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Completed acquisition by Carpetright plc of four Allied Carpet stores

ME4570/10

The OFT's decision on reference under section 22(1) given on 13 September 2010. Full text of decision published 29 September 2010.

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**Please note that the square brackets indicate figures or text which have been deleted or replaced in ranges at the request of the parties or third parties for reasons of commercial confidentiality.**

## **PARTIES**

1. Carpetright plc (Carpetright) is predominantly a retailer of floor coverings (carpets, rugs, vinyls, laminates and accessories) with 709 stores, 557 of which are in the UK. The remaining stores are located in the Netherlands, Belgium, Ireland and the Channel Islands. Carpetright trades under a number of brand names, namely Carpetright or In-House, Storey Carpets, Walter Wall, and Carpetworld. Carpetright's worldwide turnover for the year ending 2 May 2009 was £482.8m, of which £[ ] was in the UK.
2. Allied Carpets Retail Ltd ('Allied') is a floor coverings retailer with 41 UK stores, trading under the brand names General George and Allied Carpets. Allied is owned by a holding company, Allied Floor Ltd, for Hilco, a US-based investment fund.

## **BACKGROUND**

3. In 2009 Carpetright informed the OFT of a number of acquisitions of Allied stores. In November 2009, based on the information available to it at the time of its decision, the OFT announced its decision that these stores did not qualify for review under the Enterprise Act 2002 ('the Act').
4. On 11 June 2010, the OFT sent an enquiry letter to Carpetright inviting its comments on certain arrangements that Carpetright has entered into relating to four former Allied stores. These related to arrangements

regarding former Allied stores in Grantham, Chester, Cheltenham and Solihull.

#### Grantham, Chester and Cheltenham

5. The OFT does not believe that the arrangements in relation to the Grantham and Chester stores constitute 'enterprises ceasing to be distinct' even on the 'may be the case standard'. The OFT notes that the arrangements in respect of the Cheltenham store completed before the OFT's (extended) four month time period. The OFT does not consider it appropriate to exercise section 27(5) of the Act in relation to the Cheltenham store so as to link it with Solihull. As a result, these three stores are not considered further.

#### Solihull

6. Carpetright and Allied were both located in Solihull Retail Park. The common landlord of both properties approached Carpetright and invited it to surrender the lease of its existing store and take a new lease on the premises of the Allied store (which was still trading at the time). [ ] In addition to the property transaction, Carpetright purchased some stock and took on some of the former Allied store's employees from Allied Carpets Retail Limited ('ACRL') (together, the leasehold arrangements entered into by Carpetright and the landlord for the Allied store and the acquisition of stock and employees by Carpetright from ACRL, to be referred to as 'the Transaction').
7. According to the landlord, Carpetright's new lease was signed on 22 February 2010 and completed on 9 March 2010.<sup>1</sup> The lease agreement provided for transfer and relocation arrangements of the Carpetright store, including a license for Carpetright to occupy the former Allied store pending completion of the new lease. Carpetright took possession of the former Allied store on 8 March 2010 and began trading from it, in parallel with its existing store until 31 March 2010. Carpetright surrendered the lease of its previous store on 9 April 2010 and operated solely from the Allied store from this point forward.

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<sup>1</sup> Carpetright submits that the 22 February 2010 lease in fact gave it the licence to occupy the former Allied store pending completion of the new lease and that surrender of the lease of the previous store and completion of the new lease both took place on 9 April 2010. However, the OFT, adopting a cautious approach, has taken the date of completion to be 9 March 2010.

## **JURISDICTION**

8. A relevant merger situation arises when two or more enterprises cease to be distinct and either the UK turnover test or the share of supply test set out in section 23 of the Act is met.

### **Enterprises ceasing to be distinct**

9. Carpetright argues that this is not a case where two or more enterprises have ceased to be distinct for the purposes of the Act for the following reasons:
  - the transfer of the store was instigated by the landlord, not Carpetright, [ ]
  - the acquisition of stock was merely incidental to the property transaction transfer
  - there has been no consideration paid, other than for the stock, and
  - Carpetright did not undertake any formal assessment as to whether TUPE (the Transfer of Undertakings (Protection of Employment) Regulations 2006) applied to the Allied employees and, in any event, only a minority of the employees ended up working at the new store.
10. However, despite these factors, on balance the OFT believes that it may be the case that enterprises have ceased to be distinct in Solihull on the basis that:
  - the substance of the arrangement (which is what the OFT will look at rather than the form), is that the net effect of the arrangement was that Carpetright took over the site from which Allied were trading from in Solihull
  - notwithstanding the circumstances leading to the transfer, Carpetright did acquire stock directly from Allied, did receive some fixtures and fittings from Allied and did take on the former employees

- for a period of two weeks, Carpetright operated both stores whilst the Allied store retained its branding as 'Allied Carpets' – there was therefore no gap in trading between the store being an Allied one and then becoming a Carpetright one, and
- the fact that the arrangements were precipitated by the landlord, rather than Carpetright, cannot in itself be regarded as conclusive that enterprises have not ceased to be distinct.

11. The OFT therefore believes that it may be the case that two enterprises have ceased to be distinct in Solihull.

### **Share of supply test**

12. As a result of the Transaction, Carpetright and the Allied store in Solihull ('the Parties') have ceased to be distinct enterprises within the meaning of section 26 of the Act. The turnover of the Allied store in Solihull in 2009 was significantly less than £70 million so that the turnover threshold under section 23(1)(b) of the Act is not met.

13. However, the OFT believes that the Parties' combined share of supply of carpets in the UK exceeds 25 per cent (as Carpetright's pre-merger share of supply of carpets in the UK exceeds 25 per cent), so that the Transaction qualifies for review under the Act. The extended statutory deadline for considering this transaction is 13 September 2010.

### **COUNTERFACTUAL**

14. In completed mergers, the OFT generally adopts the pre-merger situation as the counterfactual against which to assess the impact of the merger. However, the OFT will assess the merger against an alternative counterfactual situation where, based on the evidence available to it, it considers that the prevailing conditions are not a realistic counterfactual situation or where there is a realistic counterfactual that is more competitive than prevailing conditions.

15. Given the circumstances of the case, as described above, the OFT has considered whether the relevant counterfactual should be altered; that is,

whether the prospect of the Allied store in Solihull continuing to trade absent the merger was not realistic.

16. In particular, Carpetright submits to the OFT that it had only taken the employees and stock of the Allied store in Solihull at a point when the landlord had already given notice to the administrator to terminate its lease of the store, so that the closure of the store and the exit of Allied from the Solihull store was therefore inevitable and imminent.
17. The evidence available to the OFT, however, suggests that this is not the only interpretation that may be placed on the facts:
  - firstly, the OFT has no compelling evidence that absent the merger the Allied store at Solihull would have been closed down by either the administrator or Hilco
  - secondly, it is not clear to the OFT whether, absent the merger, Allied could have obtained a revision to its leasehold terms from the landlord that would have allowed it to remain as a tenant in the property in question<sup>2</sup> and
  - thirdly, the OFT will take all relevant factors into account in assessing whether two enterprises have ceased to be distinct. The fact that there is a short time lapse between the factors contributing to the existence of an enterprise (that is, the taking over of the lease and the employees/stock acquisition) does not appear to it to be sufficient for it to alter its approach to the counterfactual.
18. Given these uncertainties, the OFT takes a conservative approach and considers that, that absent the merger, both Carpetright and Allied Carpet would continue to operate independently in Solihull. The OFT therefore assesses the merger against this counterfactual.
19. Further, the OFT notes Carpetright's submission to the OFT that Allied Carpets offers less of a competitive constraint on Carpetright as prior to entering administration. The OFT does not have sufficient evidence to assess this claim on a local level – in particular, the OFT's market investigation did not indicate that the Allied store in Solihull was weakened

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<sup>2</sup> In fact, the OFT understands that [ ].

as a local competitor. Given this, the OFT did not consider that it was appropriate to alter the counterfactual.

## **MARKET DEFINITION**

### **Product market**

20. Carpetright and the former Allied store focussed on the retail supply of floor coverings. In particular, the two stores overlapped in the sale of carpets, rugs, vinyls, laminates, and accessories. Carpetright submits that there was no overlap in wood floorings or other floor covering types.

Retail supply of floor coverings

Demand-side substitution

21. Carpetright submits that there is a single product market for the retail supply of floor coverings, which includes carpets (and carpet tiles), rugs, vinyls, linoleum, laminates, wood, tiles, and certain other types of natural floor coverings, such as seagrass or jute.

22. Carpetright's UK product sales mix is made up predominantly of carpets ([ ] per cent of sales). Similarly, the majority ([ ] per cent) of Allied's sales are from carpets.

23. Carpetright submits that all types of floor coverings are demand-side substitutes for the following reasons:

- they are functionally substitutable as customers perceive products with different properties such as laminates and carpets as substitutes
- different combinations of floor coverings can be used simultaneously (for example, wood and a rug) in the same room (and this can therefore create substitutability between floor coverings)

- different floor coverings are used to varying degrees in different rooms (for example, 69 per cent of adults have carpets or rugs in their sitting room, while 28 per cent have hard flooring)
- floor coverings other than carpets make up a significant proportion of sales of all floor coverings (for example, vinyl/linoleum continues to account for almost 30 per cent of sales values). and
- changes in consumer trends towards different types of floor coverings are associated with changes in trends in other types of floor coverings (for example, an increase in the growth rate of hard/smooth flooring sales has coincided with in a decrease in the growth rate of carpet sales).

24. Third party views on the substitutability between carpets and other floor coverings were mixed. Some independent retailers indicated that while consumers may have a preference for one product type over another, a price rise of five to 10 per cent would see a significant proportion of consumers switch, particularly between carpet and wood or vinyl/laminate. Other independent retailers, however, stated that customers would be unlikely to switch from carpets to other flooring types such as wood, laminate/vinyl and floor tiles following a five to 10 per cent rise in the price of carpets.

25. Market research similarly provides a mixed view on the degree of demand-side substitution between carpets and other non-carpet floor coverings.

#### Supply-side substitution

26. The OFT considers that markets are defined primarily on the basis of demand-side substitution. However, the OFT may aggregate several narrow relevant markets into one broader one on the basis of supply-side substitution when:

- (a) capacity can be used by firms to supply a range of different products that are not demand-side substitutes, and the firms have the ability and incentive quickly (generally within a year) to shift

supply between these different products depending on demand for each, and

- (b) the same firms compete to supply these different products and the conditions of competition between the firms are the same for each product.

27. In this regard, on (a) Carpetright submits that there is a high degree of supply-side substitution between different floor covering types with retailers easily able to expand their range in response to consumer demand. Floor coverings are sold by a wide cross-section of different types of retailers which have significant overlap in the types of floor coverings they supply.
28. Further, such expansion typically does not require significant investment in stock or premises as the retailers could retail through the acquisition of samples only. As an example, Carpetright submits that the major DIY chains have significantly expanded their range and sales of floor covering types in recent years. Third parties agreed that switching between floor covering types is very straightforward.
29. On (b), third parties indicated that selling one type of floor covering without the other would be counter-productive. There are no distinct barriers to switching such as supplier relationships, shop layouts or storage. Independent retailers indicated that if a retail outlet specialises in any type of floor covering it will still sell other types of floor covering. One third party indicated they primarily only sell wood flooring, vinyl and carpet tiles at their Solihull store, as selling carpet requires significant equipment and displays. However, that retailer presents a considerably different retail offer, including the prospect for substitution amongst a far broader range of products, than the majority of other floor covering retailers in the area.
30. Overall, regardless of the ease of switching on the supply-side, it was less clear that such switching in response to a price increase of five to 10 per cent would be profitable for retailers, if such switching was counter to customer preferences.
31. On balance, the evidence on demand- and supply-side substitution is mixed. On this basis, the OFT has adopted a cautious approach and has taken carpet retailing as a separate frame of reference from the retailing of



other floor coverings. It should be noted, though, that the OFT's conclusions are not dependent on this finding, as discussed below.

#### Competition between retail channels

##### Store retail offering

32. An aspect of product market definition that is often used in retail cases is the determination of which store fascia (that is, brand of store) to include within the relevant product market when examining competitive interactions. Here, the OFT's market investigation did not provide a clear picture of the constraints faced by Carpetright and the former Allied store in Solihull.

##### The OFT's market investigation

33. A number of retailers sell carpet products in the Solihull area. Within a five mile radius of the Parties, Carpetright submits that there are a significant number of independent retailers (Carpetright provided a list of 22), some regional multiples, and national household goods chains.
34. The OFT's market investigation has identified differences in floor covering retail offers and the degree of competition between them. In particular, factors such as location, price, store size, store range, service, advertising and branding play a role, to varying degrees, in determining the relative strength of a carpet retailer.
35. A number of carpet retailers the OFT contacted indicated that they did not consider that they competed with the Parties on the basis of location, a different product offering, store size or range offered.

##### Fascia with similar product offering

36. Of those carpet retailers that considered themselves to be competing with the Parties, three stores clearly provided a comparable retail offer to the Parties, with similar sized or bigger stores, similar ranges, product offerings and prices. All three stores indicated that a proportion of their customers came into their store to compare products having already been to Carpetright.

37. A further competitor indicated that even though it had a different product mix from Carpetright (with a significantly lower proportion of carpets) it nonetheless considered Carpetright as a competitor in carpets. Three of the above-mentioned four retailers are each also part of regional specialist retail multiples and benefit, to varying degrees, from some brand recognition by customers, as do Carpetright and Allied Carpets.
38. The OFT notes that of the three competitors that could be considered to offer a comparable offer to Carpetright, only one is at a close distance from the Carpetright store whereas the other two stores are at a distance of almost five miles.

#### Additional fascia

39. There are a number of additional retailers that Carpetright believes compete with its Solihull store and with the former Allied store. Of these, however, the comparability of their retail offer to that of Carpetright differs greatly – in terms of size, distance from Carpetright, weekly revenue, capacity, price, order volumes, range, product offerings and service. Certainly their offer appears less comparable to Carpetright's than does the former Allied store on at least one of these dimensions. In particular, the size and visibility of the stores were smaller than the Parties, as were estimates of their weekly sales revenue. Store range width was generally narrower, although some asserted they matched the Parties on range, despite having a store less than a tenth of the size.
40. On balance, none of the other remaining retailers individually appears to be sufficiently comparable to the Parties for the OFT to initially consider it to potentially constrain them. Further, the OFT was provided with no evidence of these other retailers exerting a competitive constraint on the Parties (for example, of the type that the OFT has used in past cases to show the existence of such constraints).
41. The OFT, therefore, considers it unlikely that sufficient customers would switch to any of the stores individually to mitigate the competitive effects of a price rise by Carpetright.

## Online and mobile retailers

42. Carpetright argued that it is constrained not only by store retailers, but also by online retailers and mobile retailers.
43. There was a consensus among third parties that internet retailing did not constrain store retailing of carpets or non-carpet floor covering products. Third parties' view was that in the event of a five to 10 per cent price rise at the store retail level, customers would not switch to internet supply. According to third parties, customers prefer to see the actual product in store and a proportion of customers want to speak to staff. The OFT received specific examples of local competitors and large wholesale suppliers having a significant internet offering, which benefitted from advertising and promotion but which had achieved very limited sales.
44. Furthermore, Carpetright's own market research, a national survey of customers, confirms this view, indicating that 90 per cent visited a store prior to purchase in order to view the stock (and 66 per cent visited the store and spoke to staff prior to purchase).
45. Mobile retailers are floor covering fitters who source floor covering direct from wholesalers and have no stock and no floor-space. The OFT notes Carpetright's submissions that mobile retailers sell from sample books in the same way as Carpetright and other bricks and mortar retailers. However, the OFT notes that it has not received compelling evidence either as part of its market investigation, or from Carpetright internal documents, suggesting that Carpetright is constrained by mobile retailers.
46. In the absence of sufficient evidence suggesting otherwise, the OFT has taken a cautious approach and considers internet and mobile retailing to be separate frames of reference from store retailing for the purposes of the competitive assessment.

## Conclusion on Product Frame

47. The evidence on demand- and supply-side substitution amongst retailers of floor coverings is mixed. The OFT therefore takes a cautious approach as part of the competitive assessment and considers carpet and other floor coverings as distinct frames of reference. However, the OFT notes that the

majority of retailers sell some combination of carpets and other floor coverings with very similar product mixes. Where this differs, the retailer tends to sell a higher proportion of other floor coverings (laminated flooring or tiles). The OFT therefore considers that if no competition concerns arise in the retail supply of carpets, then competition concerns would be less likely to arise in the retail supply of all floor coverings (as there are additional retailers active in Solihull that appear stronger in other floor coverings). The OFT therefore implicitly takes into account the overlap in all floor coverings as part of the competitive assessment of the market for the retailing of carpets in Solihull.

48. In respect of the identity of competing fascia to the Parties in the retail supply of carpets, the OFT notes that the process of market definition is concerned with identifying the most relevant constraints that, when taken together, prevent the merged firm from raising prices. The OFT has not been able to conclude that all individual competing fascia sufficiently constrain the Parties so as to warrant inclusion in the same product market as the Parties. However, the OFT has not concluded that all competing fascia taken together should be excluded from the product market. For this reason, the OFT has left open the relevant market definition and instead considered in its competitive assessment below the relative strength of each of the retailers in the area and the extent to which they could potentially be considered to compete with Carpetright and the former Allied store.

## Geographic frame

### National and local markets

49. The OFT has considered whether there are national and/or local aspects to competition for the supply of (different types of) floor coverings.
50. As this case involves only a single retail store, it represents a negligible increment to shares of supply under any reasonable consideration on a UK-wide basis. The OFT does not, therefore, consider national issues further.
51. Carpetright, however, disputes that it would have the ability to change prices locally given its national pricing strategy.

52. Carpetright submits that out of the 'price – quality – range – service' (PQRS) elements of competition, only service can be considered to vary locally. In particular, it argues that pricing is set nationally, [ ], promotions are national, and range varies locally only on the basis of store size.
53. In the OFT's view, service is in and of itself an important parameter of local competition and Carpetright confirms that service does vary locally. Moreover, the OFT notes that Carpetright also submits that when a store underperforms (for example, sales or profits fall) intervention is undertaken to assess if performance can be improved. This is also consistent with Carpetright reacting to a rival entering or strengthening its position or offer in a local market (and thereby reducing Carpetright's revenue and profits). On a cautious basis, therefore, the OFT was unable to conclude that elements of the customer experience other than service did not vary according to changes in local competition.
54. In respect of the Allied store, the OFT understands that Allied also conducted some competitor monitoring on a local basis so that some aspects of its offering pre-merger would also have been likely to vary locally in response to local competition.
55. Overall, the OFT considers that that there is likely to be a degree of local competition between carpet retailers and that post-merger, the Parties may therefore have the ability and incentive to deteriorate their competitive offering in Solihull.

#### Local geographic market

56. Carpetright submits that customers tend to visit retailers in their local town or the nearest large town. Carpetright considers a five mile radius from the Solihull store to be an appropriate frame of reference. This is based on a catchment area of [the great majority] of sales. [ ].
57. Third party views on the geographic frame of reference were mixed, but broadly supportive of Carpetright's view.
58. The OFT considers the five mile radius around the Carpetright and Allied stores submitted by Carpetright to be a reasonable starting point for the competitive assessment. A sensitivity check was also undertaken on this starting point showing that extending the catchment by a small amount did

not materially alter the competitive assessment. The OFT notes, however, that not all constraints exercised by each store on other stores within a certain catchment will be equal, with the stores located more closely to each other likely to exercise a stronger constraint on one another, other things being equal.

#### Conclusion on Geographic Frame

59. On the basis of the evidence provided by Carpetright and its market investigation, the OFT considers that in this case the five mile radius around the Carpetright and Allied stores is a reasonable starting point for the competitive assessment. However, the OFT notes that not all stores within a particular geographic frame will exert equal competitive constraints on one another and that geographic proximity is likely a significant factor in determining the constraint in this respect.

### **COMPETITIVE ASSESSMENT – HORIZONTAL UNILATERAL EFFECTS**

60. The Parties overlapped in the retail supply of carpets in the Solihull area. The OFT has therefore examined the possibility that after the merger the merged entity could unilaterally deteriorate its PQRS offering.
61. In conducting its analysis, the OFT has firstly examined direct evidence provided by Carpetright relating to the closeness of competition between Carpetright and the former Allied store.
62. Secondly, the OFT sought to assess the degree to which other retailers in the local area, identified above, would constrain Carpetright and the former Allied store post-merger; that is the closeness of those other potential competitors.
63. Thirdly, the OFT briefly considers the post-merger conduct of Carpetright.

#### **Direct evidence in relation to the closeness of competition between Carpetright and the former Allied store**

64. The OFT's market investigation has indicated that Carpetright and the former Allied store were most likely the number one and two choices for a

considerable proportion of customers. This is supported by the fact that the stores were on adjacent sites in the same retail park and both were the only national specialist chains with significant advertising spending and national brand recognition in the area.

65. Carpetright disputes the OFT's proposition that Allied and Carpetright were likely the number one and two choices for a proportion of customers submitting that: (a) competitor responses cannot be conclusively relied upon; (b) the fact that the stores were on adjacent sites in the same retail park cannot be considered a relevant factor as regards particular closeness of competition; and (c) Allied is in a much weakened position following its administration and, in fact, even pre-administration, Floors-2-Go spent more on advertising than Allied Carpets between 2004 and 2007.
66. The OFT notes, in this respect, that (a) it is discerning in respect of comments made by competitors and, in this case, the information received from competitors did not relate to competitor complaints (in which case the OFT would normally not place as much weight on competitor comments); (b) the location of stores is often a very important factor in the competitive interaction between retailers. While it acknowledges that the importance of location to consumers will vary between sectors and wider areas, it remains likely that Carpetright and the Allied store interacted very closely pre-merger; and (c) Floors-2-Go has a closer focus than the Parties on types of floor-covering other than carpets.

Adverse merger effects arising from a loss of competition evidenced by margins and diversion ratios

67. In assessing the closeness of competition and loss of local competitive rivalry between the Parties the OFT examines two sources of evidence that point to the change in incentives from the internalisation of the rivalry between them as a result of the merger: the **diversion ratio** and the **variable profit margin**.
68. The **diversion ratio** from Allied to Carpetright gives the proportion of Allied customers who, pre-merger, would divert to Carpetright as a result of Allied worsening its competitive offer. It quantifies the closeness of competition between Allied and Carpetright. The higher the diversion ratio from Allied to Carpetright, the closer a competitor Allied is likely to have

been to Carpetright and the greater the constraint on Carpetright removed by the merger.

69. It was not possible to carry out a consumer survey at the Allied store prior to conversion to Carpetright. However, Carpetright has provided the OFT with an impact analysis comparing the store performance in Solihull pre-merger and post-merger with that of a like-for-like group of stores, in order to isolate the effects of the merger on revenue at the Carpetright store. In so doing, Carpetright sought to estimate the proportion of Allied sales that have been captured by Carpetright as a result of the Allied store closing—an estimate of the diversion ratio from Allied to Carpetright. This diversion ratio was estimated to be approximately [ ] per cent, which Carpetright submitted was in line with its national share of supply and therefore did not indicate that Carpetright and the former Allied store were closer competitors than their national shares of supply would imply.
70. Given the circumstances, the OFT has no conclusive evidence as to the constraint exercised by Carpetright on Allied in Solihull, as it has no evidence of the diversion ratio from Carpetright to Allied in Solihull. However, given the similarities between the stores, it is not unreasonable to assume that the diversion from Carpetright to Allied could have been similar to the diversion the other way.
71. The OFT notes that there are a number of issues surrounding the diversion ratio calculated by Carpetright. Firstly, it relates to a short post-merger period, which reduces the reliability of the results and could be impacted by a variety of factors. Nonetheless, the OFT considers the diversion ratio to be, on balance, a reasonable estimate of the constraint imposed by the former Allied store on Carpetright and, by implication (as discussed in paragraph 70 above) of the constraint imposed by the Carpetright store on the former Allied store.
72. The **variable profit margin** reflects the proportionate difference between price and incremental costs (costs of sales, staff costs and distribution costs, for instance). Generally, the higher the variable profit margin the greater the benefit to Carpetright of each sale previously lost to Allied now captured by Carpetright and vice versa. Carpetright has submitted detailed cost information for the Solihull store, which specifically indicates the costs that vary in the short run with the level of sales. On this basis, the variable profit margin is estimated to be around [ ] per cent.



73. The combination of variable profit margin data and diversion ratios is a valuable initial indication of the change in incentives brought about by a merger. Due to the general probative value of this combination of evidence, the OFT applies a rebuttable presumption that a horizontal merger between firms with (i) high variable profit margins and (ii) significant diversion ratios between them raises a realistic prospect of a substantial lessening of competition through unilateral effects.
74. In past cases,<sup>3</sup> the variable profit margin and diversion ratio have been used to measure illustrative price rises resulting from the merger. Following the methods used in those cases, illustrative price rises in this case have been estimated to be at a level that would raise significant concerns for the OFT and that give rise to a rebuttable presumption of a substantial lessening of competition on the basis of unilateral effects. This presumption may be rebutted by the OFT itself or by Carpetright, on the basis of evidence suggesting a contrary interpretation. The evidence is examined further below.
75. Carpetright has disputed the use of the combination of the variable profit margin and diversion ratio in this case, as it considers the carpet retail segment to differ significantly from other types of retail markets where the OFT has used this data as a basis for identifying competitive harm (namely grocery retail cases and DIY store cases). This is because, Carpetright submits, carpets are a discretionary purchase that is made after careful consideration and after customers have visited a number of stores. It also points to other precedents (such as *Alliance Boots/Dollond & Aitchison*<sup>4</sup>) which, it says, involve markets with characteristics more comparable to those in this case than grocery retail cases, and which did not use variable profit margin and diversion ratio data.
76. The OFT notes the following in this respect:

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<sup>3</sup> See, for example, OFT Decision, *Anticipated acquisition by Co-operative Group Limited of Somerfield Limited*, 20 October 2008, OFT Decision *Completed Acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd*, 15 April 2009, OFT Decision, *Completed acquisition by WM Morrison Supermarkets plc of 30 stores from Co-operative Group Limited*, 17 July 2009

<sup>4</sup> OFT Decision, *Proposed joint venture between Alliance Boots Limited and Dollond & Aitchison Limited in relation to their respective optical businesses*, 1 May 2009

- the combination of variable profit margins and diversion ratios is not an industry specific measure, it provides only a framework for analysis. The OFT considers that the methodology applies just as well to the facts of this case as to the facts of other cases where the OFT has used it and notes that Carpetright has provided no evidence as to why the specific characteristics of carpet retailing mean that it would be inappropriate to use this methodology, and
- while Carpetright's reference to *Alliance Boots/Dollond & Aitchnson* is relevant in this context, in that case the OFT had extensive evidence other than on variable profit margins and diversion ratios available in respect of the competitive constraints exercised on the merging firms by independents. Such evidence was not available to it in this case (see below).

#### **Examination of further evidence in relation to other competitive constraints**

77. The identification of the Parties as likely closest competitors cannot be determinative of the likely effects of the merger alone. Close competition does not mean that other firms cannot provide important, and possibly equally important, competitive constraints. As discussed above, the OFT has identified a number of carpet retail fascias that could potentially constrain Carpetright post-merger.
78. However, the OFT notes that (a) the analysis of variable profit margins and diversion ratios as part of the assessment of the closeness of competition between the Parties implicitly considers whether a sufficient proportion of customers would switch away from the Parties to other competing retailers to make a price rise unprofitable; and (b) it is not sufficient for competitors to simply identify themselves as competing with the Parties in order to mitigate the concerns. The OFT notes that this could indicate the existence of asymmetric constraints. Instead, evidence must show that these fascias are constraining Carpetright and the former Allied store.
79. Furthermore, the OFT does not consider that all fascia in a particular area are able to exert equal competitive constraints on each other. As mentioned above, the Parties have provided no substantive evidence to indicate they were constrained by any of the retailers in the area. Particular types of evidence used in past cases to mitigate concerns were not

provided in this case. This means that the OFT is limited in the extent to which it can consider whether other fascia (and especially the two stores at the edge of the five-mile radius from the Solihull store) exert a constraint on Carpetright to the extent that the former Allied store did. This is because the catchment area of these stores possibly differs from that of the Carpetright and former Allied store in Solihull.

80. The OFT considers it likely that there is only one competitor close to the Parties that would have a similar catchment area and that has a comparable offering.
81. Given these observations, the OFT considers that the presumption raised by the combination of the diversion ratio and variable profit margin cannot be rebutted simply by identifying comparable fascia in the local area (that are in any event reflected in the level of diversion between the Parties).
82. In relation to (b), Carpetright has submitted it does not have a formal competitor monitoring process and there is no recorded communication between the store manager, regional manager, divisional controller and/or head office that may identify local competitors or detail any response of Carpetright to local competition.
83. [ ]
84. The OFT has also received evidence in relation to the Allied local competitor monitoring process. In particular, it has been provided with a 'local price comparison board' that has been used to monitor the local Carpetright store and two independents in each local area. This goes some way towards addressing the OFT's concerns as to the constraint imposed by independents on the Allied store in Solihull although it notes that this is a generic document and not specific to Solihull. In addition, its concerns in relation to the loss of any constraint on Carpetright by Allied post-merger remain.
85. Carpetright has also submitted a number of internal documents which identify independents as a constraint nationally. Independent carpet retailers are mentioned as collectively being the 'key' competitor to Carpetright, but the OFT notes that the research submitted by Carpetright (a) does not point specifically to the nature of any constraint by independents or a reaction by Carpetright to a competitive threat by

independents; and (b) the research is at a national level and may have limited inference to the independents specifically in Solihull.

### **Actual effects of the merger**

86. The OFT notes the conduct of the Carpetright store alone following the merger, with respect to its PQRS offering, has not significantly changed in the period since the merger.
87. The OFT notes, however, that (a) there has, as a result of the Allied store closing, been an immediate reduction in choice, range, and capacity following from the merger, which would tend to exacerbate the OFT's concerns; and (b) even if there had been no worsening of the Parties' competitive offer following the merger, the OFT cannot necessarily rely on these factors to show the absence of anti-competitive effects given that these effects could in fact be observed following the completion of the OFT's investigation.

### **Conclusion**

88. On the basis of the present facts, the OFT does not have sufficient evidence to rebut the presumption of a substantial lessening of competition based on direct evidence of the competitive interaction between Carpetright and the Allied store pre-merger.

## **ENTRY AND EXPANSION**

89. Any likely and timely changes in the competitive offering of rival retailers or potential new rivals may be sufficient to avert any substantial lessening of competition.

### **Entry**

90. Carpetright submits that there are very limited barriers to entry in the retail supply of floor coverings for the following reasons:
  - Retailers do not require a significant amount of retail space as most floor coverings are sold from samples; only a small minority of products

are taken directly from the store by the customer at the time of purchase.

- Entrants do not require a network of fitters as installation services are traditionally self-employed individuals that can be sub-contracted or referred to by the retailer. Carpetright, for example, refers its customers to independent installation service providers.
- Entrants can access nationwide stock distribution networks and secure stock at competitive prices through wholesalers and buyers' groups.
- Credit can be obtained from suppliers and customers pay up front. Customer deposits can usually be used to manage cash flow.
- Cutting facilities are provided by wholesalers and, to a lesser extent, manufacturers.

91. Third party views in this respect were mixed. Some independent retailers supported Carpetright's view, submitting that supply agreements were easily arranged and there had been significant recent entry. All of these entrants were smaller independent retailers. Other independent retailers provided contrary views indicating there had been very little recent entry and obtaining both the premises and the required scale to compete with Carpetright was difficult.
92. The OFT notes that there has been some recent history of entry, with a local wholesaler expanding into retail, and repositioning, with an independent retailer becoming part of a regional multiple franchise, both within the last three years.
93. The OFT also notes the Habitat entry into carpet retailing in the Solihull retail park (and that Habitat is also owned by Hilco). However, Habitat's offering is very limited when compared to that of Carpetright, so that the OFT cannot consider it sufficient to countervail any effects of the merger.

#### Expansion

94. There does not appear to have been any significant expansion in the last few years although there were some indications from the OFT's market

investigation that some floor covering retailers already present in the area were considering expanding and extending their competitive offering. These plans, however, were not definite.

#### Conclusion on Entry and Expansion

95. The OFT recognises there may be some likelihood of supply-side responses and there has been some recent history of such responses. However, the OFT considers the evidence is insufficient to suggest such a response would be likely, timely or sufficient to avert a future deterioration of its competitive offering by the Parties.

### **THIRD PARTY VIEWS**

96. Third party comments have been discussed above where relevant.
97. In general, the OFT received a variety of views as to whether local floor covering retailers in Solihull considered themselves to compete with Carpetright and the former Allied store. The OFT also received mixed views in respect of entry and expansion in the Solihull area.

### **ASSESSMENT**

98. Carpetright acquired a number of leases from stores that were formerly Allied stores. In one of these locations, in Solihull, Carpetright and Allied operated stores on the same retail park. The OFT found that, regardless of the fact that the transfer of the lease of the former Allied store to Carpetright was instigated by the common landlord, it may be the case that there were two enterprises that had ceased to be distinct under the meaning of section 23(2) of the Act so that the OFT would have jurisdiction to examine the merger (as the share of supply test was also satisfied).
99. Carpetright and the former Allied store overlapped in the supply of floor coverings in Solihull. In examining the competitive effects of the merger, the OFT examined evidence in relation to the direct competitive interaction between the Parties pre-merger. This was derived from the increase in Carpetright sales in Solihull post merger (from which Carpetright was able to estimate a diversion ratio) combined with Carpetright's variable profit

margin for the Solihull store. The combination of these two measures gave rise to a rebuttable presumption that the merger would increase the Parties' incentives to worsen their competitive offer in Solihull.

100. Carpetright argued that the existence of a number of other competitors in the Solihull area should be sufficient to allay the OFT's concerns. In this respect, the OFT notes that the constraint exercised by these competitors is already captured by the level of post-merger diversion. In addition, not all competitors will exert equal constraints on the Parties, given that only one of the competitors offering a comparable range is in close proximity to the Solihull retail park. The OFT also did not have sufficient evidence to (a) assess how the Parties reacted to local competition; and (b) assess Carpetright's submission that there was very little it could do to alter its competitive offering in Solihull given its national pricing strategy.

101. While the OFT notes that there have been some instances of entry and some potential expansion in Solihull, it does not consider these to be likely, timely or sufficient to avert a deterioration of the offering by the Parties in Solihull.

## **EXCEPTIONS TO THE DUTY TO REFER AND UNDERTAKINGS IN LIEU**

102. The OFT's duty to refer under section 22(1) of the Act is subject to the application of certain discretionary exceptions, including the markets of insufficient importance, or 'de minimis', exception under section 22(2)(a).<sup>5</sup>

103. The OFT has found a realistic prospect of a substantial lessening of competition in relation to the retail supply of carpets in the Solihull area. The OFT believes that the size of the affected market is less than £10 million. The OFT has therefore considered whether it should apply the 'de minimis' exception to the duty to refer.

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<sup>5</sup> OFT516b, November 2007.

## **'De minimis' and availability of undertakings in lieu**

104. As stated in the *Dunfermline/BRN* case,<sup>6</sup> the OFT believes that it would be proportionate to refer a problematic merger (that is, not to apply the 'de minimis' exception) where it is 'in principle' clearly open to Carpetright to offer a clear-cut undertaking in lieu of reference. This is because the recurring benefits of avoiding consumer harm by means of undertakings in lieu in a given case, and all future like cases, outweighs the one-off costs of a reference.

105. In this case, the only clear-cut and effective remedy available to Carpetright would be divestiture of the Solihull store. However, the OFT does not include what would amount to prohibition when considering whether clear-cut undertakings in lieu are available, as it is not the role of the undertakings in lieu process effectively to invite parties to abandon their own transactions.<sup>7</sup> On the basis that the OFT believes that there is no clear-cut and proportionate remedy in principle available, the OFT has proceeded to examine whether to exercise its 'de minimis' exception in this case.

## **Application of the markets of insufficient importance exception to this case**

106. In the absence of any clear-cut undertakings in lieu being, in principle, available to Carpetright, the OFT has considered in detail whether to apply the markets of insufficient importance exception to this case. The factors that the OFT considers in determining whether it should apply its discretion in respect of the 'de minimis' exception have been set out in detail in a number of cases.<sup>8</sup> The relevant factors are:

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<sup>6</sup> OFT Decision, *Completed acquisition by Dunfermline Press Limited of the Berkshire Regional Newspapers business from Trinity Mirror plc* 4 February 2008.

<sup>7</sup> See OFT Decision, *Completed acquisition by Govia Limited of South Central Passenger Rail Franchise* 6 August 2009, footnote 21. The OFT also notes in this respect that it does not consider that the three leases in Grantham, Cheltenham and Chester were part of the same transaction as Solihull.

<sup>8</sup> See, for example, OFT Decision, *Anticipated Acquisition by Orbital Marketing Services Group Limited of Ocean Park Limited*, 14 November 2008, OFT Decision, *Completed acquisition by Govia Limited of South Central Passenger Rail Franchise*, 6 August 2009, OFT Decision, *Anticipated acquisition by Koppers Inc of Cindu Chemicals BV*, 23 February 2010



- market size
- strength of the OFT's concern (that is, its judgment as to the probability of the substantial lessening of competition occurring)
- magnitude of competition lost by the merger
- durability of the merger's impact, and
- precedential implications, including replicability and transaction rationale.

107. The OFT has considered each of the above factors in determining whether to exercise its discretion in this case.

108. **Market size** – while there is some uncertainty regarding the size of the market, the OFT considers that regardless of the view the OFT takes on the precise boundaries of the product and geographic market, the value of the market in which the merger would give rise to harm would not be much greater or much less than £5 million. In coming to this view, the OFT considers that the entire revenue of both the Carpetright and former Allied stores should be taken into account, as well as that of the competitor with a comparable range that is located at close proximity to the Solihull retail park. In addition, the OFT considers that it should not take into account the entire revenue of the competitors located at a considerable distance from the Solihull retail park, as part of their revenue would be attributed to customers outside the catchment area of the Parties.

109. **Strength of OFT's concerns** - in this case, the OFT believes, that there is a realistic prospect (but not a likelihood) that the transaction will result in a substantial lessening of competition. The OFT's concerns in this case are reduced because of the fact that there are a number of retailers active in the area. While this was not sufficient to remove the OFT's concerns regarding the existence of a substantial lessening of competition (in particular, given that in this instance, one of the stores was actually closed), it did serve to reduce the OFT's level of belief as to whether a substantial lessening of competition would arise. The relatively low level of the OFT's belief would point towards the exercise of the 'de minimis' exception in this case.

110. **Magnitude of competition lost** – the OFT notes that any potential harm that it believes arises out of this case derives from an asymmetric theory of harm, that is, that while Carpetright and the former Allied store constrained

each other and constrained some of the other carpet retailers in Solihull, those other carpet retailers did not necessarily constrain the Parties. As a result of this, given the asymmetry of the constraints, the magnitude of competition lost in the market as a whole would be more limited than that lost between the Parties. As a result, the OFT's assessment of the magnitude of harm that could result from the merger points towards the exercise of the 'de minimis' exception in this case.

111. **Durability** – although the OFT has not reached a level of confidence that new entry would be timely, likely and sufficient so as to allay the competition concerns that it has, it has received evidence of some entry and repositioning by competitors. The OFT therefore notes that the duration of harm could be expected to be comparatively limited given the absence of particular entry barriers. This would support the exercise of the 'de minimis' discretion.

112. **Transaction rationale and replicability** - as part of the exercise of its 'de minimis' discretion, the OFT considers the implications of the exercise of its discretion for future cases, and in particular cases in similar markets ('replicability'). In this respect, the OFT is particularly conscious of the very unusual circumstances that led to this transaction. In particular, the OFT has seen very strong documentary evidence that, far from Carpetright setting out to acquire its closest local competitor, the transaction was instigated by the landlord of the Carpetright and former Allied store premises. Notwithstanding that this is a transaction that could be replicated in a very general sense, in that it is an acquisition of a competitor retail store (regardless of the circumstances), on balance the very unusual fact pattern that brought about this transaction (and, in particular, the strong evidence that it was instigated by a third party and not contrived by Carpetright and Allied) significantly reduces the weight that the OFT places on replicability in this case.

113. **Conclusion** - notwithstanding the size of the affected market, the OFT considers that the total impact of the merger in terms of customer harm is likely to be limited, and that the costs associated with a Competition Commission inquiry are disproportionate to the prospect of benefits from such action. Accordingly, taking into account, in particular, the unusual circumstances that led to Carpetright acquiring the former Allied store in Solihull, the OFT considers it appropriate to exercise its discretion not to

refer because the market is of insufficient importance to warrant a reference.

## **DECISION**

114. This merger will therefore **not be referred** to the Competition Commission pursuant to section 22(1) of the Act.

## **ENDNOTES**

115. In respect of paragraph 1, the OFT clarifies that the number of stores was correct as at 25 March 2010.

116. In respect of footnote 1, the OFT clarifies that Carpetright's submission was that it was in fact an agreement for lease which was signed on 22 February 2010 and that this gave it the licence to occupy the former Allied store pending completion of the new lease and that surrender of the lease of the previous store and completion of the new lease both took place on 9 April 2010.

117. In respect of paragraph 7, the OFT notes that Carpetright took possession of the former Allied store on 8 March 2010 and began trading from it, in parallel with its existing store until 31 March 2010, at which point the stock, employees and some fixtures and fittings from its existing store were moved to the former Allied store.

118. In paragraph 69, the OFT clarifies that Carpetright's submission in relation to its share of supply related to 'the retail of floor coverings in the UK'.

119. In respect of (b) in paragraph 87, the OFT clarifies that it has not observed any deterioration of Carpetright's offering in Solihull but that the OFT cannot necessarily rely on this to show the absence of anti-competitive effects given that such effects might in future be observed following the completion of the OFT's investigation.