworld grew despite the entry of the Abbeygate Picturehouse.

### **4. Cambridge**

- 4.1 The CC sets out at paragraphs 6.77 to 6.85 of the Provisional Findings its potential concerns in Cambridge. The parties have three specific concerns with the CC's analysis:
- the entry event analysis for Cambridge provides significant corroboration (supported by new evidence) of the limited competitive interaction between the Arts Picturehouse and Cineworld Cambridge, which the CC's analysis has not recognised;
  - the CC has failed to take adequate account of the impact of Vue Cambridge;
  - the Provisional Findings' treatment of the Hobson Street site as offering a potential opportunity for a new cinema in Cambridge is incomplete.

### **Entry event analysis for Cambridge**

- 4.2 The CC refers in the Provisional Findings to an event analysis based on the entry of Cineworld Cambridge in May 2004, with the caveat that this entry event occurred nearly ten years ago and may not reflect the current competitive conditions<sup>11</sup>. In the Provisional Findings, the CC noted that the opening of Cineworld Cambridge in 2004 had negatively impacted on the revenues of the Arts Picturehouse. As discussed below, there were significant external factors in Cambridge around the time of Cineworld's opening which had a material effect on Picturehouse's business, and which have not been taken into account in the CC's analysis.
- 4.3 The CC has not presented the diversion ratios implied by this entry event. Based on the same methodology used in our previous analyses of entry events, Compass Lexecon on behalf of the parties has estimated that this entry event implies diversion ratios of between 8.2 and 8.6 per cent from Cineworld Cambridge to the Arts Picturehouse<sup>12</sup>. This is significantly lower than the diversion ratios estimated by the CC's survey, which range between 26 and 30 per cent. This is further evidence that the survey and the diversion ratios derived from it are unreliable.
- 4.4 Furthermore, it is incorrect for the CC to conclude that the reduction in revenues at Arts Picturehouse at this time was due wholly to the opening of Cineworld Cambridge, and so even the diversion ratios implied by the entry analysis are likely to overstate the level of competitive interaction between the two cinemas. This is because around the time of the entry of Cineworld Cambridge in May 2004 there were several unrelated local factors that negatively impacted the revenues of the Arts Picturehouse:
- Starting from 2004, there was a major redevelopment in the area of the Lions Yard shopping centre located very close to the Arts Picturehouse cinema, which impacted footfall in the local area. The redevelopment continued until September 2008.
  - In particular, Cambridge city centre was severely affected by disruption caused by the redevelopment. The major John Lewis store temporarily moved from St. Andrew's Street (where the Arts Picturehouse is located) to a retail development near the Grafton Shopping Centre (the location of Vue Cambridge) in September 2004. The John Lewis store moved back close to its former location in November 2007, but now as part of a major new retail development.
  - As a part of this redevelopment, the number of parking spaces available in the Lions Yard car park near the Arts Picturehouse was reduced from around 1,000 spaces to 300 spaces in January 2005. The car park operated at a reduced capacity (700 fewer car-parking spaces) until mid-2007, and there was significant local publicity at the time concerning problems in parking in central Cambridge where the Arts Picturehouse is located. This exacerbated the redevelopment's impact on the Arts Picturehouse.

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<sup>11</sup> Paragraph 6.82 of the Provisional Findings and paragraph 125 of Appendix G of the Provisional Findings. .

<sup>12</sup> Following the CC's preferred approach to its entry analysis in Aberdeen (see paragraphs 20 to 21 of Appendix F of the Provisional Findings), Compass Lexecon used all Picturehouse cinemas excluding the Arts Picturehouse as the comparator set of cinemas for the Arts Picturehouse.

- 4.5 Due to the fact that these disruptions in the local area happened around the same time as the entry of Cineworld Cambridge, a comparison of the Arts Picturehouse's revenues before and after the entry of Cineworld can be assumed to overstate the impact of the entry on the Arts Picturehouse's revenues. The Arts Picturehouse suffered a severe and anticipated drop in business that Picturehouse directly attributes to disruption from the major construction works and their impact on local car-parking.
- 4.6 The CC has not advanced any evidence suggesting that it is plausible that diversion ratios have trebled over the past ten years, and the very significant difference between the CC's survey results and the results of the entry analysis (themselves overstated) adds to the weight of evidence suggesting that the CC's survey materially overstates the level of competitive interaction between the parties.

### ***Impact of Vue Cambridge***

- 4.7 The parties also consider that the CC has failed to take adequate account of Vue Cambridge's ability to ensure that the merger will have no material impact on competition in the Cambridge market for film exhibition. Vue Cambridge is a substantial cinema which, post-merger, will hold 40 per cent of Cambridge cinema screens and 45 per cent of seats.
- 4.8 Notwithstanding the parties' views in relation to the CC's survey, the parties note that the survey results suggest that for both the Arts Picturehouse and the Cineworld Cambridge, the majority of customers would switch to Vue Cambridge (57 per cent of Picturehouse customers and 60-70 per cent of Cineworld customers). In addition, the CC's analysis of historical customer visits suggested that a substantial proportion of the customers of both the Arts Picturehouse and the Cineworld Cambridge had visited Vue Cambridge.
- 4.9 This suggests therefore that any potential incentive for price increases at the merged entities' cinemas in Cambridge will be negated by the competitive constraint of Vue Cambridge.

### ***New entry in Cambridge***

- 4.10 The parties note the CC's comments on the possibility of a new cinema opening at the site of a former cinema in Hobson Street (paragraphs 6.83 and 6.84 of the Provisional Findings and paragraph 130 of Appendix G of the Provisional Findings).
- 4.11 The parties are surprised that the CC was not able to satisfy itself that redevelopment of this site was likely to occur in the near future. [§].
- 4.12 [§].

### ***Conclusions***

- 4.13 In summary, the parties consider that the following factors indicate no SLC in Cambridge:
- As with other cinemas, the unreliability of the CC's survey means that the CC should not rely on diversion ratios and GUPPIs derived from that survey. Compass



Lexecon's extension to the CC's price-concentration analysis indicates that in general, Picturehouse does not materially constrain Cineworld

- The unreliability of the survey-based diversion ratios is particularly demonstrated by the diversion ratios from the entry event analysis, which are around a third of the survey-based diversion ratios.
- The Arts Picturehouse and Cineworld Cambridge are not material competitors –Vue Cambridge is a significant alternative for cinema-goers in the area.
- Hobson Street remains a potential site for a new cinema close to the location of the Arts Picturehouse.

## 5. **Conclusions**

5.1 On the basis of the further observations set out above, the parties consider that the CC will be able to be satisfied that no substantial lessening of competition will arise in Bury St Edmunds or Cambridge.

5.2 In particular:

- The demonstrable differences between Cineworld and Picturehouse's businesses make an SLC inherently unlikely.
- The CC's survey is unreliable and the CC should therefore place little reliance on diversion ratios and GUPPIs derived from the survey.
- Entry event analyses suggest that Cineworld Bury St Edmunds grew despite the entry of the Abbeygate Picturehouse implying a negative diversion ratio, and that the diversion ratio from Cineworld Cambridge to the Arts Picturehouse is a third of that suggested by the CC's survey.
- Compass Lexecon's extension to the CC's price-concentration analysis indicates that in general, Picturehouse does not materially constrain Cineworld.
- In Cambridge, Vue Cambridge continues to be a significant competitive constraint and there is a possibility of new entry at the Hobson Street site.