OFFICE OF FAIR TRADING

Completed acquisition by NBTY Europe Limited of Julian Graves Limited

ME/3887/09

The OFT's decision on reference under Section 22 given on 24 March 2009. Full text of decision published 9 April 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. **NBTY Europe Limited (NBTY)** is a subsidiary of NBTY Inc, a vertically integrated manufacturer, marketer and distributor of a broad line of nutritional supplements in the United States and worldwide. NBTY is the holding company for most of the European activities of NBTY Inc and is a retailer of vitamins, minerals, food supplements (VMS), nuts, seeds and dried fruit (NSF), and ancillary items.

2. NBTY's retail operations in the UK include Holland & Barrett (**H&B**), a health food products retailer with 522 stores in the UK, and GNC, a specialist retailer of sports nutrition supplements and other VMS, with 31 stores in the UK. NBTY's turnover was approximately £[ ] million in the year ending 30 September 2008, of which approximately £[ ] million was generated in the UK.

3. In addition, NBTY is a vertically integrated manufacturer and supplier of VMS. NTBY also owns its own packaging operation at which it packs the majority of NBTY's own label NSF range.

4. **Julian Graves Limited (JG)** is a large independent specialist natural food and ingredients retailer. It has approximately 350 retail stores in the UK. JG's turnover was approximately £[ ] million in the year ending 31 March 2008, of which approximately £[ ] million was generated in the UK.

5. JG has its own packaging facility and most of its bulk commodity products are packaged in house. JG also operates a wholesale business selling JG branded products to garden centres and holiday destinations, and also supplies bulk foods and other products to smaller independent retailers.

TRANSACTION, PROCESS AND TIMING

6. The transaction concerns the completed acquisition by NBTY of Julian Graves, which took place on 16 September 2008.

7. The OFT became aware of the transaction through its own initiative via its Mergers Intelligence Unit. The OFT sent a preliminary inquiry letter to NBTY on 26 September 2008.

8. On 13 October 2008, the parties signed initial undertakings pursuant to section 71 Enterprise Act 2002 (the Act) to 'hold separate' both businesses.

9. The OFT did not receive a satisfactory submission from the parties until 8 December 2008. As a result the statutory and administrative deadlines were extended (pursuant to section 25 of the Act) while NBTY compiled the requisite information for its submission.

10. The statutory deadline under section 24 of the Act is Tuesday 28 April 2009. The administrative target date for the OFT to announce a decision in this case is Friday 20 March 2009.

JURISDICTION

11. The transaction has resulted in two enterprises ceasing to be distinct under section 23(1) of the Act.

12. Given that the acquired business, JG, has UK turnover in its last financial year of approximately £[ ] million, the turnover test in section 23(1)(b) of the Act is not met.

13. However, the OFT believes that it is or may be the case that the share of supply test in section 23(2)(b) of the Act is met and, therefore, that a relevant merger situation has been created. This is because the parties' combined share of supply in the UK of health food products through specialist retailers has been estimated to be approximately [70-80] per cent (increment approximately [20-30] per cent) measured by number of outlets or [60-70] per cent (increment [10-15] per cent) by sales.[1]

14. The parties contested the assertion of jurisdiction by the OFT for a number of reasons.

15. First, they noted that the share of supply test would not be met in relation to 'the sale of NSF' by all retailers which, they claimed, was the competitive lens that concerned the OFT in its investigation. The OFT does not necessarily dispute this. However, the share of supply test need not relate to an economic market, and the Act does not require the basis on which jurisdiction is asserted and the substantive competitive assessment to be linked.

16. Second, they argued that JG was not a 'specialist retailer' of 'health food products'. However, this statement is contradicted by: the inclusion of JG within a table of 'UK: leading specialist health food retailers' in the Mintel Report; JG's description of itself as an 'independent specialist natural food and ingredients retailer' on its own website;[2] and by the overall weight of evidence received by the OFT during its investigation on the characterisation of JG, as discussed in detail in the remainder of this decision.

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[1] Source: Mintel Report Health Food Retailing, April 2008 (the 'Mintel Report'). The Mintel Report measured the number of outlets of the UK's 'leading specialist health food retailers'. Although such health food retailers may sell products other than health food products, the OFT regards these data as a reasonable proxy for the sale of health food products through such specialist health food stores. Alternatively, to the extent that shares of supply are calculated by reference to the value of sales through health food stores, then the OFT believes, on the basis of the data in the Mintel Report and the parties' turnover data, that the share of supply test would also be met.

[2] www.juliangraves.com/about_us.

17. Third, they stated that the [70-80] per cent figure was incorrect given that the Mintel table was not intended to be exhaustive (it only included 'leading' retailers) and did not form any proper basis for the OFT's finding. The OFT accepts that the Mintel table may not be exhaustive (see below) but considers that it is appropriate for the OFT to have regard to recognised industry categorisations when applying the share of supply test and determining whether it is or may be satisfied.

18. Fourth, they argued that, if the OFT intended to proceed on the basis of considering the number of stores operated by health food retailers, it should take account of independent retail outlets that constitute the majority of 'specialist' health food retailers. The parties estimated that there are 1,825 such outlets.[3] It is more difficult for the OFT to determine whether all of these independent retail outlets should necessarily be regarded as 'specialists' in health food, and therefore falling within the share of supply test as set out above. However, even if they were all to be included, the parties would still have approximately a [25-30] per cent share of supply by outlets (increment approximately [10-15] per cent) after the merger.[4] As such, the share of supply test would also appear to be met if independent health food retail outlets were included.

19. Fifth, they argued that the OFT would be unreasonable in including JG as a 'health food store in the UK' but excluding other retailers that they claimed sell much more extensive and specialised ranges of 'health foods' as defined by the Mintel Report. The parties cited Boots as the 'obvious example' of such a store. The OFT fully accepts that there are other retailers (including Boots and the supermarkets) that sell 'health foods'. However, it does not accept the parties' argument that 'there is in reality no difference between the purchase of NSF products in H&B or JG and in the supermarkets (or, for example, Marks & Spencer or Boots)'. The OFT does not believe that, as discussed further in this decision, the retail proposition offered by H&B and JG should be regarded as identical to that offered by the supermarkets or pharmacies. As such, it does not believe that Boots and the supermarkets should be categorised as 'specialist health food retailers' for the purposes of the

[3] Mintel Report, April 2008.
[4] On the basis that the parties would together have 835 specialist health food outlets out of a total of 2959 including 1825 independent stores (See Mintel Report, April 2008).

share of supply test. It notes that this view was apparently shared by the authors of the Mintel Report.

20. Therefore, notwithstanding the parties' arguments, the OFT considers that it is reasonable for it to assert jurisdiction on the basis of the parties' share of supply in the UK of health food products through specialist retailers. In this regard, as discussed previously, it notes that this categorisation has been used in a specialist industry report which, although not decisive, lends support to the OFT's view that this description of goods is reasonable and appropriate.

21. The OFT believes that the share of supply test may also be met in two further ways.

- First, as discussed in greater detail further below, the transaction raises significant competition concerns in relation to the supply of NSF. While the OFT did not consider it necessary to come to a firm conclusion on the precise scope of the relevant product market but rather focused on the closeness of competition between the parties, the results of the critical loss analysis undertaken by the OFT indicates that the most appropriate candidate product market in this case would appear to be no wider than the supply of NSF through specialist retailers. On this basis, as already discussed above, and even if independent health stores were to be included, the parties' share of supply would be above 25 per cent (see paragraph 18 above).

  While, as noted above, the Act does not require the basis on which jurisdiction is asserted and the substantive competitive assessment to be linked, and indeed the OFT is always careful not to conflate the two, it nevertheless makes intuitive sense that the share of supply test should be met when the competitive lens through which the transaction is considered raises unilateral effects concerns. The OFT considers that it would be very unusual if the share of supply test were not to be met in circumstances where unilateral effects concerns arise.

- Second, the parties' share of supply of VMS in the UK is above 25 per cent. Based on data from a 2008 TNS report and data provided by JG, the parties' combined share of supply (by value) would be [25-30] per cent (increment [0-5] per cent).[5]

22. The OFT further notes that, whilst the parties made extensive submissions on how the share of supply test should be applied, the Act is clear that the OFT, in determining whether the share of supply test is met, may apply such criterion (whether value, cost, price, quantity, capacity, number of workers employed or some other criterion, of whatever nature), or such combination of criteria, as it considers appropriate (section 23(5) of the Act). Further, section 23(6) and (7) of the Act provide that the OFT may treat goods as being of different forms of supply when the transactions concerned differ as to their nature, their parties, their terms or their surrounding circumstances and the difference is one which, in the opinion of the OFT, ought for the purposes of that subsection to be treated as a material difference. The OFT considers that the sale of health food products or NSF through 'specialist' retailers should be treated as a particular form of supply for these purposes.

23. For all of these reasons, the OFT therefore believes that it is or may be the case that a relevant merger situation has been created. The Act is clear that, to the extent that there is genuine uncertainty on the existence of a relevant merger situation, this question is in any event one for resolution by the CC on the basis of a detailed investigation where the duty to refer would otherwise be met.[6]

BACKGROUND

24. H&B and JG are the two largest high street specialist retailers of health food and natural food products in the UK. As a result of the transaction the parties overlap in the retail of NSF and, to a lesser extent, VMS.

25. The total sales of NSF in the UK were worth £511 million in 2007. Nuts represent the majority of NSF sales with £309 million, followed by dried fruit with £176 million and seeds with £26 million. The retail sales of

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[5] These percentages are based on the following: (i) total annual sales of VMS of £410,656,000 (see the TSN report into VMS of 17 October 2008, p 26); (ii) H&B annual VMS sales of £[ ] (see the TNS report into VMS of 17 October 2008, p 26); and (iii) JG annual VMS sales of £[ ] (see the parties' submission of 8 December 2008).

[6] It is interesting to note that the parties accepted in their 8 December 2008 submission that the OFT has a wide discretion in its application of the share of supply test, and that the submission was based on the assumption that the OFT did have jurisdiction to review the transaction.

NSF have increased by 38 per cent in the period 2003 and 2007. Seeds were the fastest growing category. NSF can be purchased from a variety of retail outlets including those belonging to the parties and also more broadly based (in terms of range) retailers such as supermarkets.

26. The total value of sales of VMS in the UK in 2008 was £411 million. The VMS market has been growing albeit at a slowing pace (the increase of sales in 2008 as compared to 2007 was 0.7 per cent). VMS can be purchased from a variety of retail outlets including those belonging to the merging parties, drug stores (for example, Boots or Superdrug), pharmacies, and supermarkets. The market for the supply of VMS is characterised by the sale of both branded and own brand products.

MARKET DEFINITION

27. At the outset the OFT considers that it is worth noting that market definition is not an end in itself; it is a framework for analysing the direct competitive pressures faced by the merged firm. In the context of differentiated goods markets, as in the present case, the analytical discipline of market definition helps identify the extent of immediate competitive interaction between the parties' value propositions to their customers, which in this case are consumers.[7] However, in differentiated goods markets, market definition creates a risk of drawing bright lines that either overstate or understate the degree of competitive constraints posed by respective suppliers.

28. The parties devoted a substantial proportion of their case to the proposition that the relevant market, and thus the appropriate lens for assessing the merger, is the supply of NSF through all retail channels (including supermarkets and pharmacies) on the basis that NSF can be purchased from all such outlets.

29. The OFT considers, however, that while some NSF products can be purchased from a variety of outlets (including CTNs,[8] pubs and cafes as well as supermarkets and independent specialist retail outlets), a product frame of reference on this basis does not take any account of how close substitutes the different outlets are to each other. The OFT therefore

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[7] OFT Guidance 'Mergers – Substantive Assessment Guidance', paragraphs 3.11 and 3.22.
[8] Confectionery, Tobacconist, and Newsagent.

places particular importance on evidence of consumer behaviour, such as, for instance, diversion ratios that show the degree to which the parties may be able to internalise post-merger any sales that they may lose to each other pre-merger.

30. Accordingly, the OFT considers that the availability of evidence on the central question of unilateral effects (discussed below) has rendered market definition in this case less critical to our assessment.

Product scope

NSF

31. As noted above, NSF can be purchased from a variety of outlets including those of the parties and other more broadly based retailers such as supermarkets.

32. H&B and JG are the only two national high street retail chains with extensive and specialist product offerings in the retail sale of NSF, both with a strong 'natural food' or 'health food' reputation.[9] Despite the ubiquity and growth of generalist high street retailers across the UK that stock (some) NSF, these suppliers do not appear to have arrested the growth of the parties' chains in recent years. On the contrary, the parties' continued expansion in the number of operated outlets appears to be responding, at least in part, to particular consumer demand for specialist NSF offerings.[10]

33. The parties' successful value proposition to customers, therefore, may be regarded as a distinct mix of (high street) location as well as aspects of price, quality, range and service (PQRS).

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[9] See the parties' websites www.juliangraves.com/about_us where JG is described as 'UK's largest independent specialist natural food and ingredients retailer' and www.hollandandbarrett.com. This is supported by JG's 2007 Survey where 44 per cent of JG's customers considered health food stores to be a competitor of JG, which would tend to indicate that consumers perceive JG to sell health food related products (see paragraph 110 below), and the Mintel Report which describes JG as 'a speciality food retailer that concentrates on premium food ingredients that include some health and whole foods.'

[10] In particular, JG increased the number of its stores from 200 to over 360 in the period 2003 to 2008.

34. The parties argued that the majority of NSF sales take place in supermarkets and accordingly the market should be defined to include all retailers selling NSF, including supermarkets. In particular, they argued that:

- NSF products can be purchased in a variety of retail channels (in particular in supermarkets) and the survey evidence (discussed further below) suggest that (over time) many consumers multi-source NSF from all these channels. The same range and form of NSF products can be found in many of these channels, in particular in supermarkets. No specialist advice is required in relation to the purchase of NSF.

- The availability of a wide range of products in supermarkets and the evidence of multi-sourcing also mean that the NSF products are homogenous and that consumers do not consider the parties' retail offer to be any different from the retail offer of supermarkets.

- Finally, the parties note that during the last couple of years supermarkets have increased their sales considerably while sales at Holland and Barrett have fallen.[11]

35. Whilst the OFT acknowledges that NSF can be purchased in a wide variety of retail channels, the OFT considers that supermarkets are differentiated from the parties in several respects. In particular:

- They are not specialist health and natural food retailers, with a focus on NSF.

- Their product ranges differ and are perceived as different by the merging parties' customers (see paragraph 110 below) and by the supermarkets themselves (see paragraphs 36 and 115 below).

- The overall retail offer of the supermarkets differs from the retail offer of the merging parties, as identified by supermarkets' responses to the OFT questionnaire (see paragraph 115 below).

- They are primarily, though not always, located away from the high street. Given that the results of the customer surveys indicate that location appears to be very important to the parties' customers (bearing in mind too that their visit to a store is a planned, not an impulse, visit for many customers), this is a significant differentiating factor.

36. Evidence submitted by non-specialist NSF retailers to the OFT indicates that they see substantial differences between themselves and each of the parties in terms of PQRS and location. Save for one exception, supermarkets have told the OFT that they do not monitor prices at either of the parties' stores.

37. The OFT's analysis of NSF prices (discussed in paragraph 106 below) shows a closer pricing relationship between the parties' prices than between the prices of the parties and supermarkets.

38. The critical loss analysis undertaken by the OFT indicates that the most appropriate candidate product market in this case appears no wider than the supply of NSF through specialist retailers. Although critical loss analysis is typically employed as a tool for market definition, the OFT has in this case carried out this analysis alongside the unilateral effects analysis, and using the same data sources. As such, the detail of the critical analysis can be found in the competitive assessment section below, at paragraph 88.

Conclusion on product scope

39. Much of the available evidence, and most notably the critical loss analysis, points to there being a separate relevant market for the supply of NSF through specialist retailers, and not including supermarket retailers. Ultimately, however, given the relative closeness of competition between the parties, and the overall weight of all the evidence at the OFT's disposal, there is no need here to draw hard and fast conclusions on product market definition to frame the competitive assessment. Instead, in the analysis below, the OFT has focused on the

[11] Table 7 of Mintel Report, August 2008 indicates a 49 per cent increase by supermarkets in retail sales of NSF from 2003 to 2007, compared to only an 11 per cent increase to

closeness of competition between the parties and the availability of alternative choices for customers that will provide a sufficient constraint on the merged entity such that it is not able to raise prices or reduce non-price factors (such as QRS).

VMS

40. The parties overlap in the supply of VMS is considerably smaller. Even though both H&B and JG sell VMS, only H&B is a significant player with a 25 per cent share in the supply of VMS in the UK.[12] In the light of the minor increment (less than one per cent) represented by JG in VMS and in the absence of any evidence that JG's share of supply would be materially different at a local level, the OFT has not found it necessary to conclude on this product frame of reference and does not propose to consider this market any further.

Geographic scope - NSF

National dimension

41. The parties submit that the geographic market is national. H&B and JG both set their prices and promotional activities nationally. Local managers have only limited powers to carry out their own promotions.[13] In addition, decisions on strategic matters such as new store openings – their extent and location – are taken centrally.

Local dimension

42. Although the parties' pricing decisions may be made centrally, the geographic ambit of NSF retailing from the demand-side is local as consumers carry out their shopping locally. Moreover, as indicated by the survey work undertaken by the parties (discussed further below), customers are concerned not just with price but also other non-price aspects of the NSF retailers' offer, such as location, product range and availability, and helpfulness of staff. Consequently, the OFT's starting assumption for geographic market definition in retail goods and services

independents and health stores during the same period.

[12] See *TNS report into VMS,* January 2008, sales of VMS in the UK in 2007 by value for H&B was 25 per cent. The OFT calculated that JG's share of sales would be 0.3 per cent.

[13] For example, vouchering to support a new store opening.

markets has therefore been—and continues to be, absent compelling evidence to the contrary —that there will be material local competition across each relevant local area to attract and retain customers, even if not on every parameter of PQRS.[14]

43. In practice, as in previous cases, our starting point is therefore that retail mergers of this type will feature both national and local elements of competition.

44. The OFT has not considered previously the geographic market for the supply in the UK of NSF (whether through all retailers or specialist retailers). Instead, the OFT initially reviewed the parties' own methodology, which divided the UK into local shopping areas. These areas include small to medium sized town high streets and shopping areas in large towns. On the basis of this methodology the OFT identified the parties as both being present in 214 local areas.

45. In February 2009, the parties conducted customer surveys in a sample of 50 local overlap and non-overlap areas (these are discussed further below). The survey results showed that the great majority (87 per cent) of customers of H&B and JG travelled less than 30 minutes to reach the parties' stores, the vast majority of whom (81 per cent) travelled from home. On this basis, the parties argued that a 30 minute travel time around relevant stores suggests relatively large local markets and accordingly that out of town supermarkets should be included in the same geographic market as the parties' high street and shopping centre locations.

46. The OFT considers that the question of whether supermarkets should be included in the relevant geographic scope will be primarily driven by whether they have been included in the product market scope. If this was the case, then the inclusion of out of town supermarkets would need to be analysed on a local-market by local-market basis.

Conclusion on geographic scope

47. It appears to the OFT that, as with other retail markets, competition in the supply of NSF occurs on one or more of the elements of PQRS.

[14] See Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd, OFT decision 15 April 2008 (*Homebase/Focus*).

Some of these elements are likely to be competed over mostly or wholly at the national level, whereas others are likely to be competed over mostly or wholly at the local level. As noted above in relation to the relevant product market, it is not appropriate in this case to draw hard and fast conclusions on geographic market definition to frame the competitive assessment. Therefore, while a 30-minute travel time catchment area around each of the parties' stores would appear to be a reasonable starting point, the OFT has not considered it necessary to come to a definitive view on the precise scope of the market and has instead focused on the closeness of competition between the parties and the availability of alternative choices for consumers.

COMPETITION ASSESSMENT

UNILATERAL EFFECTS

48. Unilateral effects concerns can arise in differentiated markets where the merger combines two close choices for a substantial proportion of customers and where countervailing factors such as other choices, low barriers to entry or buyer power are not sufficient to constrain the loss of this close competition. In particular, in the absence of such constraints, the merged firm is likely to be able to recoup any sales lost by reducing the PQRS offer of a customer's first choice when it also owns that customer's next best choice. While customers may be able to switch to a third, fourth or more distant choices, there may, nevertheless, be latitude for the merged firm profitably to raise price or equivalently reduced QRS by a small but significant amount before this happens to any significant extent.

49. A primary focus of the OFT's investigation has therefore been whether – and, if so, in what respects – H&B and JG are each other's closest competitors at the national and/or local (that is, in local areas where they overlap) levels.

Quantitative analysis as the basis for a rebuttable presumption of unilateral effects

50. In order to assess the probability of a loss of competitive rivalry arising as a result of a merger, the OFT will, when available, examine two

sources of evidence in seeking to assess the closeness of competition between merging firms and identify the change in incentives that the internalisation of this rivalry would bring post-merger:

- diversion ratios between the merging parties – the diversion ratio is the proportion of customers lost in response to a worsened offer by one of the merging parties that would divert to the other; the higher the ratio, the closer the competition between the parties, and the greater the potential incentive for the merged firm to raise price or worsen its non-price retail offer, and

- gross margins – if firms are able to mark-up prices to a substantial degree over the cost of sales, this suggests that the collective competitive pressure from rivals is relatively low (suggesting a narrower market) because otherwise price sensitive marginal customers of the firm would switch to these rivals and oblige the firm to lower its margins (lower prices or increase spend on its non-price offer); as such gross margins are a proxy for the degree of rivalry in absolute terms between all market participants pre-merger.

51. Accordingly, the combination of gross margin data and diversion ratios can be a valuable measure of the change of incentives brought 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 margins and (ii) significant diversion ratios between them raises a realistic prospect of a substantial lessening of competition through unilateral effects.

52. The greater is the illustrative change in incentives brought about by the merger, the stronger is the presumption. All else equal, the higher the parties' gross margins and the higher the diversion ratio between them, the greater the presumed incentive of the merged firm to worsen its offer to customers. At the same time, this presumption will be weaker if the reliability or probative value of the margin or diversion ratio evidence as a guide is in doubt.

Rebuttable presumption of unilateral effects in this case

The 2009 Survey: Diversion ratios

53. The parties provided the OFT with a tailor-made customer survey commissioned by NBTY in February 2009. This survey was carried out in 40 JG stores in overlap areas, 10 JG stores in non-overlap areas and 10 H&B stores in overlap areas (the '2009 Survey'). In each area, 100 responses were collected.

54. The 2009 Survey provided the OFT with data useful for the calculation of diversion ratios and own price elasticity, which in turn enabled estimation of upward price pressure and critical loss analysis. The 2009 Survey also allowed the OFT to assess consumers' best alternatives to JG and H&B.

55. As discussed in paragraph 44 above, the parties overlap in 214 local areas. In February 2009, the parties carried out customer surveys in a sample of 50 locations. The results of the 2009 Survey revealed that the parties have a very similar profile of customers[15] and that the diversion ratios between the parties are relatively high, indicating that they are close competitors.

56. The 2009 Survey asked customers shopping at JG where they would shop if they found that their store was unavailable. Across all overlap and non-overlap areas, the survey results showed that supermarkets cumulatively accounted for approximately 50 per cent of unprompted responses of first choice alternatives. Across all overlap areas, H&B accounted for 32 per cent of unprompted responses of first choice alternatives, and JG accounted for 28 per cent. On this basis, the parties submitted that they competed more closely with supermarkets than with each other.

57. On a disaggregated basis, however, the results of the 2009 Survey in overlap areas revealed that the highest diversion is between the parties, and not between either or both of them and any individual supermarket

[15] Predominantly female (over 70 per cent), older (62 per cent are over 55 years old), and wealthier (61 per cent are ABC1). The survey also found that 64 per cent of JG and 72 per cent of H&B customers planned their trips to those stores, as opposed to shopping on the spur of the moment.

fascia (for example, Asda, Morrison, Sainsbury's or Tesco) (see Table 1 below).

58. These diversion figures are much higher than to any other single competitor including any individual supermarket fascia: the average diversion ratio to Asda is five per cent, to Tesco is 13 per cent, to Sainsbury's is 12 per cent and to Morrisons is nine per cent. Accordingly, although any individual supermarket fascia provides some constraint on the merging parties, it is clearly not as strong as that provided by the merging parties on each other. The diversion ratios to independent stores suggest that they do not represent a significant constraint. It is possible that the survey results underestimate the significance of independent stores due to the fact that they were listed as 'unnamed' stores in the survey questions. However, the OFT has no way of knowing this, and therefore the OFT is not able to place any weight on this possible explanation.

Table 1: Adjusted average diversion ratios (unprompted responses, first choice)[16]

	Diversion ratio from JG in 40 overlap areas	Diversion ratio from JG in 10 non-overlap areas	Diversion ratio from H&B in 10 overlap areas
Asda	5%	3%	6%
Holland & Barrett	32%	13%	N/A
Julian Graves	N/A	N/A	28%
Morrisons	9%	10%	10%
Sainsbury's	12%	10%	8%
Somerfield	1%	2%	0%
Tesco	13%	17%	14%
Waitrose	5%	3%	3%
Other supermarket / national stores	4%	7%	8%
Other - independent stores	3%	0%	4%
Other – unnamed	16%	35%	18%
Total	100%	100%	100%

59. The OFT also notes that these diversion ratios are orders of magnitude higher than one would expect if there was no or little differentiation between NSF retailers.[17] In particular, if that were the case, then the diversion ratios between the parties would be proportional to their market shares. Specifically, the parties submit that their combined national market shares are between eight and 13 per cent—with an

[16] 2009 Survey, response to Question 9a.
[17] That is, if diversion ratios were based on NSF shares of supply of all retailers, as identified by the Mintel Report dated August 2008.

increment from JG of between around 3 to 4 per cent to H&B's share of between around five and nine per cent. On this basis, one might expect a diversion ratio from JG to H&B of only five to nine per cent;[18] and a diversion ratio from H&B to JG of only three to four per cent.[19]

60. In non-overlap areas (as defined by the parties), the 2009 Survey revealed that the diversion ratio from JG to H&B was 13 per cent (first choice, unprompted). While at first blush this might seem an odd result, this could be a further indication of the closeness of competition between the two firms (that is, customers of one chain prefer to use the other party's store in another location rather than switch to more local alternative suppliers of NSF). It may also suggest that the scope of the 'local' market is wider than that which the parties used to identify its list of overlap stores and, thus, that the number of overlaps might actually be higher than 214 (see paragraph 44 above).

61. The parties argued that the 13 per cent diversion from JG stores to H&B in non-overlap areas can be explained by the fact that at the time of the 2009 Survey, H&B was engaged in a heavy nationwide advertising campaign. There is no evidence, however, to evaluate this assertion. Moreover, the OFT believes that the effect of H&B advertising on JG customers could equally point to the closeness of substitution between JG and H&B.

62. In addition, the OFT notes that these are average diversion ratio figures across the 2009 Survey. In three areas the diversion ratio is over 50 per cent and in another nine between 40 per cent and 50 per cent. Given that the parties' survey was based only on a sample of local overlap areas (50 out of the 214 overlap areas), this suggests that, if replicated in all overlap areas, the survey may produce a significant number of areas with diversion ratios of 40 per cent or more (see Table 2 below).

[18] That is, H&B's market share divided by the residual market share not accounted for by JB. This is 5/(100-3) = 5 per cent or 9/(100-4) = 9 per cent.
[19] That is, JG's market share divided by the residual market share not accounted for H&B. This is 3/(100-5) = 3 per cent or 4/(100-9) = 4 per cent.

Table 2: Diversion ratios in local areas (unprompted, first choice, adjusted)[20]

Percentage band	Diversion ratios from JG to H&B in local overlap areas	Diversion ratios from H&B to JG in local overlap areas
Above 50%	2	1
40p%-49%	9	0
30%t-39%	14	3
20%-29%	10	3
10%-19%	5	3
No. of overlap areas	40	10

63. The parties further argued that the closure of a JG outlet in Windsor demonstrates that JG is not competing with H&B. The parties provided a spreadsheet containing revenue information for H&B for the period of 31 weeks before the closure of the JG outlet and for the period of eight weeks since the JG closure. The parties argued that JG's closure had a limited impact on H&B sales.

64. The OFT considers that this argument is misleading. The JG closure took place on 28 December 2008. Given the strong seasonality of NSF sales, which peak before Christmas and fall afterwards, any comparison of pre-Christmas and post-Christmas sales needs to take account of the drop in sales that naturally occurs in the post-Christmas period for both parties.[21] However, the OFT sees virtually no difference in the sales of NSF in H&B Windsor between November and December 2008 and January and February 2009. The OFT considers that this evidence could in fact indicate that due to the closure of JG, H&B Windsor was able to avoid the usual post-Christmas sales slump by capturing some of the previous JG sales. We therefore were not convinced by the parties' arguments in this respect.

Use of the 2009 Survey

65. The parties argued that the results of the 2009 Survey were biased. The parties' main objections to the survey were the following:

- The OFT unduly focused on first choice alternatives rather than all spontaneous choices

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[20] 2009 Survey, response to Question 9a.

[21] For instance, the seasonality analysis of the parties' sales demonstrates that the H&B's sales of NSF in November and December 2007 were almost 1.5 times higher than the sales in January and February 2008.

- The OFT did not consider the potential framing bias. The 2009 Survey was an exit survey[22] conducted on high streets where both parties were often present, which might overstate the importance of H&B.

- The 2009 Survey had a low number of respondents at the local level, thereby calling into question the soundness of any conclusions in relation to individual local markets.

- The OFT did not use the answers to question 13 which asked consumers directly about their behaviour following a 10 per cent price increase.

66. On the first point, the OFT has analysed both first and second spontaneous responses. The OFT did not agree with the way the parties aggregated the two responses as it confuses the order of customer preferences. Instead, the OFT analysed whether those consumers who stated H&B as first alternative to JG (and vice versa), mentioned supermarkets as their second alternative (see Table 4 below).

67. On the second point, it is precisely those people who shop on the high street that are relevant in this case given that they are the most likely type of consumer to be affected by the transaction. In addition, it is standard accepted technique to conduct surveys in this manner.

68. On the third point, the OFT notes that over 6,000 customers took part in the 2009 Survey. In addition, on an individual local area basis, the OFT considers that 100 responses in each local area to be a very good response rate and consistent with consumer surveys in other local retail mergers examined by the OFT and CC that the authorities have attached significant evidentiary weight to. Nevertheless, the OFT notes that, even when results are aggregated for all local areas, the resulting average raises sufficient concern on its own.

69. On the fourth point, the OFT cautioned the parties in advance of their conducting the 2009 Survey that the wording of question 13 might be difficult for consumers to understand and answer and for the OFT to

[22] A survey of customers that just made a purchase at a JG store.

interpret. It is for these reasons the OFT did not use its results. This is consistent with the OFT's general approach to survey design in merger cases.[23]

70. Finally, the parties argued that the OFT did not give due consideration to the 2009 Survey while at the same time arguing that the survey was biased and therefore unreliable. The OFT was satisfied that the design of the 2009 Survey was in line with its long-standing best practice and therefore remains confident to use the results for the analysis outlined in paragraphs 53 to 96 above.

Gross margins

71. The parties provided details of the monthly gross margins[24] for both parties' stores over a period of one year.[25] The parties' average monthly gross margins were relatively high ([ ] per cent for H&B and [ ] per cent for JG).

Illustrative price increases as a proxy for loss of rivalry giving rise to adverse effects

72. The combination of the gross margins and the diversion ratios on a per store basis allowed the OFT to calculate a measure of the upward pressure on pricing (or equivalent worsening of non-price factors such as Q, R and S) potentially arising from the merger: the OFT has previously described this measure as an 'illustrative price increase', using the CC's nomenclature from Somerfield/Morrisons.[26] The illustrative price increases averaged 13.2 per cent in JG overlap areas and 14.3 per cent

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[23] Question 13 asks what would happen if prices in JG **and** H&B stores were to increase by 10 per cent (as opposed to just the price at the surveyed store being 10 per cent higher – as in question 11). It was not at all clear to the OFT what interpretation to place on this aspect of question 13. By contrast, the OFT calculated price elasticity estimates from the results from questions 11 and 12 as these questions are standard accepted survey questions for establishing such estimates. In particular, the questions take into account the possibility of consumers spending less at the particular store in question (in contrast to question 13.

[24] Gross margins were calculated as sales minus costs of sales in each store.

[25] The gross margin for each store was calculated as an average of monthly gross margins over a period of one year.

[26] 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*). While probative of a unilateral effects theory of harm, an illustrative price rise does not predict post merger prices.

in H&B overlap areas.[27] These levels are substantially higher than illustrative price increases that have previously led to the OFT considering there to be a realistic prospect of an SLC in mergers involving other local retail markets (for example, CGL/Somerfield, Homebase/Focus).[28]

73. The OFT notes that the above conclusion is based in part (that is, in relation to the diversion ratios) on the average results of the 2009 Survey, and recognises that there was some variation across the areas surveyed. This means that the potential scale of the unilateral effects may differ from local area to local area. The overall results indicate, however, that there may also be unilateral effects in areas not covered by the 2009 Survey. Due to the fact that the parties conducted surveys in 50 out of the 214 local overlap areas, it is not possible for the OFT to determine at this stage how many of these 'other' areas might be affected.

74. In light of the evidence on diversion ratios and gross margins discussed above, it is clear to the OFT that a presumption of unilateral effects is created given that margins and diversion ratios are high in many of the local areas surveyed (and possibly in other areas not surveyed).

75. However, the presumption may be rebutted, by the OFT itself or by the parties, on the basis of evidence suggesting a contrary interpretation for example, that the parties are not, in fact, close competitors or that rivals are close third and fourth choices for the diverting customers, or that countervailing constraints from supply-side responses (entry, expansion or repositioning) or buyer power would rectify any incentive to worsen the merged firm's offer post-merger.[29]

76. The remainder of this section on Unilateral Effects considers the other evidence obtained by the OFT during the course of its inquiry, and in

[27] These results assume demand for NSF is linear—that is, as NSF prices increase, consumers' demand becomes more sensitive to further price increases. The assumption that demand for NSF is linear therefore produces lower illustrative price increases than if other (non-linear) assumptions about the shape of the demand curve are made. As such our results are conservative.
[28] Anticipated acquisition by Co-operative Group Limited of Somerfield Limited, OFT decision 20 October 2008 (*CGL/Somerfield*), and *Homebase/Focus*.
[29] See Completed acquisition by Air France Finance S.A.S / City Jet Ltd of VLM Airlines N.V., OFT decision 9 May 2008.

particular whether such evidence supports or rebuts the presumption of unilateral effects as outlined above.

(i) Price elasticity

77. Generally, as the price of a product rises, consumers will usually demand a lower quantity, consume less or substitute that product for another product. The greater the extent to which demand falls as price rises, the more 'price elastic' is demand said to be. Conversely, when consumers continue to purchase a product in great numbers despite its price increasing, demand is said to be 'price inelastic'.

78. The 2009 Survey[30] suggested that the price elasticity of demand faced by JG and H&B individually lies between approximately −1.4 and −2.1. This says that when either JG or H&B raises price by 10 per cent, each loses between 14 and 21 per cent respectively of its business.

79. There is also an inverse relationship between the price elasticity of demand facing an individual firm and the profit margin that it makes: intuitively, a firm applying a high margin evidently does not believe demand for its products to be very price elastic.[31] This inverse relationship suggests that an individual firm facing demand with a price elasticity of −1.4 should have gross margins of about 71 per cent, whereas one facing demand with a price elasticity of −2.1 should have gross margins of about 48 per cent:[32] consistent with this, H&B's average gross margin is approximately 64 per cent and JG's is 52 per cent.[33] Put differently, these margins suggest that H&B faces demand with a price elasticity of −1.6 and JG faces demand with a price elasticity of −1.9:[34] both are within the range of estimates derived from the 2009 Survey.

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[30] Question 11 (most likely response if the price at the visited store was 10 percent higher) and question 12 (predicted reduction in spend) of the 2009 Survey.

[31] This relationship is known as the Lerner Condition and requires that the percentage margin of price over marginal cost of a firm is equal to negative of the inverse of the own price elasticity of demand faced by that firm. The Lerner Condition says that a firm's price-cost margin and the elasticity of demand that it faces are not independent of one another and estimates of each need to be consistent with one another in assessing the price set by the firm.

[32] As $1/1.4 = 0.71$ and $1/2.1 = 0.48$.

[33] JG's average margin includes some strongly underperforming stores with a margin as low as 25 per cent, many of which have been earmarked for closure.

[34] As $1/0.64 = 1.6$ and $1/0.52 = 1.9$.

80. The implication of this is that reliance can be placed in this range of elasticity estimates. The OFT considers that these elasticity estimates are relatively low (inelastic); certainly much less elastic than the OFT has observed in other similar local retail merger cases. This would in turn suggest that the parties' NSF products are not as easily substitutable with NSF products sold in other outlets (as the parties' claim) and indicates that the supply of this product is differentiated.

81. Conversely, the parties argued that (i) these estimates of the elasticity of demand are pre-merger and therefore are uninformative about the extent to which the parties will be constrained post-merger; (ii) the price elasticity of demand does not convey any information regarding consumers' sensitivity to changes in non-price factors such as QRS; and (iii) the fact that the parties may face inelastic demand is inconsistent with them competing closely with each other.

82. On the first point, the OFT notes that the pre-merger elasticity of demand facing JG and H&B is an indicator of their capacity to raise prices post-merger because the merger internalises that part of the pre-merger elasticity of demand facing each firm that is due to competition from the other. Any measure of the post-merger elasticity of demand facing the merged firm would therefore be a consequence of it having raised prices post-merger and would not be informative about the impetus to do so in the first place.

83. On the second point, the question in the 2009 Survey from which the diversion ratios were calculated was sufficiently general to capture respondents' preferences over non-price factors such as QRS, as well as price. Consequently, the OFT considers that the diversion ratios are a reasonable indicator of how close consumers perceive all aspects of the parties' retail offer (that is, PQRS) to be and therefore complement the demand elasticity information. In conjunction with the relatively low elasticity of demand, the high diversion ratios between the parties indicate that the merged firm would have the ability and incentive to raise prices or equivalently worsen non-price factors.

84. On the third point, the OFT does not consider that there is any inconsistency in the fact that the parties would appear to face relatively inelastic demand and the OFT's view that the parties compete closely with each other. To take a simple example, two players in a duopoly

may compete closely with each other and yet still face relatively inelastic demand given the absence of any other competitors in the market.

85. Moreover, if the elasticity of demand facing each of JG and H&B was low enough to indicate that each essentially is facing little competition for its own customers—as the parties suggested—then the OFT would not expect to see the levels of diversion between the parties observed in the 2009 Survey.

86. The parties further argued that, because the cumulative diversion to supermarkets is approximately 60 per cent,[35] a 10 per cent price increase would be unprofitable as it would result in the parties losing 60 per cent of their sales to supermarkets. Therefore, the parties said, any such price increase would be unprofitable.

87. However, the OFT notes that, given a price elasticity of demand of about —1.4, the merging parties would only lose 14 per cent of their sales following a 10 per cent price increase. If out of these 14 per cent, approximately 60 per cent were lost to supermarkets, then this would mean that the parties would only lose approximately 8.4 per cent of their sales to supermarkets following a 10 per cent price increase. Conversely, 91.6 per cent of the sales will be retained and the business will earn a 10 per cent higher margin on them. As a result, the OFT considers that this makes a profitable price increase more likely. The section below on critical loss analysis expands on this.

(ii) Critical loss analysis

88. As reported in the market definition section above, critical loss analysis is primarily a tool for market definition, which empirically implements the SSNIP test. However, because the analysis and data sources used in applying this tool are similar to those used above, and because it provides more detail on the closeness of competition between the merging parties, the analysis is presented here.

89. The critical loss is the percentage decrease in sales that just makes unprofitable a 5 to 10 per cent price increase (that is, a SSNIP) by a

hypothetical monopolist of some narrow candidate market. The actual loss is the predicted percentage decrease in sales in response to such a SSNIP by the hypothetical monopolist. If the actual loss exceeds the critical loss, the relevant market appears wider than the narrow candidate market considered. Estimates of the critical loss are based on gross margins. In this case, the 2009 Survey provides estimates of the actual loss calculation.

90. The parties submitted a critical loss analysis that sought to demonstrate that a price increase of 10 per cent would not be profitable because the market for NSF included supermarkets. The parties' analysis calculated critical diversion ratios between JG and H&B that would be necessary to make a 10 per cent post-merger price increase profitable, given sales lost to the supermarkets. The parties said that their analysis demonstrated that for the range of gross margins implied by the OFT's elasticity estimates (in paragraph 79), a 10 per cent price increase, given a 32 per cent diversion ratio from JG to H&B (the average diversion ratio from the 2009 Survey - see Table 1), would only be profitable where 80 per cent of JG's consumers are infra-marginal (loyal) (which the parties argued was unrealistic) and where gross margins are less than 60 per cent.

91. The OFT did not find the parties' analysis persuasive. As explained in paragraph 78, a firm's gross margin and the elasticity of demand that it faces will be (the negative of) the inverse of one another. The elasticity of demand faced by a firm, in turn, depends on the proportion of infra-marginal consumers in its customer base. Consequently, it makes no sense to conduct a critical loss analysis by varying the gross margin and the proportion of loyal customers independently of each other, as the parties' critical loss analysis did. That is, a given level of gross margin implies a certain elasticity of demand and a proportion of infra-marginal customers. It is not therefore informative to hold constant the gross margin and to vary the proportion of infra-marginal customers—nor to hold constant the proportion of infra-marginal customers and vary the gross margin—in order to generate 'critical' diversion ratios. Critical loss analysis must be conducted recognising the fundamental duality

[35] The figure of 60 per cent was presented by the parties and is based on aggregation of the survey results that the OFT considered inappropriate. The OFT figure for cumulative diversion ratio to the supermarkets is around 50 per cent.

between a firm's gross margin and the elasticity of demand that it faces.

92. To take a concrete example, the parties' analysis suggested that with a gross margin of 50 per cent and a proportion of infra-marginal customers between 60 and 80 per cent, the critical diversion ratio between JG and H&B to make profitable a 10 per cent price increase varied between 20 per cent (for a proportion of infra-marginal customers of 80 per cent) and 70 per cent (for a proportion of infra-marginal customers of 60 per cent). Consequently—the parties claimed—because the actual diversion ratio from JG to H&B from the 2009 Survey was 32 per cent, a post-merger 10 per cent price increase would only be profitable if 80 per cent of JG customers were infra-marginal, which was not realistic.

93. However, this analysis ignores the duality between gross margins and the elasticity of demand. That is, the elasticity of demand facing a firm with a gross margin of 50 per cent should be around −2. Consequently, when this firm increases its prices by 10 per cent, it loses 20 per cent of its customers: meaning it retains 80 per cent of them, that is, 80 per cent are infra-marginal. This is precisely the proportion of infra-marginal customers that the parties' own analysis indicates would make a post-merger price increase of 10 per cent profitable, given the diversion ratio between JG and H&B. It is irrelevant that lower proportions of infra-marginal customers may defeat such a price increase given the diversion between the parties, as these lower proportions are inconsistent with the existence of a gross margin of 50 per cent in the first place.

94. In this regard, the OFT undertook its own critical loss analysis, which concluded that a post-merger price increase of 10 per cent would indeed be profitable for the parties. In particular, the OFT's analysis used the parties' estimates of their gross margins of between 50 and 60 per cent and the consistent estimates of the elasticity of demand from the 2009 Survey (see paragraph 78). The OFT analysis found that the parties would need a diversion ratio in excess of 16.7 per cent (for a 60 per cent margin) or a diversion ratio in excess of 20 per cent (for a 50 per cent margin) in order to make a 10 per cent price increase profitable post-merger. The diversion ratios between the parties from the 2009 Survey are well in excess of these figures, both on average and in most local markets. This led the OFT to conclude that a 10 per cent price increase post-merger could be profitable. This in turn suggests that the

two merging parties lie within a narrow market, comprising at its widest the supply of NSF products through specialist retailers, and face insufficient competitive constraint from supermarkets for these to be included within the relevant market.

(iii) Analysis of JG customers' best alternatives

95. Based on the spontaneous (that is, unprompted) responses to the question about where consumers would shop if their JG store became unavailable, the parties' survey shows that in the 40 surveyed overlap areas, H&B is the first choice of JG's customers in 28 out of these 40 cases, or 70 per cent of these cases (see Table 3 below). In the 12 cases when H&B is not the first choice, Tesco is the most popular first choice (5 cases out of 12).

Table 3: Analysis of first alternatives to JG stores

H&B is the most favourite alternative for JG customers if their JG store becomes unavailable	**28** overlap areas
H&B is not the most favourite alternative for JG customers if their JG store becomes unavailable	**12** overlap areas
Total No. of surveyed overlap areas	**40**

96. In addition, the OFT analysed the further choices of those customers that mentioned JG as their best alternative to H&B and vice versa. The analysis revealed that a large majority of customers who considered H&B/JG as their best alternative did not consider any other store as a possible further alternative. For example, 69 per cent and 52 per cent of those surveyed at H&B and JG overlap stores respectively who considered H&B/JG as their best alternative did not consider any other stores as a possible further alternative (see Table 4). This therefore suggests that supermarkets may not be particularly close competitors to that first best alternative.

Table 4: 'If JG/HB was your first alternative choice, what other choices would you consider?'

	JG stores surveyed in overlap areas	**HB stores surveyed in overlap areas**
No other store considered	52%	69%
Another supermarket considered	31%	23%

(iv) Price tracking and matching

97. The OFT analysed price tracking and monitoring data provided by the parties. The OFT recognises that whilst price tracking or monitoring can be indicative of who the merging parties consider to be their competitors, it is not in itself sufficient evidence to demonstrate the existence of competitive constraints. For this, further information on price matching (as opposed to merely tracking and monitoring) would be needed.

98. The evidence indicates that H&B tracks prices of NSF in JG, Asda, Sainsbury's, Tesco and Tree of Life.[36] However, the data indicates that JG and H&B most closely monitor and track each other's prices. Specifically, H&B targets price reductions on JG and no other retailer. In nuts, H&B price matches or virtually price matches 13 out of 24 products sold in both JG and H&B. In five cases, the price tracking data includes a recommendation to 'match JG'. On the basis of the evidence provided by the parties, no other price-tracked retailer receives the same recommendation. Similarly, in seeds, H&B matches the price or notes that it was cheaper than JG in 11 out of 13 cases in which both JG and H&B sell the same product. Similarly, no other retailer receives the same treatment. Finally, in dried fruit, H&B either price matches, price beats or recommends to price match or price beat JG on 7 out 17 items that both retailers sell. Likewise, no other retailer is targeted.

99. The parties argued that the H&B data showing 'match JG' price recommendations were not followed as no record in the minutes of the relevant Trading Committee meetings is made of the price change recommendations, suggesting that they were not followed. Further, the parties provided spreadsheets which they argued demonstrated that the price changes were not implemented.

100. The OFT did not find this entirely persuasive. The OFT cannot be certain that silence in the Trading Committee meeting minutes necessarily demonstrates that the prices change recommendations were not implemented. Moreover, while the data in the spreadsheets were difficult to interpret, it was certainly not clear to the OFT that they supported the parties' argument.

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[36] A supplier of organic and natural products to independent health food stores in the UK.

101. H&B submitted further evidence demonstrating that it does sometimes follow supermarket prices, suggesting that supermarkets, and not just JG, are a pricing constraint. Specifically, the parties explained that in 2008 H&B decided to move away from regular promotions and adopted an alternative pricing strategy. This involved reducing many of its NSF list prices to five per cent below that of Sainsbury's (a supermarket) and to carry out promotional activity around the message of 'Every Day Low Price'. H&B selected Sainsbury's because it believed it to be within the middle band of supermarket pricing. H&B said that ultimately this new pricing strategy was unsuccessful; resulting in lost sales and margin, and H&B therefore reverted to its former strategy of higher list prices with heavier promotional activity.

102. The OFT reviewed this evidence. While accepting that this is an example of one of the parties pricing against a supermarket, the OFT considers that the lack of success of this strategy, and its subsequent abandonment, substantially reduces the power of this evidence as supporting the parties' argument that the supermarkets comprise a strong competitive constraint.

103. In relation to price monitoring and tracking by JG, the evidence provided indicated that JG tracks prices of H&B, Asda, Sainsbury's, Tesco, and Waitrose. However, JG tracks in particular detail the promotions offered by H&B comparing it with its normal prices and its prices on promotion. On the basis of this information, the OFT notes that H&B promotions mostly appear to target those JG products that are cheaper than H&B at normal prices.

104. The supermarkets do not, for the most part, track the prices of H&B or JG. They compete intensively with one another on a wide range of PQRS factors, and thus focus on tracking each other's prices. The parties argued that this is because they are too small to be significant competitors to the supermarkets and that the market definition can therefore be asymmetric. They believe that the supermarkets constrain the parties, even though the parties do not constrain the supermarkets. Moreover, given that the merger is between JG and H&B—and not between either of them and a supermarket—what matters most is the extent to which supermarkets constrain the parties and not the extent to which the parties constrain supermarkets. The OFT accepts this point,

and therefore does not place weight on evidence that the supermarkets do not track the parties' prices.

105. Nonetheless, in light of the above, the OFT considers that H&B and JG closely monitor and appear to respond to each other's prices. Indeed, H&B appears to target promotions and price reductions at JG and no other retailer. The JG and H&B price tracking data also showed that JG and H&B were in general more expensive (on average around 20 per cent) than all the supermarkets with the exception of Waitrose. The parties provided some evidence to rebut any claim of price matching and to show how closely they compete with the supermarkets. Notwithstanding that it was not entirely clear to the OFT that this evidence actually supported these arguments, the OFT considers that the remainder of the pricing evidence was sufficient to be generally supportive of the proposition that the parties are closer competitors to each other than they are to the supermarkets.

(v) Price closeness

106. The OFT undertook an analysis of the levels of prices of JG's core NSF products in order to identify which retailers were closest to JG in terms of pricing.[37] In particular, the OFT computed price differences between JG and H&B for those core NSF products that only the two merging parties sell. The OFT then compared these price differences to the price differences for core NSF products sold by JG and by supermarkets. The OFT's results suggested that the JG—H&B price differences were much less variable over the core NSF products compared than were any of the JG—supermarket price differences.[38] This narrowness in the dispersion of JG and H&B prices over core NSF products—by comparison to the

[37] The top ten best selling NSF products represent [ ] per cent of JG's NSF sales and [ ] per cent of H&B's.

[38] The OFT calculated the coefficient of variation over the pairs of price differences to do this. The coefficient of variation is defined as the average value in a set of data divided by the standard deviation of that set of data. In absolute value, the coefficient of variation provides a scale-free measure of how wide a distribution of values is. In this case, the OFT took the sample of core NSF products sold only by JG and H&B and calculated the price difference between each of them. The OFT then divided the average value of these price differences by the standard deviation of these price differences to calculate the coefficient of variation between the prices of JG and H&B—its value was 1.21. The OFT then repeated this exercise for the core NSF products sold by JG and the supermarkets. The coefficients of variation varied from 2.23 (JG and Tesco) to 14.73 (JG and Sainsbury's), averaging 6. The implication is that, for the core NSF products that they sell, prices at JG and H&B vary much less than do prices at JG and any of the supermarkets.

dispersion of JG and supermarket prices—is consistent with the merging parties being closer competitors to each other than to the supermarkets.

107. The parties raised a general objection to this analysis on the basis of the linear approach taken to converting all sales into the same weight units. The parties argued that the price of a 500 gram bag would not typically be double the price of a 250 gram bag, and thus that any comparison of converted prices would be misleading when retailers sold different bag sizes. The parties further argued that it was not clear that the prices were collected at the same point in time and that competitive interaction is not accounted for in the data. Finally, the parties argued that the estimated results merely provided an indication of the similarity in pricing structures for two particular retailers.

108. The data in the OFT's analysis came from JG's 'Core product price audit' from April 2008. The data was collected by JG itself and the OFT did not carry out any price conversions for different package sizes other than those undertaken by JG itself. The OFT therefore considers that its analysis represents a snapshot of the competitive interaction between JG, H&B and the supermarkets as it took place at the time the core product price audit was carried out, given that this evidently was the purpose of the audit.

109. The OFT considers that its analysis of price levels is a directionally useful way to ascertain how closely JG's pricing follows that of H&B. Even if, as the parties suggest in paragraph 107 above, the result of our analysis provide nothing more than an indication of the similarity of the pricing structure of two retailers, this would nonetheless point to the similarity of the two business models.

(vi) Customer preferences

110. The parties also provided the OFT with an Exit Survey conducted by JG in June 2007 in six stores with 263 respondents ('2007 Survey').[39] This survey provided some additional evidence about consumer behaviour.

111. In terms of customer preferences, the results of the 2007 Survey suggested that health food stores are closer competitors to JG than

[39] JG Exit Survey, Retail Maxim (June 2007).

supermarkets (44 per cent of consumers identified health food stores as competitors to JG). The OFT considers that this could be explained by the fact that JG's customers also value location and that whilst JG and H&B are both mostly located on the high street, supermarkets that have retail space in these areas (which will tend to be 'smaller stores' in grocery retailing terms) may be unable to stock the entire range of NSF (even though in theory a wider product range is available through their larger stores). In addition, the 2007 Survey suggested that H&B appeared to be the closest competitor to JG, with a large majority of customers mentioning H&B in the unprompted part of the questionnaire.

112. In addition, the results of the 2009 Survey revealed that the two main reasons why customers shop at H&B and JG are due to location (32 per cent) and range of products (27 per cent).

113. The parties argued that the 2007 Survey findings are not reliable because they are based on a small sample of respondents (263) in only six locations. The parties further argued that the 2009 Survey directly contradicts the findings of the 2007 Survey.

114. The OFT accepts that the limited number of respondents to the 2007 Survey (particularly when compared to the 2009 Survey) means that the OFT should place less weight on it than on the results of the 2009 Survey. Nevertheless, the OFT notes that the results do not appear to be inconsistent with those of the 2009 Survey, and therefore are directionally useful in verifying and supporting the results of the 2009 Survey. Accordingly, the OFT has used the 2007 Survey to further inform its analysis rather than to derive important measures of competition such as diversion ratios (where the 2009 Survey was used).

(vii) Customer and competitor responses

115. Various third parties (competitors as well as consumers) indicated that they viewed H&B and JG as close competitors due to the similarity of their offering. These views corroborate a statement made by the CEO of H&B, who stated regarding the purchase of JG in September 2008:[40]

[40] Peter Aldis in a Baugur media release regarding the acquisition of JB by NBTY dated 17 September 2008.

> 'This is an exciting milestone for our company, and fantastic news for our business as we have always identified Julian Graves as a key competitor. It has therefore continued to be an acquisition target.'

116. The OFT invited large supermarkets to assess the closeness of competition between them and the parties across several dimensions of NSF retailing, notably price, range and quality. Of the five supermarkets that responded, all agreed that their NSF retail offer was far closer to the retail offer of other supermarkets than the retail offer of the merging parties. Indeed, save for one instance, none of the supermarkets claimed to monitor the NSF retail offer of the merging parties, whereas they do monitor each other's prices. One supermarket stated:

> '[The merging parties] are well down the list of competitors for [us]. They fulfil a very different shopping mission which [we don't] target heavily, namely that of the shopper who is looking primarily to buy health food products. Their store locations (high streets) also mean that [we] infrequently compete head on.'

117. The parties argued that they should be able to access the evidence submitted by supermarkets. This was not possible due to the confidential nature of the supermarkets' responses. Instead, the OFT presented the parties with the main arguments in an aggregate and anonymised manner.

118. The parties also argued that the OFT did not take account of the asymmetric nature of the constraint between supermarkets and the parties whereby the parties are constrained by the supermarkets, but supermarkets are not constrained by the parties.

119. The evidence provided by the supermarkets was focused, however, on a more factual assessment of retailers' PQRS. It involved, among other things, comparing supermarkets' own retail offer in NSF with the offer of the merging parties. As discussed in paragraph 116 above, the supermarkets did not consider their NSF retail offer to be similar to that of the merging parties, whilst they considered the parties' offer to be similar to each other.

National effects

120. Following the merger, NBTY will be present through H&B and JG in 613 local areas. H&B and JG are both present in (at least) 214 of these local areas. In light of the above analysis, it would appear that the parties are particularly close competitors and accordingly, the OFT cannot rule out that the merger will lead to a significant national effect whereby the parties will face a decreased competitive pressure at the national level.

121. The national effect could be facilitated by the fact that the merging parties already take important commercial decisions (such as pricing or promotional activities) nationally. It is therefore possible that, following the merger, the parties will have the incentive to increase prices or worsen other aspects of their retail offer. We also note here that each party was a strong second choice for a significant proportion of customers even in non-overlap areas, again suggesting that unilateral effects may not be confined to local overlap areas.

Absence of countervailing factors

122. New entry, the threat of new entry, and expansion by existing suppliers, can all represent important countervailing factors, constraining the competitive behaviour of the merged entity, post-merger.

123. The parties' main argument is that NSF can be purchased from many other retailers, including supermarkets, pharmacies and other independent health food and natural food retailers, and that barriers to expansion by these other retailers are low. Further, the parties argued that barriers to entry or expansion in NSF for other retailers (that is, non-supermarkets) are very low.

124. Whilst the OFT notes the parties' comments above, it also is mindful of the fact that, to outweigh substantial harm arising from the merger, any entry or expansion must be timely, likely and sufficient to restore the loss of competition arising from the merger.[41] In this particular case, the scale of any such entry or expansion in this case would need to be substantial in order to offset the impact of this merger, given the scale

[41] See Merger Guidelines 'Substantive assessment guidance' (OFT516), paragraphs 4.17-4.26.

of the local overlaps and the strength of these parties as competitors at a national level.

Constraints from entry

125. The parties argued that barriers to entry are low and that other NSF retailers may enter the market. The parties cited the existence of at least 1,800 independent health food and natural food retailers, the recent entry of companies such as Cranberry into the market, as well as JG itself, which has opened 160 stores in the last five years.

126. The most recent entry into NSF has been by Cranberry. However, the OFT notes that Cranberry currently lists (on its web site) only 12 outlets in the UK, 10 of which are located in London.[42] Accordingly, the OFT does not consider a small operator, such as Cranberry, to demonstrate the ease of large scale entry, able to constrain the parties post-merger.

127. The OFT acknowledges that barriers to entry to the NSF retail market are relatively low for an independent stand alone store, as it would be relatively simple to rent suitable premises on a high street and set up supply contracts. Establishing a specialist reputation may, however, be more costly and time-consuming to achieve.

128. Moreover, as explained in paragraph 124 above, the OFT considers that the scale of the entry in this case would need to be substantial in order to offset the scale of the overlaps and the potential pressure on PQRS arising from the merger. The OFT notes that entry on a larger scale, similar to H&B and JG, would involve larger financial capital which may be beyond the reach of an individual entrant. Indeed, the OFT notes that JG's rapid expansion was only achievable through the financial backing of its parent, Baugur. In addition to the capital required to establish a large national chain of retail stores, there may also be considerable sunk costs (for example, advertising) in establishing a reputation for specialist retailing of health products and NSF to rival that of the parties.

129. In relation to entry at the local level, although barriers to entry are low, the OFT considers that it is highly unlikely that independent stand alone stores will enter the market in over 200 local areas. It is also not clear

[42] See www.cranberryuk.com. Cranberry also offers franchising to interested parties.

that a set of independent stores will pose the same competitive constraint on the parties, as they did on each other pre-merger, given the elimination of competition at a national level.

130. Finally, the OFT is not aware of any internal documents from the parties showing that they were concerned or have identified potential entry from other players (or for that matter expansion from existing suppliers).

131. In light of the above, the OFT is not persuaded that the timeliness of any entry would offset any consumer harm sufficiently quickly. Indeed, we note that the parties' own expansion has taken place over many years.

Constraints from expansion

132. In addition, the parties argued that barriers to switching are low, as evidenced by the degree of multi-sourcing by consumers between the parties and supermarkets, with the 2009 Survey showing that 50 per cent of customers had purchased NSF from supermarkets during the last six months. The parties contend the quality and range of the products are not distinctive and not superior to those stocked in supermarkets and that four out of the five big supermarkets already stock a more extensive range of NSF SKUs[43] than H&B in their range of stores. The parties conceded that the only potential barrier for supermarkets may be access to shelf space, however, they submitted that supermarkets offer extensive NSF ranges online (for example, Ocado and Tesco home delivery), where shelf space is not an issue.

133. The parties argued that supermarkets are able to impose a strong competitive constraint upon the parties, as they have access to a large amount of retail space and could expand their range of NSF to stock more variety simply by expanding shelf space in the event that the merged entity increased its prices.

134. In particular, the parties submitted that the Mintel Report shows that the major supermarkets account for over 70 per cent of the UK NSF market and have expanded their share of this market, with a 22 per cent growth in supermarket sales in the NSF category, between 2005 and 2007.

[43] Stock keeping units.

They also pointed out that, over this same period, H&B has suffered a decline in NSF sales of [ ] per cent.[44]

135. However, the OFT notes that the parties have not shown any direct causation between the increase in supermarket sales and the decrease in H&B sales. The OFT notes that during this period JG was undergoing aggressive expansion and that some (perhaps even a large portion) of H&B NSF lost sales could be attributed to the expansion of JG during this period. Indeed, the Mintel report shows an eight per cent increase at independents and health food and natural food stores overall.

136. In addition, the parties provided one example to demonstrate that supermarkets pose a competitive constraint upon them. In 2007, Tesco opened a large store in Galashiels, Scotland. JG's minutes for August 2007 record that the entry for the JG store at Galashiels showed a [ ] per cent decline in sales and notes:

> 'External Influences, Large Tesco store opened last year. Store hasn't done well this year.'

137. Although the OFT notes the entry of Tesco and decline in JG sales, we also note that the August 2007 minute records that there were staff performance issues within the Galashiels store, which may account for some of the decline in JG sales:

> 'The unacceptable performance has been followed through. The manager needs to demand more of her associates to act upon their lack of commitment.[ ]
> Objective Qtr 4
> 1. A/M to monitor manager and associates on every visit and raise awareness to customer service and conversation.
> 2. A/M need to work with the manager and coach the team ongoing. A.M and Manager to question the training commitment within the store.'

138. In light of the above, the OFT cannot be confident that the [ ] per cent decline of sales in JG Galashiels store is due solely to the entry of Tesco

[44] In addition, the parties stated that H&B sales of vegetarian products, herbals teas, green teas and Rooiboos had also declined, thereby demonstrating that the supermarkets are constraining the parties. Although the OFT acknowledges that the supermarkets' sales in these items have increased, the parties did not provide any evidence to demonstrate the direct causation between the increase in supermarket sales and corresponding decrease in H&B sales.

in the area. Moreover, even if it were, this does not necessarily imply that the Tesco store is an ongoing competitive constraint on JG's pricing. It is also not clear (and indeed it is highly unlikely) that Tesco's entry in this local area was in response to high prices by JG. As such, the OFT is not persuaded that the potential for local entry by supermarkets would constrain the competitive behaviour of the merged entity.

139. Finally, the parties argued that even if the parties were to raise prices above the competitive level, or otherwise worsen their QRS proposition post-merger, there is every reason to believe that the major supermarkets would be able to be in a position to respond immediately.

140. In general, the OFT considers that the scale of expansion in this case would need to be substantial and pervasive in order to offset the scale of the overlaps and the potential pressure on PQRS arising from the merger. Whilst the OFT acknowledges that supermarkets could easily expand their range of NSF products, they will only do so if such a range expansion provides a more profitable use of shelf space. In addition, due to limited shelf space, in order for a supermarket to expand their NSF range, they would need to pull another item from their shelves, leading to a contraction of a range in another product category. Even if supermarkets were to provide more shelf space, however, it is not clear that this would be sufficient to make them much closer competitors, given the variety of evidence showing the range of dimensions on which differentiation occurs and is important to customers.

141. The OFT further notes that supermarkets stated that they do not vary their retail offer in response to the parties. Furthermore, given that, as set out in paragraph 104 above, supermarkets do not, for the most part, price track the merging parties it is unlikely (as asserted by the parties in paragraph 139 above) that they would be aware of a 10 per cent price increase and respond to it. In addition, given a low own price elasticity, the total amount of diverted sales will be relatively small following a 10 per cent price increase (see paragraphs 77 to 87 above).

142. Given the above, while the OFT considers it a plausible argument, at least in theory, that the supermarkets would expand their range in order to constrain the parties post-merger, the OFT has not received sufficient evidence to conclude that such expansion would be sufficiently timely

and likely to offset any consumer harm that may arise as a result of the merger.

Constraints from buyer power

143. Given that the parties are retailers and that their customers are individual consumers, no significant countervailing buyer power can realistically be attributed to the demand side.

CONCLUSION ON UNILATERAL EFFECTS

144. The OFT considers that the weight of the above analysis indicates that the parties are each other's closest competitors, possibly even forming a distinct relevant market, and that there is insufficient evidence to indicate that other suppliers – and in particular supermarkets - are a sufficiently close alternative choice for consumers to constrain the competitive offer of the merged business going forward.

145. Further, the OFT considers that the scale of entry or expansion in this case would need to be substantial in order to offset the scale of the overlaps and the potential pressure on PQRS arising from the merger. In light of the above, the OFT is not persuaded that the timeliness of scale of any entry and/or expansion would offset any consumer harm sufficiently quickly.

146. Accordingly, the evidence obtained by the OFT during its inquiry does not therefore rebut the OFT's presumption of unilateral effects arising from the combination of high diversion ratios and high gross margins.

147. The OFT therefore considers that, when assessed against pre-merger market conditions, there is a realistic prospect of significant unilateral effects in some (perhaps many) local areas. More specifically, the OFT found that in 25 out of 40 overlap surveyed areas, the diversion ratio from JG to H&B was over 30 per cent and the post-merger upward price pressure in JG stores would be higher than 10 per cent. Accordingly, the OFT considers that the test for reference is met on the basis of unilateral effects in relation to, at a minimum, these 25 areas.[45] The test may also be met in relation to some of the other overlap and non-overlap surveyed

[45] The areas are listed in the Annex.

areas where the diversion ratio and upward price pressure is still significant. Furthermore, given that the parties surveyed only 40 out of 214 overlap areas, it is likely that the true extent of the potential unilateral effects is considerably higher, in which case the test for reference would be met in a further number of local areas.

148. These unilateral effects could take a number of forms including raising prices, lowering service standards, lowering the range or quality of goods offered, reducing investment levels or otherwise harming consumers in those local areas. The OFT also considers that unilateral effects concerns may also arise at the national level. However, given that the test for reference is met (against pre-merger conditions) at the local level, the OFT has not needed to come to a definitive view on the impact of the merger on competition at the national level.

COORDINATED EFFECTS

149. As reflected by the analysis above, the focus of the OFT's investigation was on the potential for the merger to have resulted in unilateral effects concerns. As a result, the OFT did not devote time and resource to considering the potential for coordinated effects concerns. Given that the test for reference is met in relation to unilateral effects concerns, it has not been necessary for the OFT to conclude on this alternative theory of harm.

VERTICAL ISSUES

150. Both parties have their own packaging facilities that are used for packaging of NSF products sold in the parties' stores. No other party has used the parties' facilities pre-merger. Given that the post-merger situation does not materially change from the pre-merger situation, the OFT does not consider that vertical concerns arise in this case.

COUNTERFACTUAL

151. Section 22 of the Act imposes a duty to refer upon the OFT if the OFT believes it is or may be the case that the completed acquisition by NBTY of JG has resulted or may be expected to result in a substantial

lessening of competition within any market or markets in the UK for goods or services.

152. In order to decide whether the duty to refer applies, the OFT considers the merger's impact relative to the situation expected to prevail absent the merger (that is, the counterfactual). Generally speaking, this will be the current (pre-merger) conditions of competition.

153. In this case, the parties have submitted that, absent the merger, JG would have failed and exited the market within a short period of time regardless of the transaction and that the failing firm defence criteria are met.[46]

154. In order to treat this as the appropriate counterfactual for the assessment of the merger, the OFT considers that sufficient compelling evidence is required, particularly as the postulated counterfactual involves the exit of one of the merging parties. In effect, the parties are arguing that, to the extent competitive harm may arise, the merger is not the cause of the harm as it would occur in any event. Where this type of absence of causation between the merger and the lessening of competition is argued, the OFT will as a matter of policy seek a high level of supporting evidence (within the parameters of its belief relevant to the reference test of the Act, which entails a comparison of the outcomes with and without the merger). This approach to evidentiary burden is appropriate given the asymmetry of information on such a key point: such claims are easily made but often difficult to verify independently, not least within the constraints of first-phase merger control. Accordingly, the following analysis is consistent with that adopted in previous OFT decisional practice under the Act.[47]

155. The OFT has recently published a 'Restatement of OFT's position regarding acquisitions of failing firms'.[48] This provides for three

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[46] See the OFT's treatment of evidence required to meet the conditions of its failing firm defence (Mergers Guidance – Substantive assessment guidance, paragraphs 4.36-39.

[47] To date, the OFT has applied the 'failing firm' defence four times under the Enterprise Act 2002: (i) *Anticipated acquisition by First West Yorkshire Limited of Black Prince Buses Limited* 26 May 2005; (ii) *Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry,Liverpool, Barrow-in-Furness and Nelson)* 11 December 2007; (iii) *Completed acquisition by the CdMG group of companies of Ferryways NV and Searoad Stevedores NV* 24 January 2008; and (iv) Homesbase/Focus.

[48] Published on 18 December 2008.

conditions that must be satisfied in order to benefit from the failing firm defence (summarised below):

- inevitability of market exit of the firm in question absent the merger
- with no serious prospect of re-organisation, and
- with no less anti-competitive alternative to the merger (that is no realistic acquisition by a less anti-competitive purchaser and no substantially better competitive outcome following failure of the firm in question).

156. The OFT has examined each of the criteria (set out below) and considers that the information and evidence provided by the parties does not satisfy the required evidentiary standard for the purpose of the failing firm defence.

JG's market exit absent the merger

157. The parties commissioned a report ('Failing Firm Report') from Duff & Phelps, a consultancy, which states that there were a number of factors which meant that JG's likely exit from the market was immediate, irrevocable and unconnected to its acquisition by NBTY.

158. In brief, according to the Failing Firm Report JG's declining profitability had led to significant operating losses for the year ending 31 March 2008 and the five months ended 31 August 2008. The weakened balance sheet resulted in negative equity in August 2008. This declining cash flow performance led to difficulties in servicing interest payments and projected a breach of the revolving credit facility in early October 2008. The parties submitted that, by summer 2008, 63 out of 80 of JG's suppliers had put JG on 'stop' signifying that they would cease supplying JG. Moreover, according to NBTY, KPMG were unwilling to sign an unqualified audit opinion for the year ended 31 March 2008 based on 'going concern' issues. In light of the above, combined with the fact that the UK retail market had significantly deteriorated, the Failing Firm Report envisaged that JG's cash short fall may have led to the business entering administration as early as October 2008.

159. A review of Julian Graves income statement by the OFT reveals that JG has maintained a consistent level of profitability in past financial periods. However, while equity has remained positive up to the end of the 2008 financial period, two main factors caused the value of the company to fall in 2007/2008: (1) JG was forced to write-down the value of the company by £1.4 million in 2007; and (2) JG accrued a large amount of new debt on its balance sheet. In relation to cash liquidity, it would appear from the accounts that if JG was unable to re-finance or negotiate with its creditors in order to meet its debts, then it may have been the case that the firm could have failed.

160. While the OFT acknowledges that the above indicates relatively poor performance in 2007/2008, the OFT is uncertain whether the firm would have failed as a result of it. The loss to the company in 2008 could have been made up in 2009 and the firm could have retained a positive value. The OFT considers that typically a firm would have to sustain several periods of losses and be in negative equity before it would be considered to be failing on the basis of balance sheet insolvency.

161. Accordingly, in light of the above, the OFT cannot be entirely confident that the business, as it was then, was in such a parlous position that without the merger it would have exited the market and this would have occurred in the near future. However, even if it were the case that JG, under existing management, would have ceased operation it is not decisive in the question as to whether the relevant assets of JG of competitive significance would have exited the market on a permanent basis. This question is considered in more detail below.

Could JG have been re-organised?

162. The parties submitted that there was no serious prospect of re-organising the JG business because raising the additional required capital was unlikely, plus there were issues with suppliers, stock outages, deteriorating margins and cancellation of key contracts. In addition, there were rent arrears, and a number of loss making stores were tied into long leases. Finally, the economic outlook for retail in the UK had deteriorated and the Failing Firm Report states that placing JG into administration would have been a better option for (the then parent) Baugur.

163. On the available evidence, the OFT accepts that the re-organisation of JG to improve its business would have required a substantial cash injection. However, the parties have not provided any internal documents to indicate that the company had considered the possibility of re-organisation. In light of the above, the OFT cannot be entirely certain that the business, as it was then, could not have been re-organised. However, even if it were the case that JG could not have been re-organised, the OFT must consider whether there were any less anti-competitive alternatives to the merger.

No less anti-competitive alternative to the merger

164. The OFT considers that even if exit from the market is inevitable, there may be other realistic buyers whose acquisition of the business would produce a better outcome for competition. Alternatively, it may also be better for competition that the firm fails and the remaining players compete for its customers and assets than that those customers and assets be transferred wholesale to a single purchaser.

165. On 3 June 2008, Baugur instructed Deloitte to dispose of JG.[49] The parties submitted that there were no other credible bidders for the JG business and that, as far as they were aware, they were the only bidders in the process.

166. In order to be satisfied that no other realistic purchaser existed, the OFT contacted Deloitte to ascertain that all possible options had been explored. Deloitte confirmed that there were in fact at least two other credible purchasers for JG. Both of these purchasers were private equity companies with the ability to raise the necessary funds to run the business. The private equity firms had made preliminary offers based on an information memorandum. Both private equity firms had then conducted due diligence and then confirmed their bids. Deloitte stated that all bidders were informed at the time that other bidders were in the process and that therefore there was a degree of competition for the JG business. The OFT understands that NBTY was ultimately successful because it offered the highest bid. [Endnote 1]

[49] Deloitte was mandated to market for sale either all of the issued capital, the business and assets, or the debt or the refinancing of the debt.

167. Accordingly, the OFT considers that there were in fact other interested bidders and that the sale of the JG business to a private equity firm, with no existing interests in health and natural food retailing, and in particular in relation to the supply of NSF, would have resulted in a substantially less anti-competitive alternative to the merger.

Conclusion on counterfactual

168. In light of the evidence provided above, the OFT has not felt it necessary to conclude on whether JG would have, absent the merger, exited the market, or on whether JG could have been re-organised. However, it is clear from the evidence that there was more than one substantially less anti-competitive alternative to the merger. Accordingly, the third limb of the failing firm defence is not met.

169. In these circumstances, the OFT considers it is appropriate to consider as the correct counterfactual in this case the pre-merger conditions of competition. Assessed against this counterfactual, the OFT believes 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 UK – that is, the supply of NSF in a number of local areas in the UK.

THIRD PARTY VIEWS

170. Third party comments have been discussed, where relevant, in the text above.

ASSESSMENT

171. The parties are the two largest high street specialist retailers of health natural food products in the UK, and they overlap specifically in the supply of NSF and VMS products.

172. The OFT considers that, as a result of the merger, there is a realistic prospect of a substantial lessening of competition arising in a large number of the local areas where the parties are both present in relation to the supply of NSF. In addition, it may be the case that there is also a realistic prospect of a substantial lessening of competition at the national level although the OFT has not needed to conclude on this point.

173. Despite the possibility that barriers to entry in the supply of NSF may be low in any given individual local market, the OFT was not convinced that other NSF retail outlets, including supermarkets, would be able to enter either nationally or in a sufficient number of local markets to constrain the parties post-merger. In addition, the OFT did not receive sufficient evidence to conclude that expansion by retailers, in particular supermarkets, would be sufficiently timely and likely to offset any consumer harm that may arise as a result of the merger.

174. Finally, the OFT considers that although JG may have been struggling financially prior to its acquisition by NBTY, it does not meet the OFT's criteria of a 'failing firm'. In particular, the OFT notes that there were at least two other credible bidders (private equity firms) for the JG business that would have created a substantially less anti-competitive outcome on the basis that they were not trade buyers, and therefore not close competitors to JG.

175. Therefore, assessed against the appropriate counterfactual of pre-merger conditions, the OFT believes 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 – that is, in relation to the supply of NSF in a number of local

areas in the UK.[50]

UNDERTAKINGS IN LIEU OF REFERENCE

176. NBTY made no offer of undertakings in lieu of reference to the Competition Commission.

DECISION

177. The OFT has therefore decided to refer the completed acquisition by NBTY of Julian Graves to the Competition Commission pursuant to section 22 of the Act.

ENDNOTES

1. Deloitte has informed the OFT that NBTY's bid for JG was unconditional.

[50] The OFT considers that the test for reference is met on the basis of unilateral effects in relation to, at least 25 areas. The test may also be met in relation other surveyed areas where the diversion ratio and upward price pressure is still significant. Furthermore, given that the parties surveyed only 40 out of 214 overlap areas, it is likely that the true extent of the potential unilateral effects is considerably higher, in which case the test for reference would be met in a further number of local areas.

ANNEXE

25 surveyed overlap areas with high diversion ratios and high illustrative price increases

No.	Local overlap area	Diversion ratio from JG to H&B	Illustrative price increases
1	Taunton	54.2%	32.3%
2	Staines	51.6%t	28.6%
3	Ormskirk	46.7%	24.3%
4	Derby	45.6%	21.6%
5	Falmouth	45.5%	22.1%
6	Fleet	43.8%	21.3%
7	Dorking	43.6%	18.6%
8	Birmingham	42.7%	17.3%
9	Hemel Hempstead	42.0%	19.2%
10	Bromsgrove	40.3%	17.3%
11	Bedford	40.0%	18.5%
12	Scarborough	36.5%	14.3%
13	Durham	36.1%	15.2%
14	Sutton	36.0%	15.7%
15	Newton Abbot	35.4%	14.8%
16	Huddersfield	33.3%	13.6%
17	Coventry	33.0%	12.7%
18	Chester	32.9%	13.7%
19	Harlow	32.8%	13.2%
20	Merry Hill (Dudley)	32.6%	13.3%
21	Bournemouth	32.6%	12.8%
22	Tonbridge	30.8%	11.8%
23	Southport	30.7%	12.1%
24	Maidenhead	30.5%	12.3%
25	Warminster	30.5%	11.3%