OFFICE OF FAIR TRADING

Completed acquisition by WM Morrison Supermarkets plc of 30 stores from Co-operative Group Limited

CR/34/09

The OFT's decision on reference under section 22(1) given on 10 July 2009. Full text of decision published 17 July 2009.

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. **WM Morrison Supermarkets plc (Morrisons)** is a large national grocery retailer, operating primarily one-stop grocery stores.

2. The **Co-operative Group Limited (CGL)** is the UK's largest co-operative with a diverse range of activities including the operation of banks, funeral services, farming, pharmacies and food retailing. This case involves CGL's food retailing.

TRANSACTION

3. The transaction concerns the completed acquisition by Morrisons of 30 stores (the Acquired Stores) from CGL.

4. In order to avoid a reference of its acquisition of Somerfield Limited (Somerfield) to the Competition Commission (CC),[1] CGL offered undertakings in lieu in which it was required to divest stores in 133 local areas (divestment stores). As part of this divestment process, CGL invited bids from Morrisons for a number of packages of stores which comprised both divestment stores and additional stores that CGL was willing to sell. Following negotiations, Morrisons agreed to purchase two packages consisting of 10 divestment stores and 28 non-divestment stores

[1] Anticipated acquisition by Co-operative Group Limited of Somerfield Limited, 20 October 2008 (CGL/Somerfield).

respectively.[2] Morrisons agreed to acquire two further non-divestment stores at Mansfield and at Chester le Street. It is the 30 non-divestment stores that are the subject of this decision, as the 10 divestment stores that were acquired as part of the CGL/Somerfield divestment process necessarily raised no competition concerns given that Morrisons had been approved by the OFT as a suitable purchaser.

5. The parties notified the transaction to the OFT on 15 May 2009.The administrative deadline is 13 July 2009 and the statutory deadline is 20 September 2009.

JURISDICTION

6. As a result of this transaction Morrisons and the Acquired Stores have ceased to be distinct. The UK turnover of the Acquired Stores for the financial year ended January 2009 was [over £70 million]. As a consequence the turnover threshold set in section 23(1)(b) of the Enterprise Act 2002 (the Act) is met. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

MARKET DEFINITION

7. The merger gives rise to an overlap in the supply of grocery retailing in the UK, more particularly in one-stop and mid-sized grocery stores.

Product scope

8. This industry has been examined extensively in recent years by both the OFT and the CC.[3]

9. In line with the OFT's and CC's previous decisional practice, the parties submitted that the product markets which are relevant to the assessment of the transaction are:

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[2] The acquisition of the 10 divestment stores was made pursuant to a separate sale agreement with CGL from the 28 non-divestment stores; given that these purchases were not inter-conditional, the OFT was not required to consider them as a single relevant merger situation.

[3] For recent OFT examples, see CGL/Somerfield and Completed acquisition by Tesco Stores Limited of Brian Ford's Discount Store Limited, 22 December 2008 (Tesco/Brian Ford). For CC examples, see The supply of groceries in the UK market investigation (April 2008) (groceries report); Tesco plc and the Co-operative Group (CWS) Limited: a report on the acquisition of the Co-operative Group (CWS) Limited's store at Uxbridge Road, Slough by Tesco plc (November 2007) (Tesco/CWS); Somerfield plc and Wm Morrison Supermarkets plc: A report on the acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc (September 2005) (Somerfield/Morrison); and Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc), Wm Morrison Supermarkets plc, J Sainsbury plc, and Tesco plc: a report on the mergers in contemplation (September 2003) (Safeway report).

(a) one-stop stores: those with a net sales area of 1,400 square metres or above. These stores form their own product market, and

(b) mid-size stores: those with a net sales area of less than 1,400 square metres but above 280 square metres. These stores are constrained by one-stop stores and so one-stop stores must be included in any market definition with mid size stores as its focus.

10. An aspect of product market definition in previous grocery investigations has been which store fascia to include within the relevant product market when examining competitive interactions from the perspective of large grocery retailers (such as Morrisons). In CGL/Somerfield, the OFT included large grocery retailers (for example Asda and Tesco) together with regional grocers and symbol groups in the effective competitor set. However, limited assortment discounters (LADs), frozen food retailers and specialist retailers were not included within the effective competitor set for large grocery retailers.

11. Morrisons has submitted that LADs, frozen food retailers and specialist retailers should be included as effective competitors. As discussed in the draft OFT/CC joint substantive guidelines,[4] the OFT's view is that market definition is a useful tool but is not an end in itself, and that what is important is to identify the competitive constraints faced by the merging firms. For this reason, while the OFT takes a cautious approach at Stage 1 of its analysis and excludes LADs and frozen food retailers from the effective competitor set, it does take into account other fascias where relevant in its Stage 2 analysis in circumstances where the available evidence (for example, survey results and diversion ratios) indicates that LADs and frozen food retailers may provide effective competition to large grocery retailers.[5]

Geographic scope

12. Previous CC and OFT decisional practice in supermarkets have found that there are both national and local aspects to competition.

13. In CGL/Somerfield there were many local areas for the OFT to consider. To 'filter out' local areas of overlap between CGL and Somerfield where no concerns could arise on any plausible market definition, the OFT used the following store catchment areas in its Stage 1 analysis:

- for one-stop stores, 10 minutes' drive time in urban areas and 15 minutes' drive time in rural areas, and

[4] Merger Assessment Guidelines, A joint publication of the Competition Commission and the Office of Fair Trading, Consultation Document, April 2009, par 4.47.
[5] For an analogous approach, see, for example, Tesco/Brian Ford.

- for mid-size stores, a five minute drive time in urban areas and 10 minutes drive time in rural areas but these stores are also constrained by one-stop stores within a 10-minute drive time (or a 15-minute drive time in rural areas).

14. The parties have followed this approach in their submission to the OFT.

HORIZONTAL ISSUES

National competition

15. When considering the merger effect at the national level it is appropriate to consider the merged entity's share of supply across all store sizes combined since national competition does not take place according to the size of an operator's retail stores. On this measure, after the merger the transaction will result in an increment to Morrison's national market share of less than one per cent.

16. In light of this the OFT does not consider that competition concerns arise at a national level as a result of this merger.

Local competition

Stage 1 analysis

17. In its submission to the OFT, Morrisons largely followed the methodology set out in Annex 1 of CGL/Somerfield in filtering out those stores where no competition concerns could arise on any plausible candidate market: this involves finding any overlap in the 'maximum reach isochrone' (the maximum area of geographic overlap, essentially), and then filtering in the 'primary isochrone' (centred on the Acquired Store) and in various isochrones re-centred on areas of population (census output areas).[6]

18. Seven of the 30 Acquired Stores failed the Stage 1 analysis and required further investigation. These were the stores in Maghull, Mitcham, Southwark, Wallsend, Frodsham, Mansfield Woodhouse and Ramsbottom.

[6] As a departure from the methodology in CGL/Somerfield, and with the OFT's agreement, Morrisons omitted competitor re-centring in its filtering exercise as this would not have been probative of additional competition concerns given that re-centring on census output areas was conducted. Population re-centring can be considered more probative as it reflects the shoppers' ability to travel to a particular store from their home.

Stage 2 analysis

19. As a result of carrying out customer surveys, Morrisons was able to calculate the diversion ratio between the acquired CGL store and the overlapping Morrisons store.

20. Consistent with the OFT's approach in CGL/Somerfield, Morrisons has followed the methodology employed by the CC in its Somerfield/Morrisons inquiry. According to this methodology, a store is considered to fail Stage 2 if the diversion ratio from the target to the acquiring store (or vice versa) is above 14.3 per cent and the illustrative price rise (IPR) is above five per cent.

Diversion ratio tests

21. Out of the seven local areas that failed the Stage 1 analysis,[7] there were two stores that failed the diversion ratio test (that is, had a diversion above 14.3 per cent[8]), namely Maghull and Wallsend. In Maghull, the diversion ratio from the CGL target store to the Morrisons store was 14.9 per cent (diversion in the other direction was eight per cent). In Wallsend, the diversion ratio from the CGL target store to the Morrisons store was 26.8 per cent (diversion in the other direction was 3.8 per cent).

Illustrative price rises

22. The rationale for calculating IPRs is to estimate the incentive that the acquirer would have post-merger to raise its prices or equivalently worsen its non-price offer (that is, quality, range or service - 'QRS') in the local area.

23. The IPR calculation takes into account both percentage gross profit margins ('margins') — that is, sales less direct costs of sales, as a proportion of sales — and diversion ratios, the underlying presumption being that the combination of high margins and high diversion ratios is a good indicator that the merger will result in both the ability and the incentive to increase

[7] In respect of the Mansfield store, Morrisons was unable to conduct surveys as the CGL Mansfield store was closed. The diversion ratio from CGL/Somerfield, which was only available in respect of the diversion from CGL Mansfield to Morrisons (but not vice versa) was 2.7 per cent. Although the diversion ratio from Morrisons to CGL Mansfield is not available, the OFT does not believe this would be high, given that the Morrisons Mansfield store revenue is £[...] p.a. whereas the CGL Mansfield revenue is £[...] which is consistent with the view that diversion from the smaller to the larger store is likely to be much higher than the other way around. This is confirmed by a review of the diversion ratios from Morrisons to target stores which are significantly below the diversion ratios from the target stores to Morrisons stores and is generally consistent with OFT past experience.

[8] Diversion ratios were calculated on a revenue basis. The OFT considers this to be a more probative basis for assessing unilateral effects than customer diversion, as firms considering the likely responses of their customers to price changes will be concerned with any loss of revenue, not specifically customers.

prices. Due to the general probative value of this combination of evidence, therefore, the OFT applies a rebuttable presumption that a horizontal merger between firms with (i) high margins and (ii) significant diversion ratios between them raises a realistic prospect of a substantial lessening of competition through unilateral effects.[9] If it arises, however, this presumption, may be rebutted by the OFT itself or by the parties, on the basis of evidence suggesting a contrary interpretation.[10]

Calculation of IPRs

24. Morrisons submitted to the OFT that the standard method for calculating IPRs uses inappropriately restrictive assumptions given the specific facts of this case; in particular, the standard calculation assumes that (i) diversion ratios (that is, in each direction) and margins between the relevant Morrisons and CGL stores are 'symmetric', and (ii) consumers' demand for groceries is isoelastic (that is, that the proportion of consumers that switch in response to a proportionate change in price remains constant as the price level increases). In this case, there was a significant difference between CGL's and Morrisons' margins at their respective stores and in the diversion ratios between the relevant stores (depending on the direction of the diversion).

25. The incentive to raise price for the target CGL store in this case (or equivalent worsening of the non-price offer) arises because the merger would internalise the profit on sales diverted from the target store to the Morrisons store when the target store raises its prices. If the diversion ratios and margins between the two stores were symmetric, Morrisons would have the same incentive to raise prices at its original stores as well. In competitive equilibrium (as modelled by the IPR) both the target and Morrisons will raise their prices further as they face increased demand from the sales that divert to one another as a result of the initial price raising incentive. However, the diversion ratio is far lower from the Morrisons to the CGL target store, and so the equilibrium price rise for the target will be considerably dampened compared to the symmetric situation. Therefore, where, as in this case, the diversion ratios and margins are not equal, using the higher diversion ratio and the higher margin and ignoring the effect of a much lower diversion ratio the other way and lower margin of one store will overestimate the IPR.

IPRs in Maghull and Wallsend

26. Even on the basis of an approach that assumes symmetric margins and diversion ratios, the IPR for the store in Maghull is below five per cent, so that the rebuttable presumption does not arise.

[9] See OFT Decision *Completed Acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd*, 15 April 2009 (Homebase/Focus), paragraphs 61ff.
[10] Tesco/Brian Ford, paragraph 35.

27. In respect of the Wallsend store, the IPR - based on assumptions of symmetric margins and diversion ratios - exceeds five per cent, although not by much. Therefore the OFT examined the IPR under a plausible range of less cautious and - given the specific facts of this case (that is, the very low level of the diversion ratio from Morrisons to CGL and Morrisons' comparatively lower margin) – less restrictive reflections of the actual margins, asymmetry and the curvature of demand, and reached the conclusion that the IPR (both from CGL to Morrisons and vice versa) would, on this basis, be less than five per cent.

28. Given the above, the OFT's conclusion is that the rebuttable presumption is not triggered in relation to the Wallsend store.

THIRD PARTY VIEWS

29. The OFT has received no third party comments in relation to the competitive assessment of this transaction.

ASSESSMENT

30. The transaction concerns the completed acquisition by Morrisons of 30 stores from CGL.

31. Morrisons conducted surveys in the seven areas where primary competition concerns were identified on the basis of isochrone- and fascia-count-based filtering. The customer survey indicated significant diversion ratios (that is, over 14.3 per cent) in only two areas, namely Maghull and Wallsend (where the diversion ratio from the CGL target store to Morrisons was 14.9 per cent and 26.8 per cent respectively).

32. Even on the most cautious approach, the IPR for the store in Maghull is below five per cent. In respect of the Wallsend store, the IPR on the most cautious approach exceeds five per cent, although not by much. Therefore, the OFT examined the IPR under a plausible range of less cautious and, given the specific facts of this case, less restrictive assumptions about the actual margins, asymmetry and the curvature of demand, and reached the conclusion that the IPR, on this basis, would be less than five per cent. Accordingly, neither the Maghull or Wallsend store fails the diversion ratio/IPR test.

33. Consequently, the OFT does not believe that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

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