Anticipated acquisition by Co-operative Group Limited of Somerfield Limited

ME/3777/08

The OFT's decision on reference under section 33 given on 20 October 2008. Full text of decision published on 17 November 2008.

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.

THE PARTIES

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

2. At the time of making its submission to the OFT, CGL had 2,228 food retail stores comprising 1,717 convenience stores, 452 mid size stores and 59 one-stop stores.

3. **Somerfield Limited** (Somerfield) is a food retailer with (at the time of making its submission to the OFT) 877 outlets comprising 221 convenience stores, 616 mid size stores and 40 one-stop stores.

TRANSACTION

4. In July 2008 the parties entered into a sale and purchase agreement under which CGL will acquire the entire share capital of Somerfield's holding company, Violet Holdings Limited. Completion of the transaction is conditional on receiving OFT clearance.

JURISDICTION

5. As a result of this transaction CGL and Somerfield will cease to be distinct. The proposed merger does not have a Community dimension under the EC Merger Regulation[1] since both parties achieve more than two thirds of their Community turnover in the UK.

6. The UK turnover of Somerfield exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied.

7. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

MARKET DEFINITION

8. The parties overlap in the retail of groceries in the UK. This industry has been examined extensively in recent years by both the OFT and Competition Commission (CC).[2]

9. At the outset the OFT considers that it is worth noting that market definition is not an end in itself but simply a starting point for the competitive analysis. This is especially true in activities such as grocery retailing in which the different retailers are highly differentiated in their offerings across many factors such as price, store locations, the number of products on offer, the amount of choice within each product category, store facilities, shopping ambience, staff service levels, home delivery services and

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[1] Council Regulation (EC) No 139/2004.

[2] For OFT examples, see Anticipated acquisition by Tesco Stores Limited of a store in Paisley from Somerfield plc, OFT decision of 30 April 2008 ('**Tesco/Somerfield**'); Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson), OFT decision of 11 December 2007 ('**Tesco/Kwik Save**'); Anticipated merger between Co-operative Group Limited and United Co-operatives Limited, OFT decision of 23 July 2007 ('**CGL/United**'); Anticipated acquisition by Tesco plc of 45 outlets from Adminstore Ltd, OFT decision of 5 March 2004 ('**Tesco/Adminstore**').
For CC examples, see The supply of groceries in the UK market investigation (April 2008) ('**groceries report**'); Tesco plc and the Co-operative Group (CWS) Limited: a report on the acquisition of the Co-operative Group (CWS) Limited's store at Uxbridge Road, Slough by Tesco plc (November 2007) ('**Tesco/CWS**'); Somerfield plc and Wm Morrison Supermarkets plc: A report on the acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc (September 2005) ('**Somerfield/Morrison**'); and Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets plc; J Sainsbury plc; and Tesco plc: a report on the mergers in contemplation (September 2003) ('**Safeway report**').

branding. As such, there will be a continuum of constraints placed on each retailer in each individual location which may not be easily captured in a precise market definition.

Product scope

10. In past cases the CC and the OFT have considered that grocery retailing comprises three broad product markets:

- **One-stop stores**: those with a net sales area of 1,400 square metres or above.[3] These stores form their own product market.

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

- **Convenience stores**: those with a net sales area of less than 280 square metres. These stores are constrained by all grocery stores and so the product market focussed on convenience stores must also include mid size and one-stop stores.

11. The parties submitted that these distinctions should form the basis for the OFT's analysis in this case.

12. The OFT questioned other grocery retailers about the most appropriate product market definition and almost all agreed that the distinctions listed above were appropriate. Some retailers raised concerns about the precise sales area threshold between a mid size store and a one-stop store although they did acknowledge that some distinction between mid size and one-stop was necessary and recognised the difficulties involved in determining a precise threshold for the purpose of merger analysis.

[3] In its market investigation into groceries, the CC considered that the floor size threshold for larger grocery stores was larger than 1,000 to 2,000 square metres (paragraph 12) but used the threshold of 1,400 square metres for much of its analysis (paragraph 13). In Tesco/CWS the CC also used 1,400 square metres as the threshold.

13. An aspect of product market definition in previous grocery investigations has been which store fascia to include within the relevant product market. The parties accepted that the OFT and CC's previous approach to this issue provided a reasonable approach for this case. The OFT questioned other grocery retailers about this, and about the CC's findings that some grocery retail fascia fell outside the product market if that product market is taken from the perspective of the large grocery retailers (Asda, CGL, Marks & Spencer, Morrison, Sainsbury's, Somerfield, Tesco and Waitrose).[4] Those included in the effective competitor store fascia, besides the large grocery retailers, are regional grocers and symbol groups, but not limited assortment discounters (LADs), frozen food retailers and specialist retailers.[5] The full list of those included in the effective competitor set is in annex A.

14. Not all third parties agreed with this approach with some arguing that the 'effective competitor' set should be widened whilst others argued that it should be narrowed (with respect to Marks & Spencer, for example).

15. One of the key reasons that the CC did not consider the LADs to be in the same product market as large retailers was that they typically sell fewer than 1,000 products (or SKUs – stock-keeping units), compared with around 5,000 to 10,000 SKUs sold by large grocery retailers in stores of a similar size.

16. The parties argued that a rival does not need to stock an equivalent number of products in order to compete effectively. To support this, they gave the OFT evidence showing that Somerfield's best selling 1,000 SKUs account for a little over [ ] per cent of its sales while its top 1,500 SKUs account for a little over [ ] per cent of its sales. Similarly, for CGL its top 1,000 SKUs account for around [ ] per cent of its sales while a little under [ ] per cent of sales is accounted for by its top 2,000 SKUs. On this basis, the parties argued that a LAD selling around 1,000 SKUs should be considered as a competitive constraint on a large retailer.

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[4] Paragraph 3.3 of the groceries report.
[5] Paragraph 14 of the groceries report.

17. Some third parties provided evidence to the OFT arguing that the LADs and frozen food specialists should be included in its product market definition. This evidence included that:

- some or all of the LADs can satisfy consumer demand in every product category (even if the overall number of products stocked is less than that stocked in a supermarket operated by one of the largest six supermarket operators)

- some frozen food specialists, particularly Iceland, stocks a comparable number of products to Somerfield

- in selected areas, Iceland's sales increased considerably as a result of a Somerfield store closure in the local area

- some major supermarkets react to price changes by the LADs

- some major supermarkets have included direct comparisons to the LADs in their advertising

- a greater proportion of Somerfield shoppers also shopped at Iceland relative to the population as a whole,[6] and

- the LADs and frozen food specialists have been winning market share from the largest six supermarket operators.

18. However, given that the product market definition is only a starting point and, in this case, has predominantly been used to shape the stage one filtering exercise (detailed in annex A), the OFT, in adopting a cautious approach, has used the product market definition used by the OFT and CC in recent reports. That is, there are three distinct product markets distinguished by size of the sales area (as set out in paragraph 10 above) and these product markets are fascia specific (as set out in paragraph 13 above).

[6] Based on TNS Worldpanel data for the eight weeks to 27 January 2008.

19. Despite this cautious approach to market definition, other evidence, such as survey results and diversion ratios, are used later in this decision for the purposes of competitive assessment and take account of the degree of competitive constraint from other competitors such as the LADs and frozen food specialists. Therefore, in some local areas these retailers will be considered as providing effective competition to CGL and/or Somerfield given the level of the diversion ratio between the LADs and the parties in those specific areas.

Geographic scope

20. Previous CC and OFT reports into supermarkets have found that there are both national and local aspects to competition.[7] The parties did not disagree with this and proposed that, for the local dimension of competition, the appropriate measures were:

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

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

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

21. In Somerfield/Morrison the CC considered that the geographic market for one-stop stores was a 10-minute drive time for urban areas and a 15-minute drive time for rural areas. For mid-size stores the geographic market was a five-minute drive time for urban locations and a 10-minute drive time for rural locations.

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[7] For example, CGL/United (paragraphs 103 and 104); Tesco/Adminstore (paragraph 11); Safeway report (paragraph 2.65).

Finally, for convenience stores, the CC found that the geographic market was a catchment area of up to one mile.[8]

22. Similarly, in its groceries report the CC found that the geographic market for one-stop stores was 10 to 15 minutes' drive time and for mid size stores it was five to 10 minutes with respect to other mid size stores but, in a development since Somerfield/Morrison, the CC found that these stores are also constrained by one-stop stores within 10- to 15-minute drive time.[9] For convenience stores, however, the CC used both a five-minute drive time and half a mile radius, and also found that these stores are constrained by one-stop stores and mid-size stores in the catchments described above.[10]

23. The OFT considered it reasonable for the parties to present the data on the basis of a five-minute drive time for convenience stores, and to use that measure as the predominant measure for the stage one filtering exercise. But the OFT insisted that the parties also provided a sensitivity check by analysing the convenience stores that failed the filtering exercise on the five-minute drive time measure on a one mile radius measure; a radius consistent with that used by the CC in Somerfield/Morrison.[11]

24. The OFT tested this approach to the geographic scope with third parties. All said that they agreed with it.

25. Consequently the OFT has adopted the approach set out in paragraph 20 above as the geographic market for its local area analysis, which is consistent with the CC's groceries report (and has evolved since the CC's Somerfield/Morrison report). For the national dimension of competition the OFT has used the whole of the UK as there is no evidence to suggest that a narrower definition would be more appropriate.

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[8] Paragraphs 6.51 and 6.66 of Somerfield/Morrison.
[9] Paragraph 4.145 of the groceries report. Paragraphs 3.51–3.54 of the groceries report suggest that the drive time ranges the CC gave in its geographic market definitions reflect differences between urban and rural locations.
[10] Paragraphs 15(c) and 4.145(c) of the groceries report.
[11] Paragraphs 6.54(c) and 6.66 of Somerfield/Morrison.

HORIZONTAL ISSUES

NATIONAL COMPETITION

Unilateral effects

26. The OFT has investigated whether there is a realistic prospect that the proposed merger would lead to a substantial lessening of competition at the national level.

27. When considering the merger effect at the national level it is appropriate to consider the merged entity's share of supply across all store sizes combined since national competition does not take place according to the size of an operator's retail stores. On this measure, after the merger CGL will account for less than eight per cent of total UK groceries sales. It would face strong competition from other larger retailers in this product market, including Tesco (around 25–30 per cent), Asda (10-15 per cent), Sainsbury's (10-15 per cent) and Morrison (around 10 per cent). After the merger, at least based on share of supply data, it is reasonable to consider that CGL will in effect become a stronger fifth rival to the UK's four largest supermarket operators.

28. In light of CGL's limited estimated market share of all UK groceries (post-merger), and the presence of four larger supermarket operators, the OFT does not consider that unilateral effects competition concerns at the national level arise as a result of this merger.

Issues with the supply chain

29. During the course of its investigation the OFT also examined whether the proposed merger can be expected to create or strengthen buyer power to such an extent that it distorts grocery suppliers' incentives to invest in new capacity, products and production processes.

30. The CC examined this issue in its groceries report and found that the supermarkets code of practice has beneficially constrained the

exercise of excessive buyer power of the four largest supermarket operators to some extent. However, it also expressed some concern about the impact on suppliers' investment and ability to innovate as a result of some current practices by the four largest supermarkets.

31. The proposed merger will increase significantly the scale of CGL's purchasing requirements, and may serve to increase the degree of buyer power held by CGL (or of Co-operative Retail Trading Group (CRTG), the buying group of which CGL is the principal member and administrator – see further below). However, in terms of overall scale the merged entity will only be the UK's fifth largest grocery chain. The parties submitted that, even if all purchases made in the context of CRTG were considered together, its post-merger share of purchases of groceries for resale would still be less than 10 per cent.[12]

32. Most suppliers were not concerned about the proposed merger. However, one supplier told the OFT that it was concerned that the proposed merger would result in a downward pressure on its supply prices.

33. In light of the still relatively modest scale of CGL's purchasing requirements and the fact that it will be only the fifth largest supermarket operator, the OFT does not consider that the proposed merger will adversely affect grocery suppliers to the detriment of UK consumers.

Coordinated effects

34. The OFT considered whether there is a realistic prospect that the proposed merger would lead to a substantial lessening of competition at the national level by creating or strengthening some form of coordinated effects operating between the national grocery groups.

35. The CC (in its groceries report) considered that sustaining coordinated conduct over thousands of differentiated products, or

[12] Pursuant to the conclusions reached in the groceries report, the CC is currently proposing that all supermarkets with a turnover of at least £1 billion (which would capture the merged entity) should undertake to follow a new supermarkets code of practice. This merger would increase the number of supermarkets bound by the code of practice.

choosing a smaller group of products on which to coordinate, would be sufficiently complex to prevent the emergence of tacit coordination.[13]

36. In addition to the difficulties of finding a focal point on which to coordinate, after the merger the merged entity would have a national share of supply of about seven to eight per cent – a little less than Morrison currently accounts for, and still some way behind Sainsbury's, Asda and Tesco in particular. As such, the parties argue that the proposed merger will not represent a significant change to the present market structure. Notwithstanding this, given that any meaningful coordination at the national level would require the participation of the leading supermarket groups, the merger is dilutive rather than concentrative – in other words, it results in an increase in the number of large supermarket operators from four to five players – and hence the OFT considers that it is presumptively likely to reduce the prospects for coordination amongst the leading supermarket groups rather than increase them.

37. In addition, the OFT has not received any evidence to suggest that the proposed merger will eliminate a disruptive party to existing coordinated behaviour.

38. After the merger there will still be considerable differences in incentives between the merged entity and the four 'big four' leading supermarket operators.[14] This, as the parties submitted, is because of substantial differences in the merged entity's:

- market share at the national level – as already mentioned above, it will be lower than that of the four leading operators, in particular quite some way below that of Tesco, Sainsbury's and Asda

- make-up of its estate of supermarkets – it will largely be an operator of mid size and convenience stores while the four leading supermarket operators' estates are weighted more

[13] Paragraph 8.40 of the groceries report.
[14] Asda, Morrison, Sainsbury's and Tesco.

heavily in favour of one-stop stores.[15] Given the asymmetric nature of the market (see paragraph 20 above), the parties argue that CGL's convenience and mid size stores will not constrain the one stop stores operated by the big four players, but will be constrained by them, and

- average cost and price levels – this was confirmed by the CC in the groceries report, where the CC found that: 'other large grocery retailers [that is, those outside the big four] and large wholesalers pay higher prices than the four largest grocery retailers but pay similar prices as each other.'[16] CGL's pricing levels are typically higher than those of larger rivals (for example, approximately [ ] than Tesco). The OFT considers that significant differences can be expected to remain post-merger notwithstanding any improvements to the costs base that are achieved from the merged entity's increased purchasing requirements.

39. In addition, the parties argue that the merger will not increase the likelihood of coordination through improving the ability of firms within the market to monitor each other, and also will not increase price transparency. They argue that CGL is already relatively difficult to monitor due to its approach of setting prices on the basis of several national price bands rather than a single national price.

40. The OFT also considered whether, at the national level, coordination may take place on the basis of one retailer (A) coordinating its behaviour (for example, in relation to agreeing retail prices), with another retailer (C) facilitated by information obtained from, and shared with, a common supplier (B), (of the type the OFT is currently investigating in its dairy retail price initiatives investigation[17]).

41. In response to these concerns, the parties submitted that the merged entity would have no additional incentives to engage in this form of coordination. They argue that any such coordination

[15] For example, see table 3.1 (page 33) of the CC's groceries report.
[16] Paragraph 7.22 of the CC's groceries report.

would not be possible unless it involved the 'big four' supermarkets because of their holdings of one-stop supermarkets which constrain all other supermarkets, and cited the significant differences in incentives between the merged entity and these other operators (such as different market shares, make-up of estates, and cost bases – as already discussed above) and the fact that the proposed merger would make very little difference to overall market structure at the national level.

42. The parties also argue that to the extent this type of coordination may be driven by suppliers, their incentives will not be materially affected by the proposed merger – there will merely be one fewer retailer with whom to coordinate. Alternatively, to the extent that such coordination may be driven by retailers, there will be no greater incentive on the post-merger CGL independently to agree higher retail prices than there is currently, and further, the price bands adopted by CGL make any such coordination even more difficult, as a range of prices would have to be set, making coordination more difficult to monitor and effectively implement for CGL. Finally, the parties argue that even if coordination is imposed on branded products, this is likely to be self-defeating in the presence of strong own brands (a sizeable proportion of CGL's sales are made up of own brand products), which would not be part of any coordination and therefore take share away from the branded products.

43. The OFT considers that the parties' arguments on why CGL's incentives to engage in some form of national coordination (of either type discussed above) are not changed by the proposed merger are plausible. Overall, the OFT does not consider that the proposed merger gives rise to concerns about either tacit coordination in general or coordination of the 'A to C via B' type discussed above.

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[17] See OFT press release: www.oft.gov.uk/news/press/2007/170-07.

LOCAL AREA COMPETITION

Introduction

44. The OFT, in this case, examined two theories of harm that might affect consumers at the local level. The first of these is that, as a result of this proposed merger, CGL and/or Somerfield may be able to raise prices, lower service standards, lower the range or quality of goods offered, reduce investment levels or otherwise harm consumers in those local areas in which Somerfield and CGL are currently competing. This is a standard unilateral effects theory of harm.

45. CGL argued that one of the bases for a unilateral affects theory of harm at a local level – ability to raise price – was of reduced relevance in this case given CGL's pricing policies. CGL submitted that it allocates each of its stores to one of [ ] pricing bands; although it considers a range of factors in allocating a store to a pricing band, predominant among these is the store format (which is strongly correlated to the store size).[18] As such, local pricing is not based on local competition. The OFT has considered this pricing policy but does not consider it rules out any form of unilateral effects concern for two reasons. First, CGL accepted that local conditions may be taken into account to some extent in determining price and the OFT has not, in any event, seen conclusive evidence that there is no prospect of local price flexing in any form. Second, pricing is only one of a number of ways in which competitive harm might occur, such as a deterioration of non-price factors such as quality, range and service. As such, the OFT has examined whether the merger creates unilateral effects at a local level.

46. The second theory of harm focuses on whether there is a loss of competition arising from local overlaps between Somerfield and other members of the buying group, CRTG, in which CGL participates (who are all regional co-operatives). This theory of harm, which is not based directly on a local overlap between the

[18] Data submitted by CGL show that [ ].

two merging parties, is discussed in the section ‘regional co-operatives’ below.

47. In order to determine the prevalence of local area competition concerns (as a result of either of the two theories of harm outlined above) the parties undertook detailed local analysis. The methodology applied for this analysis, which is detailed at annex A, closely follows previous work undertaken by the CC in the groceries sector, in particular the recent groceries report and the Somerfield/Morrison report.

48. In the context of this local analysis work, it is important to understand the role of the initial filtering exercise undertaken, which is to reduce the number of local areas for investigation to a manageable number. The stage one filtering rules are therefore deliberately conservative, making it likely that the actual number of local areas ultimately posing competition concerns is lower than the number of local areas that fail the initial filtering tests, once the usual aspects of competition (such as ease of entry, ease of customer switching, countervailing buyer power and – most importantly - closeness of competition between the merging parties as measured by diversion ratios) have been examined.[19]

49. In addition to local area mapping and fascia and store size identification, customer surveys were an integral part of the filtering exercises in order to calculate diversion ratios between the parties’ stores. Surveys were undertaken by the parties at over 400 stores throughout the UK and over 35,000 customers were surveyed.

50. The results of the stage one filtering and stage two competition assessment analysis are detailed below, starting with the unilateral effects theory of harm at the local level.

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[19] In its Safeway report (paragraph 2.204), the CC made the same point when it said 'In constructing our isochrone analysis, our objective at the outset was to identify all local areas where, as the result of each of the mergers, choice and competition would be to any great extent reduced. We wished, in other words, to eliminate any clearly unproblematic areas from our consideration. The subsequent question of what reduction in the number of fascias in an area might be considered as being against the public interest following each of the proposed mergers was then a matter of judgement, to be decided taking all relevant considerations into account'.

Unilateral effects

51. To examine unilateral effects at the local level, the OFT undertook a two stage approach. Stage one, as mentioned above, involved a desktop filtering exercise centred on the Somerfield store which identified 582 Somerfield stores which do not overlap (either within the maximum reach isochrone or within the primary isochrone) with a CGL store (of the relevant size) (the 'Somerfield-centred' analysis).[20] The desktop filtering also identified a further 156 Somerfield stores which did overlap with at least one CGL store in the relevant geographic market but where sufficient other competitors (three or more) were also present in the relevant geographic area to satisfy the OFT that these overlaps did not warrant further analysis. This exercise left 139 Somerfield stores that required further investigation because the overlap resulted in only two (or fewer) other competitors present in the relevant geographic area; in other words, in these areas, the merger resulted in a reduction in fascia from four to three, or worse.

52. In addition to identifying these areas, the OFT asked the parties to undertake the analysis centred on certain of the CGL stores (the 'CGL-centred' analysis). This is because in some local areas, overlaps may arise from the presence of a one-stop Somerfield store and a mid size CGL store, which would not have been picked up by the Somerfield-centred analysis – the Somerfield one-stop store would have been deemed to be unconstrained by the CGL store on the basis that it is in a lower size band, and therefore excluded from the analysis. However, from the point of view of those who shop at the CGL store, the CGL store may be constrained by the Somerfield store and this possible (one-way or 'asymmetric') constraint will be lost after the merger.

53. The filtering centred on the CGL stores identified 153 CGL stores which overlap with larger Somerfield stores. Eight local areas (comprising eight CGL stores which overlap with seven Somerfield stores) failed the stage one filtering exercise which had not already failed the stage one filtering on account of a previously identified overlap on the Somerfield-centred analysis.

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[20] See annex A for a description of the isochrones used.

54. Stage two of the local unilateral effects analysis involved a competition assessment of the localities comprising the remaining 146 stores.[21] This assessment involved:

- the parties' carrying out a customer survey at the Somerfield and CGL stores and calculating diversion ratios and illustrative price rises[22] as a result (also see annex A), and

- examination of particular circumstances in certain local areas, that is, openings and closures of stores, expiry of leases and availability of suitable sites in some local areas.

55. The customer surveys took place at 115 Somerfield stores and 120 CGL stores. The parties did not undertake surveys at 37 of the Somerfield stores that failed the stage one filtering exercise since it was apparent that these local areas would be unlikely to pass any of the stage two tests and therefore the OFT would be likely to find a realistic prospect of a substantial lessening of competition in those areas.

56. The parties, using the diversion ratio (14.3 per cent) and illustrative price rise (five per cent) thresholds from the Somerfield/Morrison report[23] identified local areas centred around 58 overlapping Somerfield stores which did not pass the stage two tests.[24] Also, as discussed in paragraph 53, the CGL-centred analysis identified eight CGL-centred potentially problematic areas overlapping with seven Somerfield stores. Stage two analysis of

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[21] 139 Somerfield stores plus the additional seven which overlap with the eight CGL stores.
[22] The illustrative price rise is a measure which the CC used in Somerfield/Morrison. It incorporates the diversion ratio from a store (which provides some indication of whether a store has the ability to raise its prices) and the profit margin of a store (which provides some indication of whether a store has the incentive to raise its prices). Therefore, the illustrative price increase is probative of unilateral effects theory of harm. It does not, however, predict post merger prices nor does it suggest that the OFT is willing to tolerate post merger price increases of up to five per cent. For further information see the OFT's decision of 8 May 2008, Anticipated acquisition of the online DVD rental subscription business of Amazon Inc by LOVEFiLM International Limited.
[23] The OFT previously used these thresholds in its CGL/United decision.
[24] The parties provided sensitivity checks by undertaking the diversion ratio analysis both on revenue and the number of customers, and by calculating illustrative price rises using linear demand curves and isoelastic demand curves. The OFT used the results based on revenue

these areas showed fails in local areas containing three Somerfield stores. When combined with the 37 stores which were not surveyed, these stores make 98[25] local areas in all which were identified as raising competition concerns after the completion of the stage two analysis.

57. The OFT received no evidence during the course of its investigation to warrant moving away from the diversion ratios and illustrative price rise thresholds adopted by the CC in its Somerfield/Morrison report, and accepted as relevant by the parties in this case. See annex A for further details on the methodology, and in particular the diversion ratio and illustrative price rise thresholds used by the OFT in this case.

Additional evidence on specific local areas

58. This section considers further evidence submitted by the parties for the purpose of arguing that unilateral competition concerns would not arise as a result of the proposed merger in certain of the 98 specific localities that failed the stage two filtering analysis discussed above. This evidence can be categorised as: (i) low barriers to entry for convenience store operators; (ii) imminent entry from rivals; (iii) expiry of leases; (iv) imminent closure within the CGL estate; and (v) recent changes to store formats. Each of these are discussed in turn.

(i) Convenience stores

59. of the 98 local areas that failed the stage two filtering analysis, three were centred around Somerfield convenience stores (and overlap with four CGL stores, three of which are themselves convenience stores). They are located at Banchory, Keynsham and Nairn.

60. Past cases undertaken by both the OFT and CC have shown that generally barriers to entry into the operation of convenience stores

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diversion ratios and isoelastic demand. The CC in Somerfield/Morrison used the same approach. See annex A for further details.

[25] 58 + 3 +37.

have not been high such that new entry would be likely to defeat any attempt by a convenience store to raise prices.[26]

61. The evidence received by the OFT did not indicate that barriers to entry or expansion were significantly higher in the relevant areas in this case than would normally be expected based on the general findings in recent reports.

62. Therefore, the OFT has not found a realistic prospect of a substantial lessening of competition with respect to these three local areas (thus making the number of local areas raising competition concerns 95).

(ii) Imminent entry

63. The OFT will take account of evidence of new entry when coming to a decision on the prospect of a merger resulting in a substantial lessening of competition.[27]

64. Of the stores that failed the stage two filtering exercise, the parties submitted some evidence on forthcoming new entry by third party competitors in relation to 13 stores, but concentrating in particular on why the merger would not give rise to a realistic prospect of a substantial lessening of competition given the prospect of new entry in four areas.

65. The four areas to which the parties drew the OFT's attention in particular, all of which failed both the stage one and stage two filtering exercises were: [ ].

66. In [ ] and [ ], the parties submitted that Tesco has received planning approval to build one-stop stores in the areas. However, the parties also submitted that building work has not yet started in either area, and the OFT did not receive evidence as to the likely start date for the building work. Therefore, the OFT does not

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[26] The one exception to this relates to convenience retailing in Filey (a rural town of around 7,000 people in Yorkshire) where the CC was not confident that entry would resolve the competition issues that it had identified (paragraph 7.48 of Somerfield/Morrison).
[27] This may be considered as part of the correct counterfactual. See paragraphs 3.23 and 3.24 of the OFT's guidance – Mergers: substantive assessment guidance, OFT516, May 2003.

consider that entry in these local areas is sufficiently timely or likely such that it should adjust its counterfactual.

67. In the [ ] area, a Tesco one-stop store is currently under construction. However, the parties were not sure when the store was due to open and therefore the OFT cannot be confident that entry in this local area would be sufficiently timely such that it should adjust its counterfactual. The OFT notes that, even if the Tesco entry were timely, the stage two survey results showed that CGL and Somerfield are close competitors (the diversion from CGL to Somerfield was [ ] per cent and from Somerfield to CGL it was [ ] per cent) and so the OFT cannot be sure that the entry of Tesco would induce enough shoppers away from these stores in sufficient numbers such that the OFT's concerns would fall away. In light of the above, the OFT has therefore not adjusted its counterfactual to take into account entry into the local area in [ ].

68. In [ ]**,** the parties submitted that Tesco has recently opened (in September 2008) a one-stop store on [ ] that will compete with the parties' existing stores in the local area.

69. The OFT notes that the customer surveys revealed that the diversion ratio from CGL's [ ] store to the Somerfield store was around [ ] per cent. The survey was undertaken before the Tesco store opened and it would be reasonable to assume that the new Tesco store would attract many CGL customers as their next best choice, especially as the two stores are located close to each other. However, the OFT cannot be sure that the opening of Tesco store would eliminate all realistic competition concerns in this area by substantially changing customers' choices such that **sufficient** numbers of CGL shoppers at [ ] no longer consider the Somerfield store as their next best alternative.

70. Given the uncertainty surrounding the impact the Tesco opening will have in the area, the OFT has decided to take a cautious approach and therefore – even given that the counterfactual now includes Tesco's new entry into the local area in [ ] – it does not follow that there is no realistic prospect of a substantial lessening of competition occurring in this area.

(iii) Expiry of Somerfield leases

71. The parties submitted that, within the stores that failed the stage two filtering exercise, there are two Somerfield stores that are leased where lease expiry meant Somerfield should not be considered as an ongoing competitor (located at [ ]). Both are mid size stores. In these instances the parties are effectively arguing that Somerfield is an 'exiting' firm such that the counterfactual should not in fact be pre-merger conditions of competition. In line with its decisional practice to date (see in particular Tesco/Kwik Save), the OFT will accept such arguments only where there is compelling evidence that exit would inevitably occur (such that there is no realistic prospect of the store remaining in the market).

72. [ ]. In this local area the merger results in a reduction in fascia from two to one and the parties decided not to survey the store's customers.

73. The parties submitted that the lease expired on the property in [ ], and that they expect the site from which Somerfield has been operating to be subject to a compulsory purchase order following possible redevelopment of the district. Somerfield's grocery activities will be [ ].

74. However, the OFT cannot be sure that the parties' expectations will be realised, especially in a timely manner (within one or two years). Moreover, the fact that Somerfield has continued to trade from the site (despite the lease expiring [ ]) throws further doubt on whether it is correct for the OFT to adjust its counterfactual in this instance. The OFT does not consider that the evidence before it is strong enough for it to move away from pre-merger conditions as the most appropriate counterfactual and therefore it will not exclude the local area centred on [ ] from the list of areas in which it believes the test for reference is met.

75. [ ]. Although results based on Somerfield's [ ] store did pass the stage two filter, when analysed from the perspective of CGL's overlapping store at [ ] the local area failed the stage two filtering exercise (the diversion ratio from the CGL store to the Somerfield store was around [ ] per cent). The lease in [ ].

76. The OFT considers that there is not compelling evidence that Somerfield would have exited the [ ] locality in the near future. The OFT cannot be sure that [ ]. As with the case in [ ], the OFT does not consider that the evidence before it is strong enough for it to move away from the counterfactual being the pre-merger situation and therefore it will not exclude the local area centred on [ ] from the list of areas in which it believes the test for reference is met.

(iv) Imminent CGL store closures

77. The parties also provided information on recent and imminent CGL store closures at Bishopsworth, [ ]. In these areas, the OFT has examined whether the closure of the CGL store – assuming it were shown to be independent of the merger – would be such that the local area would not fail the stage one and stage two filter tests.

78. The OFT notes that the Somerfield store at Bristol (Knowle) – which overlaps with the CGL Bishopsworth store – already passes the stage two filtering tests and therefore the Bishopsworth closure makes no difference to the outcome of the OFT's analysis.

79. Likewise, although for different reasons, the closure of only one of CGL's four stores in [ ] is not sufficient for that local area (centred on [ ] – the Somerfield store with which it overlaps) to pass either of the filtering tests. Therefore, this store closure does not affect the outcome of the OFT's analysis.

80. [ ] CGL's stores at [ ] and [ ] overlap with Somerfield's mid size store at [ ]. The [ ] store closed in August 2008 which means that the area centred on Somerfield's [ ] store no longer fails the primary isochrone filter. The parties submitted that the [ ] store closed on 12 October 2008. However, the [ ] local area would still fail both stage one (on census output area re-centring) and stage two tests since two other CGL mid size stores remain in the area (and the diversion ratio from CGL's mid size store at [ ] to the [ ] Somerfield store was measured to be [ ] per cent). Therefore, the

OFT has not removed the [ ] local area from its list of areas in which it believes the reference test has been met.

81. [ ] Somerfield's mid size store at [ ] overlaps with CGL's mid size store at [ ] which the parties submitted will close in November 2008. However, CGL will retain its mid size store at [ ] (also in the primary isochrone). The parties submitted that the closure of the [ ] store would allow the local area centred on [ ] to pass the filtering exercises since less than 10 per cent of the population would face a reduction in choice of fascia as a result of the merger on the census output area re-centring (the only filtering test that the area fails) which would therefore mean that it would have passed that filtering test.

82. After careful consideration of this area, and in the absence of sufficient compelling evidence, the OFT is not sufficiently confident that the expected closure of the [ ] store can be considered independent of the proposed merger. The OFT was not provided with clear and unambiguous evidence that CGL's decision to exit at [ ] was causally unrelated to the proposed merger. Therefore, the OFT still considers that the local area centred around [ ] raises competition concerns.

(v) Store format changes

83. During the course of the investigation the parties submitted evidence that two of CGL's stores (at Stanford le Hope and [ ]) had changed format; both migrating from mid size store status to being convenience stores.

84. If the stage one filtering exercise had been re-run using the changed formats for these two stores, both local areas would have passed the filtering at that stage. On that basis, these stores would not have been included within the set of stores on which the stage two analysis (including customer surveys) was carried out.

85. However, despite this, the OFT is conscious that stage one filtering methods, however sophisticated, are still relatively blunt instruments to use in order to gauge the competitive effects of a

merger. Customer survey results used in stage two provide better information on which to base a decision and, given that survey results are available in those local areas, the OFT cannot ignore that evidence. Importantly, the parties told the OFT that both stores had already changed format at the time of the customer survey.

86. In [ ], the measured diversion ratio from the Somerfield mid size store to CGL was [ ] per cent and from CGL to Somerfield it was more than double that at [ ] per cent. As such, the OFT cannot be sufficiently confident that, over time, the store format would change customers' preferences to such a degree as to eliminate competition concerns in this local area. Therefore, the OFT has not removed the [ ] local area from its list of areas in which it believes the reference test has been met.

87. Like [ ], the Stanford le Hope local area involves a Somerfield mid size store (at Corringham) overlapping with a CGL convenience store. The measured diversion ratios were [ ] per cent (Somerfield to CGL) and [ ] per cent (CGL to Somerfield), which are considerably lower than the diversion ratios measured in Whitstable. Moreover, there are considerable differences in the sizes of the Somerfield and CGL stores.[28] Given the CGL store had only recently changed format at the time of the survey from which the measured diversion ratio was only marginally above the 14.3 per cent threshold adopted in this case, it is reasonable to conclude that the degree of diversion may be lessened over time as shoppers get accustomed to the new store format. The OFT has not found a realistic prospect of a substantial lessening of competition in this local area. As such, the number of local areas raising competition concerns is reduced to 94.

[28] The Somerfield store is around 1,300 square metres which makes it just under the threshold for a one-stop store used in this case.

Competition concerns arising from Somerfield/regional co-operative overlaps

Introduction

88. During the course of its investigation of the proposed merger, the OFT received a number of concerns from customers relating to local areas where current grocery competition is primarily between Somerfield and one of the regional co-operatives that are members of the CRTG buying group.

89. Some consumers expressed concern to the OFT that after the merger they will face a 'Co-op monopoly' (on the basis that they do not in practice distinguish between CGL and regional co-operatives as distinct fascias). From a customer perspective, this is not surprising given that the stores themselves can look very similar;[29] however visual similarity between two fascia is clearly not a sufficient basis for the OFT to conclude that they do not compete.

90. The OFT investigated whether there was any prospect of the test for reference being met through the replacement (as a result of the merger) of a Somerfield store (competing fully pre-merger against a local regional co-operative) with a CGL store (which might be thought to compete with the local regional co-operative to a lesser extent than the Somerfield did given the links between CGL and the regional co-operatives). The extent to which this theory of harm could give rise to the realistic prospect of a substantial lessening of competition depends on:

- the relationship between CGL and the regional co-operatives, and
- the extent to which there remains sufficient existing competition from third parties in the relevant local area.

[29] The OFT notes that [ ].

91. It is worth noting at the outset that the OFT has previously found that there was a realistic prospect of a substantial lessening of competition arising in local areas when CGL acquired a regional co-operative (see CGL/United). In that case, the OFT stated that:

> 'In this case, other grocery retailers explained that they tend not to distinguish between stores operated by different co-operative societies in their analysis of competitors. Both parties' decisions on product ranges are made in consultation with CRTG, and the 'Co-op' own-brand products available in both parties' stores are identical. National promotional activity is co-ordinated by CRTG, which negotiates the terms with relevant suppliers. However, the parties at no point sought to argue that their stores should not be treated as competing local propositions in the merger assessment. Indeed, there would appear to be scope for the PQRS offering to vary between the parties' local overlap stores. Each party is free to determine the amount of shelf space allocated to different product categories, and price-setting decisions are taken independently. Local managers have some ability to propose local pricing, promotional or product range initiatives, subject to sign-off from their society management. There is also clearly scope for local quality and service aspects of competition to vary between stores, and for consumers to respond to such variation through switching behaviour' (paragraphs 110-111).

92. It does not follow from the CGL/United decision that there is no prospect of a substantial lessening of competition arising in this case. First, as a conceptual matter, the asymmetry of the reference test ('is or may be the case that … the creation of that situation may be expected to result in a substantial lessening of competition …' (section 33 of the Act)) means that the OFT may legally find the test for reference could be met in both CGL/United and in the present case. Such an outcome could arise where the relationship between CGL and the regional co-operatives is not one of full competition, but neither is it one of zero competition. In that situation, the OFT is required under the Act to take a cautious approach in both cases. Second, it is clear from the paragraphs in CGL/United cited above that the OFT had some reservations as to whether CGL and the United regional co-operative should be treated as fully independently competing fascia. However, because this point was not argued by the parties in that

case, and because of the cautious approach required by the Act, the analysis proceeded on the basis that they were independent fascia.

93. In this case, the parties have sought to argue that CGL and the regional co-operatives are competing fascia, and hence the OFT has considered the relationship between them in some detail, whilst being conscious of its findings in CGL/United.

Relationship between CGL and regional co-operatives

94. This theory of harm raises the question of how independent the various co-operatives are in their grocery retailing from CGL. It was necessary for the OFT to consider whether regional co-operatives should be treated as fully independent from CGL (full competition), or as effectively synonymous with CGL for competition assessment (zero competition), or somewhere between those two extremes (as appears likely given the OFT's factual observations in CGL/United quoted above). To assist the OFT, the parties provided extensive evidence on the relationship between CGL and the regional co-operatives, which is discussed below.

95. By way of background, CRTG operates on behalf of approximately 25 co-operative societies. CGL Food Retail, a business unit within CGL, acts as the manager and representative member of CRTG. The CRTG Category Management Team (employed by CGL Food Retail) conducts and concludes all negotiations with suppliers in relation to cost prices, terms of trade, ranges and promotions for the food operations of all CRTG members.

Pricing

96. The OFT first considered the pricing relationship between CGL and the regional co-operatives and found that there is some similarity in the pricing models adopted by CGL and at least some of the regional co-operatives. All of the regional co-operatives receive a list of recommended retail prices from CGL. The list provides the prices that CGL will charge in its stores once the prices are effective (albeit with variations across store bands – as mentioned in paragraph 45 above, CGL's price list is based according to [ ] pricing bands). In other words, CGL circulates its future price list to all other members of CRTG, albeit that this does not expressly identify which stores will fall within which pricing band.

97. The parties informed the OFT that other CRTG members are not bound by the CGL price recommendations. However, information received from the regional co-operatives during the course of the OFT's investigation showed that at least some CRTG members follow the recommended prices (either absolutely or adjusted in some systematic manner).

98. In order to demonstrate the independence of the other CRTG members (the regional co-operatives) the parties submitted to the OFT the results of a mystery shopping exercise,[30] one aspect of which concerned prices. The parties used two measures of price differences between the CGL, Somerfield and regional co-operatives – average relative price differences and relative absolute price differences. The mystery shopping exercise showed that prices between CGL and the regional co-operatives varied from being [ ] to [ ]. By way of comparison, prices between Somerfield and the regional co-operatives varied from around [ ] to [ ]. The parties themselves acknowledged that the price dispersion between Somerfield and the regional co-operatives was greater than between CGL and the regional co-operatives.

99. In terms of promotional activity, which can be considered part of pricing, CRTG negotiates terms with suppliers for each promotional period on behalf of the members. Members are free to decide the amount of space they will allocate to a particular CRTG promotion. However, if a store stocks a product immediately prior to the start of a promotion on that product, it is obliged to run that promotion.

Product range

100. Considering product range similarities, CGL and the regional co-operatives stock a similar range of branded products and they share the same own label brand. For any given amount of shelf space for a particular product category, CRTG [ ]. To the extent that there is a Co-op own label offering in a given product category, this is included in the CRTG range strategy. CRTG audits every member society to ensure compliance.

101. On the basis of the evidence before it, the OFT understands that CGL and other CRTG members source almost all of their products via CRTG and

[30] Based on 44 products over the period 19–22 September 2008.

therefore offer to customers a very similar basket of products, especially own-brand products. CRTG's offered product range is discussed and agreed collectively by the CRTG members.

102. On product range, the parties submitted that it is a natural consequence of being members of the CRTG buying group that CGL and the regional co-operatives will have a similar retail offer (in terms of the specific products on offer). Further, the parties submitted that stores of a similar size of any fascia will stock a similar range of products (in terms of the number of products on offer).

103. To test this, another aspect of the parties' mystery shopping exercise compared products stocked by Somerfield, CGL and regional co-operative stores (using 10 commonly purchased product categories). The exercise showed that, for most stores, there were differences between the CGL and the regional co-operatives in the amount of choice offered to shoppers in each of the product categories. When the comparison was undertaken between Somerfield and the regional co-operatives it emerged that there were more differences in product range between them.

104. Overall, therefore, the data are consistent with the notion that being part of the same buying group may dampen competition in product range in this case. (It is worth noting, however, that stores of different sizes – perhaps significantly sizes, even within the same size classification – were used in this exercise and the parties were not able to control for this.)

Cost base

105. Related to product range is the fact that CGL and other CRTG members share a common cost base across proportions of their ranges and those common costs are communicated to CRTG members. Currently Somerfield can seek to compete with CRTG members by reducing its cost base relative to them (and vice versa), but after the merger this competitive dynamic will be lost. Also, there is some scope for CRTG members to reduce their costs relative to their CRTG member rivals with respect to those costs which do not relate to the buying group. However,

when CRTG members are co-located in local markets their incentives to seek cost efficiencies are reduced.

Summary on relationship between CGL and regional co-operatives

106. On the basis of the evidence discussed above, overall, therefore, there is a significant degree of explicit co-operation and similarity in retail offer between the CRTG members.

107. The merger therefore raises the prospect that the local competition in terms of price, range diversity and/or quality that existed between the CRTG member and the Somerfield may therefore be substantially lessened when the Somerfield becomes a CGL post-merger.

108. The OFT considered two specific forms that the theory of harm based on overlaps between a Somerfield store and a regional co-operative store could take. First, that competition could be reduced in areas where no CGL store was present pre-merger. Second, that competition could be reduced in areas where a CGL store was present pre-merger. Each is discussed below.

Competition concerns in Somerfield/regional co-operative overlap areas (where no CGL)

109. The proposed merger would create new overlaps between CGL (after the merger) and other CRTG members in local areas, in some of which they face no or few other effective competitors.

110. The OFT investigated whether in these circumstances the merger could effectively lead to some form of coordination between the merged entity and other CRTG members given the relationship between CGL and the regional co-operatives discussed above.

111. The parties argued strongly that the conditions for concerns over tacit coordination (transparency, deterrence, punishment mechanism) were absent in relation to grocery retailing at the local level. However, the OFT's concerns in this area do not derive from the prospect that all suppliers operating in a geographic area will tacitly coordinate within that area, but rather from the explicit links (in terms of pricing, product range and common costs) between CGL and the regional co-operatives.

112. The parties argued that it would be inaccurate to characterise CGL and the regional co-operatives as one and the same fascia, or as following each other in a local market, and provided evidence showing differentials between them which have been discussed above. Nevertheless:

- in terms of pricing, it is clear that some regional co-operatives do in fact base their prices on the CGL price lists; the OFT therefore considers it realistic that, post-merger, CGL would in some instances be able to raise a former Somerfield store's prices in a particular local area in the knowledge that the regional co-operative in question would be likely to follow suit; this is likely not to be the case for all regional co-operatives, but in the time available the OFT has not been able to determine to any degree of accuracy to which regional co-operatives this would apply and to which it would not[31] (and, in any event, the issue of pricing is not determinative of the OFT's concerns for the reasons given in the second bullet below), and

- in terms of promotions, range (in particular, own brand products) and a common cost base, it is clear that CGL is closely linked to all regional co-operatives; for this reason, it is clear that there will inevitably be more muted competition between a CGL store and a regional co-operative than a Somerfield store and a regional co-operative: the differential between these two situations is sufficient in the OFT's view to give rise to a realistic prospect of a substantial lessening of competition in the absence of sufficient other constraints.

113. Given the OFT's concerns above, in order to gauge the scope of this theory of harm and to identify relevant local markets in which it might operate, the OFT asked the parties to undertake further filtering work (as detailed in annex A) which would identify relevant overlaps between Somerfield and regional co-operative stores as if these regional co-operatives were CGL stores.

114. The OFT considered it appropriate to apply the same methodology used for considering unilateral effects to determining which areas should be filtered in or filtered out – even though this concern was

based around some form of coordination between the regional co-operative and CGL. This is because, on the most cautious view, a regional co-operative that did closely follow CGL's pricing recommendations would, given the other aspects of the co-operatives' offer (that is, promotions, range, common cost base), appear – in PQRS[32] terms – to be very similar to an actual CGL store (such that they should be counted as one fascia). In that situation, the lessening of competition would be very similar in effect to a unilateral effect.[33] Hence it is reasonable to consider that a competitive constraint from third parties that would prevent a 'standard' unilateral effect should suffice also to prevent the coordinated effect being considered here.

115. This exercise identified 64 Somerfield stores that had not previously been identified in the filtering work related to the standard unilateral effects theory of harm.

116. The parties conducted surveys at 53 Somerfield stores, 14 CGL stores and 129 regional co-operative stores. Three local areas had no surveys undertaken in them (including one, around Ipswich Carr Street, in which the Somerfield store is yet to open). [Endnote 1] These three areas automatically failed the OFT tests.

117. Based on the filtering exercise set out in annex A, the OFT identified 32 local areas (including the three which were not surveyed) centred around Somerfield stores that it considers raises a realistic prospect of a substantial lessening of competition based on the overlap between a Somerfield store and a regional co-operative. [Endnote 1]

Competition concerns in Somerfield/regional co-operative overlap areas (where a CGL is present)

118. The second form of the Somerfield / regional co-operative overlap theory of harm which the OFT investigated concerns areas where a Somerfield

[31] By way of additional complication, the merger might itself change the incentives of one or more regional co-operatives in terms of their pricing policies vis-à-vis the CGL recommended price list.
[32] Price, Quality, Range, Service.

store and a CGL store already overlap at the local level, and a CRTG member store is also present in the local area.

119. In areas that would have passed the first stage filter for a unilateral effects concern – on the basis that there remained at least three other independent competitors – the OFT considered whether there were any 'five to four' (or above) areas that passed the filter when one or more of the nominally independent competitors that had been taken into account was a regional co-operative. If there were such areas, given that regional co-operatives cannot be considered to be universally fully independent competitors from CGL, it is necessary to consider whether competition concerns arise in that area. However, the parties' filtering exercise revealed no candidate local areas beyond those already identified as concerning in the standard unilateral effects filtering exercise – that is, there were no areas additional to those discussed in the unilateral effects section that would have failed the first stage test had regional co-operatives been treated as the same fascia as CGL.

120. The OFT also considered whether the way that CRTG operates means that the substantial lessening of competition in certain existing CGL/Somerfield overlap areas would be enhanced if another CRTG member were also present in the local market. To the extent that the CRTG member follows the lead of the CGL store, any unilateral effect arising through the coming together of CGL and Somerfield may also be transmitted to the other local CRTG members and, as a result, any local unilateral effect may be extended (that is, 'aggravated' unilateral effects). However, to the extent that the OFT has already found a realistic prospect of a substantial lessening of competition in these areas, any remedy in respect of standard unilateral effects concerns would also mean that there was no merger-specific lessening of competition in such areas.

[33] This theory of harm should not, strictly speaking, be characterised as a unilateral theory of harm because the merging parties are not internalising competition between them.

Conclusion on competition concerns arising from Somerfield/regional co-operative overlaps

121. The OFT considers that the merger gives rise to a realistic prospect of a substantial lessening of competition in 32 local areas in which there is an overlap between Somerfield and a regional co-operative store. [Endnote 1]

122. The OFT acknowledges that these Somerfield/regional co-operative theories of harm are a result of the relatively exceptional nature of this particular aspect of the case, and the OFT would not expect these issues to arise in other grocery cases that do not involve such a close relationship between two nominally separate operators.

Merger efficiencies

123. The parties submitted that the transaction will lead to buying efficiencies. Three potential sources of buying efficiencies are put forward:

- where the same supplier supplies both CGL and Somerfield, the combined entity will migrate all purchases of such products to the lower price

- the increased scale of purchases will enable the merged entity (and hence the CRTG buying group of which CGL is a member) to secure larger discounts, and

- CGL will be able to enjoy larger production runs of own brand goods.

124. The parties submit that the claimed efficiencies are merger specific, arguing that the increased purchasing volumes, and the opportunity to adopt the better of the two supply prices, would not arise other than through a merger (or at the very least through Somerfield joining CRTG).

125. There are two ways in which the OFT may take efficiencies into account in its analysis of a merger.[34] One is where they are rivalry enhancing such as to mean that a realistic prospect of a substantial lessening of competition is not found despite concentration arising in a market from the merger. The other is if overall customer benefits (delivered via

[34] Paragraphs 4.29–4.35 of the OFT's Substantive Assessment Guidance, May 2003, OFT516.

efficiencies) from the transaction outweigh the substantial lessening of competition concerned caused by the merger such that the OFT chooses to exercise its discretion not to make a reference to the Competition Commission.[35]

126. The parties did not seek to argue in this case that the efficiencies derived from the merger were such that they outweighed the (aggregate) substantial lessening of competition caused by the merger (that is, including all the unilateral effects concerns arising in the 94 local areas discussed above).[36]

127. Rather, the parties argued that the efficiencies derived from the merger were sufficiently rivalry-enhancing that they should be seen as preventing a substantial lessening of competition arising in those situations where Somerfield overlapped with a regional co-operative and where the OFT had found concerns based on the absence of sufficient independent competition. In particular, they argued that efficiencies would be sufficient to prevent a substantial lessening of competition arising in any Somerfield/regional co-operative overlap areas where the fascia count in the local area would be reduced from four to three.[37]

128. The OFT guidance (paragraph 4.32) states that the 'key question is whether the claimed efficiency will enhance rivalry among the remaining players in the market' and gives the example of where two smaller firms merge to provide more effective competition to a larger rival. The guidance makes it clear (paragraph 4.31) that in all cases 'in order for the OFT to take account of efficiencies that are claimed to enhance rivalry, they must be: (a) demonstrable; (b) merger-specific; and (c) likely to be passed on to customers'.

[35] See OFT Decision: Completed acquisition by Global Radio UK Limited of GCap Media plc, 8 August 2008, for a fuller description of the customer benefits exception, including the OFT's interpretation of the Act that it is not possible under the Act for the OFT to exercise its customer benefits discretion in relation to one particular finding of a substantial lessening of competition (in market X) but then to make a reference (or accept an undertaking in lieu of a reference) in respect of another substantial lessening of competition (in market Y).
[36] For the reasons given in footnote 35, it would not have been possible for the OFT to decide under s33(2)(c) that benefits from the buying group outweighed only the substantial lessening of competition in areas in which Somerfield overlapped with a regional co-operative and fewer than three competitors (ie outweighed only a subset of the overall competition concerns).
[37] When the regional co-operative is counted as if it were a CGL – see annex A.

129. The OFT does not accept the parties' argument in this instance. The OFT did not receive sufficiently compelling evidence that the buying efficiencies and consequent customer pass-through would occur and would occur sufficiently such as to offset competition concerns that would otherwise arise in individual local areas.

130. The OFT's caution in this regard was heightened by the fact that the parties were confident that their own calculations suggested that, in the context of competitive conditions in all the local areas that raised standard unilateral effects concerns, the level of customer pass-through of efficiency benefits would not be enough to countervail the harm to consumers as a result of the loss of competition in those areas. As such, the OFT considers it implausible that the rivalry created by the buying efficiencies would clearly be sufficient to negate prima facie competition concerns in the Somerfield/regional co-operative group overlaps.

131. For this reason, the OFT has not accepted the parties' arguments about efficiencies being rivalry enhancing in this case.

Horizontal concerns arising through ownership of landsites

132. The CC found that when a grocery retailer in a highly-concentrated local market exercises control over a landsite in that area, it makes entry more difficult for a competing retailer, allowing the incumbent retailer to continue to benefit from its position and therefore creating an adverse effect on competition.[38] Mechanisms for controlling land in this way included land bank sites, landsites that are leased or sub-leased to third parties, restrictive covenants, and exclusivity arrangements.

133. To the extent that competition concerns arise from ownership by one of the merging parties of controlled landsites from which it currently benefits, these are not merger specific and are therefore not considered further in this decision. However, the proposed transaction raises the possibility of creating new ownership associations between controlled landsites held pre-merger by one party and mid-range or larger stores operated by the other party in highly-concentrated local markets. Such concerns would arise in

[38] Paragraph 7.121 of the groceries report.

local markets in which the parties do not already have overlapping grocery stores.

134. Such newly-created common store/landsite control situations could create one of two potential competition concerns.

- First, the combination of a land bank owned by one party in an area where it does not have a store but where the other party is actually present could reduce the actual potential competition that the land holder would have presented in that area on the basis that the holder of the land bank might have entered the local area by opening a supermarket on its land bank site.[39] The theory of harm arises because the holding of a land bank by one party could be regarded as differentiating that party from other competitors in terms of its status as a potential entrant into that local area.

- Second, the combination of a controlled land site held by one party in an area where it does not have a store but where the other party is actually present could increase barriers to entry in that area. This is because the landsite controller would post-merger have a greater incentive not to allow a competitor on the site in order to protect its local store.[40]

135. The OFT examined each of these theories of harm. During the course of its investigation the OFT found that CGL [ ] a number of sites with other land use controls associated with them. Somerfield [ ] holds some land banks and has a number of other sites with other land use controls associated with them.

[39] This theory of harm is based on a reduction in *actual* potential competition, rather than *perceived* potential competition, given that the parties stated that CGL did not know pre-merger where Somerfield held land bank sites. See OFT decision Completed acquisition by Air France Finance S.A.S/City Jet Ltd of VLM Airlines N.V. (10 June 2008) for the distinction between actual and perceived potential competition.
[40] The OFT considered that the holding of a controlled land site – other than a land bank on which a supermarket could be built – was insufficient for the holder of the controlled land site to be regarded as a potential entrant into that area.

Removal of potential competition

136. In response to the OFT's concern that the merger could remove a potential competitor in areas in which one party had a land bank and where the other was present, the parties noted that the CC did not find it appropriate to implement a remedy with respect to land banking since it did not find more generally that grocery retailers were engaged in holding undeveloped land as a strategy to impede the entry by rival grocery retailers in local areas.[41]

137. However, the OFT does not consider that this is sufficient in itself for it to dismiss the realistic prospect of a substantial lessening of competition arising in such areas. It does not necessarily follow from the fact that the CC has concluded that it is not appropriate to implement a remedy in the context of a market investigation that similar facts are incapable of giving rise to a realistic prospect of a substantial lessening of competition in a merger context.

138. The OFT considers that, to the extent that a supermarket owns land that is suitable for a store in an area where it is not present, it may be that they should be considered a potential entrant in that area. To the extent that the merger eliminates that constraint in a highly concentrated local market, concerns may arise.

139. The parties' empirical work[42] demonstrated that there was only one land bank held by Somerfield (at [ ]) that was proximate to a CGL store in a highly concentrated area. However, because Somerfield was already present in this area as an active competitor with a current store, the theory of harm based on

[41] Paragraph 7.121 of the groceries report. The CC decided against imposing remedies in respect of leases because it was not considered appropriate to interfere with leases negotiated with third parties.

[42] This work consisted of three phases: (a) elimination of sites not suitable for use as grocery retail stores (based on the CC's methodology described in paras 7.98 to 7.113 and in particular footnote 245 of the CC's Groceries Report); (b) elimination of sites not within the primary isochrone of a mid range or larger store of the other party; and elimination of sites where none of the mid range or larger stores of the other party identified in (b) are in concentrated markets (in accordance with the methodology described by the CC in paras 7.69 to 7.122 for identifying highly concentrated local markets (save that CGL took a conservative approach by not applying the CC's market share filter, something which would eliminate more sites)).

potential competition through entry into the local area is not applicable.[43]

Raising barriers to entry

140. In response to the OFT's concern that the combination of a controlled land site owned by one party with an operating store of the other party could raise barriers to entry (because the landsite controller would post-merger have a greater incentive not to allow a competitor on the site in order to protect its local store), the parties submitted to the OFT that the CC is in the process of remedying competition concerns that it found in specific highly concentrated local markets with respect to restrictive covenants and exclusivity arrangements, including providing a remedial mechanism for when issues are raised in the future.[44] As such, these points should not be an issue for the OFT in its merger analysis.

141. Further, the parties pointed out to the OFT that any restriction on the use of land cannot be enforced unless the land holder directly benefits from the restriction. In other words (in the context of this case), the land holder must be proximate to the site with a restriction on it. Therefore, the parties argued, the OFT's theory of harm cannot hold since it is premised on the creation of new overlaps between the merged entity and restricted sites. However, the theory of harm would be that any restriction that was not previously enforceable (because there was no benefiting land nearby) would become enforceable as a result of the combination of the controlled land site with a nearby store of the other merging party.

142. The OFT considered carefully whether this potential theory of harm was sufficient – in itself, and without any further information on competitive conditions in the 15 local areas in which the parties submitted this fact pattern arose – to create

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[43] Competition concerns arose in [ ] as a result of the overlap between the CGL store and the (open) Somerfield store. Therefore, a divestment will be required in the [ ] area.
[44] In addition to chapter 11 of the CC's groceries report (especially paragraphs 11.138–11.230), see the remedies timetable on the CC's website at:

competition concerns. Ultimately, the OFT considers that it is fanciful to conclude that a substantial lessening of competition could arise based on an increase in barriers to entry into a local area caused merely by the presence of some form of controlled land site, in particular given that the CC has identified a mechanism for remedying the adverse effect on competition that resulted from high barriers to entry in such highly concentrated markets.

BARRIERS TO ENTRY AND EXPANSION

143. The CC's recent groceries report found that, in general, barriers to entry and expansion differed across product markets (that is, according to the size of the store).

144. For larger (**one-stop**) stores, the CC found that the planning system generally and controlled land sites in a number of highly-concentrated local areas formed a barrier to entry.[45]

145. For **mid size** stores, the CC found that controlled land sites in a number of highly-concentrated local areas formed a barrier to entry.[46]

146. Other CC investigations have come to similar conclusions with respect to one-stop and mid size stores. In Somerfield/Morrison, for example, the CC felt that it could not rely on new entry to resolve any immediate lessening of competition as regards to one-stop or mid size stores. This was because of the limited availability of sites, either because of physical availability or planning restrictions.[47] Although these barriers can eventually be overcome, the CC emphasised that they cannot be expected to be overcome in a timely manner (that is, within a two year period).

147. For the **convenience** store product market, the CC found that limited barriers to entry or expansion meant that any barriers did

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www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/timetable_remedies_040908.pdf
[45] Paragraph 7.122 of the groceries report.
[46] Paragraph 7.122 of the groceries report.
[47] Paragraph 7.46 of Somerfield/Morrison.

not form an adverse effect on competition.[48] Similarly, in Tesco/Adminstore, the OFT considered that, in general, any barriers to entry for convenience retailing were surmountable.[49] The issue of barriers to entry in the convenience store sector has been addressed above (paragraphs 60 to 62).

148. The OFT put the CC's findings on barriers to entry from its groceries report to third parties in the current case.

149. All third parties told the OFT that they agreed with the CC that obtaining planning approval is a significant barrier to entry, especially for one-stop stores. On mid size stores, almost all third parties agreed that the lack of available sites and, related to this, restrictive controls on land sites, constitute a substantial barrier to entry and expansion.

150. Some third parties told the OFT that the CC did not identify all of the barriers to entry and expansion, however. Some suggested that independent convenience store operators do face higher barriers to entry and/or expansion than the CC considered, primarily through differences in buying prices between them and the larger operators. The CC, in its groceries report, did not find that convenience store operators face a barrier to entry or expansion arising from any cost advantage relative to other grocery retailers.[50] The OFT has not received any information persuading it to depart from the CC's findings and does not consider that this merger is of such magnitude to significantly increase barriers to entry or expansion for other convenience store operators.

151. In conclusion, the OFT considers that barriers to entry and expansion are high in the one-stop and mid size markets. By contrast, barriers to entry in the convenience market, which have already been addressed above (paragraphs 60–62), are considered to be generally low such as to prevent competition concerns from arising in respect of convenience stores.

[48] Paragraph 7.122 of the groceries report.
[49] Paragraph 32 of Tesco/Adminstore.

COUNTERVAILING BUYER POWER

152. Customers are individual consumers and therefore do not possess any countervailing buyer power.

VERTICAL ISSUES

153. Vertical concerns do not arise in this case. Although CGL administers CRTG, the buying group (discussed above), [ ].[51] Therefore, CGL is not in a position where it can increase its rivals' costs in order to recoup those lost sales via CGL's own retailing activities.

154. The parties submitted to the OFT that CGL currently does not use its position in relation to CRTG to foreclose or disadvantage other CRTG members.

155. On the basis of the evidence before it the OFT does not consider that the proposed merger will provide the merged entity with any additional ability or incentive to foreclose downstream rivals.

THIRD PARTY VIEWS

156. During the course of its investigation the OFT solicited views from a large number of food retailers comprising large supermarket chains, symbol groups, LADs, frozen food specialists, convenience store operators and regional retailers. In addition, the OFT sought views from retailer trade bodies and suppliers.

157. Additionally, a considerable number of individual shoppers wrote to the OFT highlighting the possible adverse affect of the proposed merger on their local areas.

158. No third party told the OFT that the proposed merger raised competition concerns at the national level. At the local level, all third parties considered that competition concerns would arise.

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[50] Paragraph 7.31 of the groceries report.
[51] [ ].

159. Some third parties provided details of how they believed local concerns should be remedied, and on this comments diverged. Some third parties did not consider that retailers like the LADs or Marks & Spencer would offer effective competition to the merged entity and large grocery retailers, and therefore should be excluded from purchasing required divestments on competition grounds. Others disagreed and thought the LADs and/or Marks & Spencer should be included.

ASSESSMENT

160. CGL and Somerfield overlap in the retail of groceries. CGL has over 2,000 outlets and Somerfield has around 880. In investigating this merger the OFT has relied a great deal on recent market investigation and mergers work undertaken by the CC in the UK grocery sector. This work has allowed both the OFT and the parties to begin their analysis of the proposed merger at a relatively advanced level. In particular, the OFT has benefited from the CC's recent work in devising a framework for local area filtering.

161. The market definition used in this case follows that used in recent CC work and comprises three product markets (which included other large grocery retailers, regional grocers and symbol groups, but excluded LADs, frozen food retailers and specialist retailers). The geographic dimension to competition is both national and local, with the scope of the local area being different according to whether it is in an urban or rural location. The market definitions in this case are set out below.

Product market	Local geographic market (drive times)	
	Urban	**Rural**
One-stop stores: those with a net sales area of 1,400 square metres or above.	10 minutes.	15 minutes.
Mid size stores: those with a net sales area of less than 1,400 square metres but above 280 square metres and one-stop stores.	5 minutes for other mid size stores and 10 minutes for one-stop stores.	10 minutes for other mid size stores and 15 minutes for one-stop stores.
Convenience stores: those with a net sales area of less than 280 square metres plus mid size and one-stop stores.	5 minutes for other convenience stores, 10 minutes for one-stop stores and 5 minutes for mid size stores.	5 minutes for other convenience stores, 15 minutes for one-stop stores and 10 minutes for mid size stores.

162. The OFT has not found any realistic prospect of competition concerns arising at the national level (whether through unilateral effects – including the merger's likely effect on grocery suppliers – or coordinated effects).

163. At the local level, the OFT applied a two stage filtering approach which is described in detail at annex A. The filtering results were adjusted in a small number of cases to take account of low barriers to entry in the convenience market and a format change of one CGL store. However, in the main the OFT's findings on unilateral effects grounds at the local level are a result of the two stage filtering work.

164. The OFT analysis (corroborated by third parties) indicates that barriers to entry are high in the one-stop and mid size markets.

165. The OFT considers that as a result of the proposed merger, there is a realistic prospect of a substantial lessening of competition arising in 94 local areas as a result of local unilateral effects.

166. During the course of this investigation, the OFT has examined in some depth the competitive interaction between CGL and the regional co-operatives. This issue – described in paragraphs 94 to 108 above – occurs as a result of CGL acquiring a (fully independent) Somerfield store that overlaps in the relevant local area with a regional co-operative (that is not (fully) independent of CGL). Evidence before the OFT indicates that competition may be substantially lessened in these local areas as a result of the proposed merger because of similarities in pricing, promotions, product range and quality between CGL and the regional co-operatives through their membership of the buying group, CRTG. Given that, to date, this scenario has not occurred before, the UK competition authorities have not had cause to consider the implications on local competition (and therefore the welfare of local shoppers) of it. The OFT's analysis has found that the merger creates the realistic prospect of a substantial lessening of competition arising in 32 local areas as a result of this interaction. [Endnote 1] The OFT considered, but rejected as not compelling, the parties' arguments that efficiencies derived by the merger would enhance rivalry in some or all of these areas sufficiently to negate the prima facie competition concern.

167. The OFT has found that there is a realistic prospect of a substantial lessening of competition as a result of the proposed merger in 126 local areas [Endnote 2], comprising 94 areas in which unilateral effects concerns arise and 32 areas in which competition issues concerning CGL's relationship with other CRTG members arise [Endnote 1].

168. The OFT considered but dismissed the prospect of a substantial lessening of competition arising as a result of the proposed merger with respect to ownership of controlled land sites.

169. Consequently, the OFT believes that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

UNDERTAKINGS IN LIEU OF A REFERENCE

170. Where the duty to make a reference under section 33(1) of the Act applies, pursuant to section 73(2) of the Act, the OFT may, instead of making such a reference, and for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which has or may have resulted from it or may be expected to result from it, accept from such of the parties concerned undertakings as it considers appropriate.

171. The OFT has therefore considered whether there might be undertakings in lieu of reference (UILs) which would address the competition concerns outlined above. The OFT's *Mergers Substantive Assessment Guidance* states that, 'undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut, and those remedies are capable of ready implementation'.[52]

172. As made clear from the OFT's guidance, the OFT must be confident that the proposed UILs will address the competition concerns. Consequently, in those cases in which there is doubt over the precise identification of the substantial lessening of competition or over the effectiveness of the undertakings, the OFT is likely to consider that accepting UILs is not appropriate.

173. CGL offered a number of UILs to address the different competition concerns identified by the OFT.

174. In respect of the competition concerns expressed by the OFT regarding the relationship between CGL and the regional co-operative stores post-merger, [ ].

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[52] Paragraph 8.3.

175. The OFT considered carefully whether this undertaking could be regarded as acting in a clear cut fashion to remedy the OFT's competition concerns, having regard to the obligation on the OFT to achieve as comprehensive a solution as is reasonable and practicable to the substantial lessening of competition and any adverse effects resulting from it (section 73(3) of the Act). Ultimately, the OFT did not consider that the [ ] was a clear-cut remedy on the basis that:

- [ ] wholly independent operator from the regional co-operatives; in particular, they would retain the same cost base (in so far as this is common to members of the buying group) and – to a significant extent – would have similar own-brand ranges, promotions and branding; given the importance of these connections between CGL and the regional co-operatives, [ ] was insufficient for the OFT to be able to dismiss any realistic prospect of a substantial lessening of competition occurring through coordination between CGL and a regional co-operative going forward, and

- [ ] on an ongoing basis raises similar difficulties to those encountered by all behavioural remedies, namely that it would require ongoing monitoring and enforcement by the OFT rather than acting as a one-off structural change to the market; there is no reason in this case why these general objections to behavioural undertakings do not apply.

176. In respect of the OFT's unilateral concerns (and as an alternative to [ ] in respect of the CGL/regional co-operative relationship) CGL offered to divest individual stores in local overlap areas in order to remedy the competition concerns identified by the OFT where the OFT found that the test for reference was met in a particular local area.

177. Although presented as a series of sequential options, CGL's overall UIL offer included divestment of stores in all of the 94 local areas in which the OFT identified concerns about unilateral effects arising from the merger and divestment of stores in all of the 32 local areas in which the OFT had concerns regarding the post-

merger interaction between CGL and the regional co-operatives.[53] [Endnote 1]

178. CGL's UIL offer included a willingness to make divestments in further local areas beyond the 126 stores referred to above should the OFT find concerns in respect of those additional areas. [Endnote 2] However, it was not necessary to consider such undertakings given that the OFT's duty to refer applies only in respect of the 126 local areas. [Endnote 2] This is consistent with the OFT's approach of reaching its judgment on its statutory duty to refer independent of the scope of the actual offer, if any, of undertakings.

179. CGL indicated that it would be prepared to arrange for the divestments to be made in 'packages' to address the OFT's concerns about the practicability of considering and consenting to a large number of individual disposals.

180. The OFT considers that the choice of the store to be divested should be left open to CGL given the OFT's conclusion on the requirement for a partial up-front buyer (see below). However, the OFT notes that the overlap in some locations is caused by more than one CGL store, and therefore in the event that CGL decided to dispose of the CGL fascia rather than the Somerfield fascia in a particular problem area, it might be necessary to divest more than one CGL store in that area.

181. The OFT therefore considers that CGL's offer to divest:

- either of the Somerfield or all of the relevant CGL store (or stores) in all of the 94 local areas in which the OFT identified concerns about unilateral effects arising from the merger, and

- the Somerfield store in all of the 32 local areas [Endnote 1] in which the OFT had concerns regarding the post-merger interaction between CGL and the regional co-operatives

[53] In addition to offering to divest the relevant CGL stores, CGL also offered to [ ]; however, in terms purely of remedying the competition concerns created by the proposed merger, the OFT considers that the offer to [ ] is unnecessary given that the OFT's merger-specific concerns are resolved by means of divestment undertakings in the relevant local areas.

was sufficient to act as a clear-cut and comprehensive remedy to the competition concerns identified by the OFT.

182. The OFT considered whether there was any prospect that accepting undertakings in lieu in respect of the Somerfield/ regional co-operative overlaps could be said to involve a risk of over-enforcement in so far as the regional co-operatives differed in the extent to which they operated independently from CGL.[54] However, the OFT believes that the test for reference (on at least the 'is or may the case' standard) is clearly met with regard to all local overlaps identified between Somerfield and a regional co-operative given that there are consistent links between all regional co-operatives and CGL in terms of product range, promotions and common costs. As such, the OFT believes it appropriate to accept undertakings in lieu in respect of this concern.

Up-front buyers

183. The OFT considered whether it is appropriate in the circumstances of this case to require that the relevant divestments be made in whole or in part to an up-front buyer or buyers.

184. An up-front buyer requirement means that the proposed divestment purchasers will have committed contractually, subject to formal OFT approval of the undertakings in lieu, to acquiring the relevant divestment store(s) before the OFT accepts undertakings in lieu. This means that the OFT will consult publicly on the suitability of the proposed divestment purchasers, as well as any other aspects of the draft undertakings, during the public consultation period.

185. The OFT will seek an up-front buyer where the risk profile of the remedy requires it, for example where the OFT has reasonable doubts with regard to the ongoing viability of the divestment

[54] In particular, whilst some regional co-operatives informed the OFT that [ ].

package and/or there exists only a small number of candidate suitable purchasers.[55]

186. In this case, there are clearly a significant number of purchasers who might be interested in acquiring certain divestment stores. However, the parties themselves accepted that in a minority of divestment areas ([ ] CGL/Somerfield overlap divestments and [ ] Somerfield/regional co-operative overlap divestments [Endnote 3]) there were expected to be only [ ] potential buyers that might be interested in buying the divested store and who were able to do so on the cautious basis that only [ ] would be able to purchase the stores.

187. Throughout the case the parties devoted considerable effort to seeking to persuade the OFT that it would be inappropriate to insist on an up-front buyer provision in this case, and in particular that it would be inappropriate to do so with regard to all of the stores to be divested. Their main arguments were that:

- this case differs from the other cases in which the OFT has required an up-front buyer (that is, that potential buyers here all have experience of operating supermarkets, it is easy to find such a buyer not already present in a local area and all stores are profit making)

- although it may be reasonable to exclude LADs and Iceland from the market definition, it is not reasonable to extend that position to purchaser approval when these operators are capable of restoring pre-merger competition in some local areas

- even if (discounting the LADs and Iceland) the number of potential purchasers is low ([ ]), CGL could package stores together in order to make a purchase of any particular store more attractive

[55] See in particular Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd 15 April 2008 and Completed acquisition by Global Radio UK Limited of GCap Media plc 8 August 2008.

- it would be disproportionate for the OFT to require an up-front buyer provision on the entire suite of 126 divestments [Endnote 2] given the large majority of them will not be difficult to sell and it was only a small minority (of [ ] stores [Endnote 3]) where there was only [ ] identified potential purchasers, and

- requiring an up-front buyer in this case would create issues of administrative workability, particularly given that the transaction remains anticipated; multiple potential buyers may try to exploit their commercial position by using the threat of frustrating the disposal process to get the proposed transaction referred to the CC as a way of trying to extract more beneficial terms from the parties.

188. In order further to persuade the OFT that an up-front buyer provision is not required in this case, CGL alternatively (or additionally) offered [ ].

189. The OFT has considered carefully the above arguments but does not find them persuasive such that it should not require any form of up-front buyer in this case.

190. The OFT considers that, where the parties have demonstrated that there can reasonably be expected to be [ ] potential purchasers, no up-front buyer should be required for these stores. The OFT considers that imposing an up-front buyer in respect of all divestment stores risks becoming disproportionate to the harm (that is, the failure to sell the stores and therefore to remedy the competition concerns) that is sought to be avoided. However, given that there are [ ] stores [Endnote 3] where there can be expected to be only [ ] potential purchasers ([ ] might not in actual fact be interested in acquiring the store), there is genuine uncertainty about the viability of divestment in these cases.

191. The fact that these [ ] stores [Endnote 3] are merely a subset of a larger number of divestments, most of which have [ ] potential purchasers, cannot be seen as removing the need for an up-front buyer. The OFT remains concerned to ensure that a successful

remedy is achieved in the minority of divestment areas in the same way that it was concerned to ensure the existence of a purchaser in previous cases where only one retail store was being divested (Homebase/Focus[56]).[57]

192. The OFT considered carefully whether CGL's offer [ ] was sufficient to allay the OFT's concerns in the [ ] areas in question. [Endnote 3] Ultimately, however, the OFT considers that there is merit in ensuring that divestments are achieved as quickly as possible in these areas, rather than allowing the possibility that they are remedied only at the end of the divestment process (during which time there is a risk that the relevant stores will degrade or will not be in a position to provide effective competition). The OFT is conscious that, by requiring CGL to find purchasers for each of these [ ] stores [Endnote 3] prior to acceptance of the undertakings in lieu, CGL remains highly incentivised to ensure that as comprehensive a solution as is reasonable and practicable to the substantial lessening of competition is achieved in each of these localities as quickly as possible.

193. In line with the parties' offer, however, the OFT has decided that – in view of the scale of divestments required in this case and the fact that the availability of [ ] purchasers for the remaining [ ] divestment stores is premised on the parties' own expectations of which purchasers would be interested in which stores – it would be appropriate and proportionate to accept the parties' offer [ ] in connection with those [ ] stores that are **not** part of the up-front buyer set. In this way the OFT will have greater certainty that a satisfactory remedy will be achieved in all divestment areas.[58] [Endnotes 2 and 3]

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[56] Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd 15 April 2008.
[57] The parties argued that [ ] the requirement of an up-front buyer would delay completion of the overall acquisition, and therefore delay the benefits to customers of the merger. However, the OFT has not considered in detail the extent to which the transaction is beneficial to customers and, in any event, it would be open to the parties to waive this condition such that the merger proceeded upon suspension of the duty to refer rather than acceptance of undertakings in lieu.
[58] To the extent that CGL is able to divest of all the relevant stores that are not part of the up-front buyer set during the divestment period, no divestment trustee would be appointed and [ ].

194. In conclusion, therefore, the OFT has decided that, on a cautious basis, any undertakings in lieu that it accepts should include a partial up-front buyer provision for the [ ] stores [Endnote 3] where there are expected to be only [ ] potential effective competitor purchasers, comprising [ ] in relation to the OFT's unilateral effects at the local level concerns and [ ] in relation to the OFT's concerns about a Somerfield overlap with the other CRTG members. [Endnote 3]

DECISION

195. The OFT's duty to refer the anticipated acquisition by CGL of Somerfield to the Competition Commission pursuant to section 33 of the Act is suspended because the OFT is considering whether to accept undertakings in lieu of reference from CGL pursuant to section 73 of the Act.

ENDNOTES

1 The OFT's calculations at the time of announcement of the suspension of the duty to refer indicated that there were 32 local areas in which there is an overlap between Somerfield and a regional co-operative store and where the test for reference is met. Further checking of the application of the OFT's methodology following announcement of the decision to suspend the duty to refer in fact revealed that the correct number of local areas was 39 including six areas which were not surveyed (not three areas as reported in paragraph 116). This does not affect the OFT's ability to accept undertakings in lieu of a reference since the parties offered to divest stores in all of these areas. Since accepting the undertakings in lieu of a reference, new information provided to the OFT showed that the number of local areas in this category was 38 including five areas which were not surveyed.

2 OFT's calculations at the time of announcement of the suspension of the duty to refer indicated that there were 126 local areas in which the test for reference was met. Further checking of the application of the OFT's methodology for overlaps between a Somerfield a regional co-operative following announcement of the

decision to suspend the duty to refer in fact revealed that the correct total number of local areas was 133 (see Endnote 1). Since accepting the undertakings in lieu of a reference, new information provided to the OFT showed that the total number of local areas was 132 (Endnote 1).

3 OFT's calculations at the time of announcement of the suspension of the duty to refer indicated that there were [ ] stores where there are expected to be [ ] potential effective competitor purchasers and as a consequence the OFT concluded that any undertakings in lieu that it accepts should include an up-front buyer provision for these [ ] stores. Further checking of the application of the OFT's methodology for overlaps between a Somerfield a regional co-operative following announcement of the decision to suspend the duty to refer in fact revealed that the correct total number of stores subjected to an up-front buyer provision should be [ ]. This does not affect the OFT's ability to accept undertakings in lieu of a reference since the parties offered to subject all of these [ ] stores to an up-front buyer provision.

ANNEX A: FILTERING METHODOLOGY

A.1 The proposed transaction will see CGL acquiring around 880 stores from Somerfield. In order to analyse the effects of the proposed merger at the local level the OFT employed a filter to identify those local areas which do not require in-depth examination since they would be most unlikely to present competition concerns. The filtering methodology that the OFT applied in this case has closely followed previous work undertaken by the CC in the supermarkets sector. Broadly speaking, the filtering separated out the OFT's investigation in two parts – stage one and stage two.

The stage one filter

A.2 The stage one filter identified local areas in which the parties overlapped and which of those overlaps would be most unlikely to present competition concerns.

A.3 To identify overlaps, the filter used a 'maximum reach' isochrone. The 'maximum reach' isochrones were deliberately chosen on a conservative measure (that is, two to four times greater than the geographic market definition for a local area) in order to capture overlaps between the parties as comprehensively as was reasonable and to allow for the asymmetric constraints approach (described below). Measured in drive times, the 'maximum reach' isochrones are set out in table A1. The underlying road speed assumptions are listed at the end of this annex at table A3.[59] Definitions of urban and rural followed the CC's Safeway report. That is, urban areas are population areas of at least 10,000 people (based on 2001 census data) and all other areas are rural.[60]

[59] The parties used CACI Limited for the mapping and filtering work, as did the CC in its groceries report.
[60] See paragraphs 55 and 56 of appendix 5.1 to the Safeway report.

Table A1: 'Maximum reach' isochrone drive times

Store type	Urban area isochrone	Rural area isochrone
One-stop	20 minutes	30 minutes
Mid size	15 minutes	25 minutes
Convenience	15 minutes	20 minutes

A.4 Once local areas resulting in an overlap between the parties had been identified, the filtering exercise identified those local areas in which competition concerns were most unlikely to arise. It did this by initially centring the isochrone analysis on the Somerfield stores being acquired in the overlap areas (known as the primary isochrone) and on some CGL stores which may be constrained by a larger Somerfield store – a constraint which would not be picked up by the filtering exercise had it been centred solely on Somerfield stores. For example, if local area analysis was centred on a one-stop Somerfield store which overlapped with a mid size CGL store, the stage one filter would not deem the Somerfield store to constrain the CGL store and therefore the local area would not be identified as being potentially problematic. But in this example, the Somerfield store may very well be constraining the CGL store and therefore the local area should be examined in further detail.

A.5 By taking account of asymmetric constraints which would not have been picked up by centring the analysis on Somerfield stores alone, the parties identified 153 CGL stores in local areas which overlapped with some 24 potentially relevant Somerfield stores.

A.6 A local area was deemed to be unlikely to present competition concerns if at least three other (non-merging) fascia were present in the primary isochrone.[61] What is more, an asymmetric constraints approach was adopted. This means that larger stores were deemed to impart some constraint on smaller stores but not vice versa. In terms of the filtering exercise, the market definition was adopted in the filtering rules (so, for example, mid size stores in urban areas were deemed to be constrained by one-stop stores within 10 minutes' drive time of the reference store and by other mid size stores within a five-minute drive time of the reference store).

A.7 In terms of the relevant fascia, the stage one filtering exercise followed the product market definition in determining which fascia would be counted. For one-stop and mid size stores these are listed in table A2.

Table A2: Fascia used in stage one filtering for one-stop and mid size stores

Asda	'Symbol groups':
Booths	Nisa-Todays
Budgens	P&H Retail
CK Supermarkets	Select & Save
Co-operative societies (not CGL)[62]	Centra
Dunnes	Best-One
Harry Tuffins	Spar
Longs	VG/Vivo
Marks & Spencer	Premier (Booker)
Morrison	Londis
Proudfoot	Costcutter
Roys	Key Store/Key Shop
Sainsbury's	
Tesco	
Waitrose	
Whole Foods	

A.8 For convenience stores, all grocery retailers were included in the fascia count apart from specialist retailers (for example, bakers or butchers), LADs and frozen food specialists.

A.9 In addition to the primary isochrone filtering (centred on the Somerfield stores and the additional CGL stores), the stage one filtering exercise also replicated the primary isochrone filtering but re-centred on: all relevant competitors identified in the primary

[61] This is consistent with pervious work undertaken by the CC and OFT including Somerfield/Morrison (paragraph 6.86) and CGL/United.
[62] The non-CGL co-ops were treated collectively as a single fascia, as they were in CGL/United.

isochrone; on all population centres[63] in the primary isochrone (for one-stop and mid-size stores only); and on all census output areas in the primary isochrone (for one-stop and mid size stores only).

A.10 Therefore, multiple differently centred isochrones were applied to each local overlap area, all using the same rules and approach. A local overlap area failed the stage one filtering exercise (meaning that it did require further investigation) if three or fewer fascia were present (after the proposed merger) in any of the differently centred isochrones. However, a local area would only fail on the census output area re-centring if more than 10 per cent of the population in the primary isochrone would experience a reduction in fascia to three or fewer.

The stage two filter

A.11 Stage two of the OFT's investigation focused on the local areas which failed the stage one filter. The methodology employed at stage two followed that undertaken by the CC in its Somerfield/Morrison investigation.[64] In this investigation the CC sought to gauge how close the rivalry was between the merging parties at the local level by surveying customers on their likely level of switching between the parties (the diversion ratio). The CC considered that the diversion ratio alone was insufficient to indicate whether the merger would result in significantly reduced competitive constraint at the local level.[65] Therefore, the CC calculated 'illustrative price rises' in order to estimate the incentive that Somerfield had after the merger to raise its prices or equivalently worsen its non-price offer in the local area. The illustrative price rise takes into account not just the diversion ratio (which indicates the extent to which the merged entity can

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[63] Population centres used were based on 2001 census data. For England and Wales, settlement area boundaries which were issued by the former Office of the Deputy Prime Minister were used. For Scotland, developed land use area boundaries (as defined by the Ordinance Survey) were used. In all areas, the population centres must have had a population of at least 5,000 people at the time of the 2001 census to be used in the filtering exercise. There are no overlap areas in Northern Ireland. These methods of defining population centres were used by the CC in Somerfield/Morrison (see: GeoBusiness Solutions Limited, 'Competition Commission Somerfield/Morrison Inquiry: verification and independent analysis', 26 June 2005 http://www.competition-commission.org.uk/inquiries/ref2005/somerfield/index.htm).
[64] Paragraphs 7.1–7.16 and appendix D of Somerfield/Morrison.
[65] Paragraph 7.5 of Somerfield/Morrison.

internalise customer switching) but profit margins as well (high margins may indicate little local level competition and a larger incentive to increase post-merger prices or equivalently worsen non-price factors).

A.12 Based on the Somerfield/Morrison methodology, the parties failed a local overlap at the stage two testing if the diversion ratio[66] was above 14.3 per cent and the illustrative price rise was five per cent or more. Moreover, in CGL/United, the OFT adopted the same approach. The parties in this case provided sensitivity checks by undertaking the diversion ratio analysis both on revenue and the number of customers, and by calculating illustrative price rises using both linear demand curves (which assumes demand becomes more sensitive to changes in price as the price level increases) and isoelastic demand curves (which assumes that demand is equally sensitive to changes in price regardless of the price level). The OFT used the results based on revenue diversion ratios and isoelastic demand curves.[67]

A.13 The CC explained how it came to use a diversion ratio of 14.3 per cent as a threshold: 'In a market for undifferentiated products, they would simply be proportional to market shares. Somerfield put it to us that we should 'reality check' the threshold we were applying to determine an SLC, against market share thresholds typically used by competition authorities when considering undifferentiated markets. In such an undifferentiated market, two firms each, for example, with 12.5 per cent (that is, one-eighth) of the total market would have diversion ratios to one another of 14.3 per cent (that is, one-seventh). Since the merger of two such firms would result in a market share of 25 per cent, and since our Merger Guidelines suggest that mergers which result in a market share of below 25 per cent are less likely to raise competition concerns, a diversion ratio of 14.3 per cent seemed a reasonable level at which to consider diversion ratios that would give rise to competition concerns.'[68]

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[66] The diversion ratio tested against the threshold was weighted by customer spend (the revenue diversion ratio) and was the higher of the two figures of the diversion from Somerfield to CGL and the diversion from CGL to Somerfield.
[67] The CC used the same approach in Somerfield/Morrison – paragraphs 7.7 and 7.26.
[68] Paragraph 7.12 of Somerfield/Morrison.

A.14 An illustrative price increase of five per cent was chosen by the CC as a suitable threshold since this level of price change is used for SSNIP tests (when deciding on market definitions) which the CC thought provided a useful benchmark for the purpose of considering illustrative price rises.[69] Although the OFT accepted the five per cent illustrative price rise test in this case, it also investigated whether a one or a two per cent illustrative price rises made any difference to the overall results and found that they did not.

A.15 The parties also undertook an additional test whereby if a store fails the stage two tests, the diversion ratio itself was tested for statistical significance[70] above 14.3 per cent. However, the OFT did not adopt this additional test, which is consistent with the CC's approach in Somerfield/Morrison.[71]

The CRTG members filter

A.16 The stage one filtering exercise described above initially treated the non-CGL co-operatives as being separate from CGL. However, as explained in the **Somerfield/regional cooperative overlaps** section above, the OFT, taking a cautious approach, subsequently asked the parties to undertake the stage one filtering exercise by treating CGL and the other CRTG members as a single fascia. The method for undertaking this filtering exercise was essentially the same as the stage one filter described above with some modifications. These included:

- in an area where a CRTG member mid size store overlaps with a Somerfield one-stop store, the filtering analysis was also centred on the CRTG member store (the fascia counting included all one-stop stores and all mid size stores), and

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[69] Paragraph 7.11 of Somerfield/Morrison.
[70] Using a t-test at the conventional 5 per cent significance level with the standard error for the customer diversion ratio calculated assuming a binominal distribution for whether survey respondents switch.
[71] Paragraph 7.23 of Somerfield/Morrison.

- in an area where a CGL mid size store overlaps with a Somerfield one-stop store and a CRTG member one-stop store, the primary isochrone was centred on the CGL store in addition to centring it on the Somerfield one-stop store. When it was centred on the CGL store the fascia counting included all one-stop stores and all mid size stores.

A.17 In addition, in the interest of proportionality (and time) the CRTG members filtering exercise did not include census output area re-centring.

A.18 The OFT then filtered the overlapping areas. The filtering methodology essentially mirrored that applied in the unilateral effects theory of harm. That is, based on survey analysis, local areas in which the diversion ratios from the Somerfield to the co-operatives (remembering that CGL and the regional co-operatives are treated as one fascia) **and** from the co-operatives to Somerfield is at least 14.3 per cent and the illustrative price rise (for both the Somerfield and co-operatives stores) were five per cent or more were treated as 'fails'.

A.19 The OFT used the illustrative price rises calculated on an assumption of isoelastic demand, as it did for the unilateral effects theory of harm (paragraph A.12 above). However, in the minority of cases where the isoelastic demand produced a negative illustrative price rise, the OFT found that these areas raised a realistic prospect of a substantial lessening of competition.[72]

[72] The formula for the illustrative price rise (under the assumption of isoelastic demand) produces negative numbers when the combination of the profit margin and the diversion ratio is greater than one (in decimal terms), or when one of the two is very high. These are precisely the conditions under which competition concerns arise.

Table A3: Road speeds used in determining the isochrones

Description of Road Class	Speed (km per hr)	Junction Delay Time
Motorway (Rural)	112	0.00
A Road (Rural)	72	0.05
B Road (Rural)	65	0.07
Unclassified Road (Rural)	54	0.10
Ferry	12	5.00
Motorway (Urban)	80	0.00
A Road (Urban)	45	0.15
B Road (Urban)	39	0.20
Unclassified Road (Urban)	30	0.25
Motorway (Metropolitan)	58	0.05
A Road (Metropolitan)	27	0.25
B Road (Metropolitan)	23	0.30
Unclassified Road (Metropolitan)	20	0.40
Motorway Toll (Rural)	112	0.20
A Road Toll (Rural)	72	2.00
B Road Toll (Rural)	65	3.00
Unclassified Road Toll (Rural)	65	4.00
Motorway Toll (Urban)	85	1.00
A Road Toll (Urban)	45	2.00
B Road Toll (Urban)	39	3.00
Unclassified Road Toll (Urban)	30	4.00
Motorway Toll (Metropolitan)	58	1.00
A Road Toll (Metropolitan)	27	2.00
B Road Toll (Metropolitan)	23	3.00
Unclassified Road Toll (Metropolitan)	20	4.00
Motorway Roundabout (Rural)	56	0.05
A Roundabout (Rural)	36	0.05
B Roundabout (Rural)	32	0.05
Unclassified Roundabout (Rural)	32	0.05
Motorway Roundabout (Urban)	42	0.05
A Roundabout (Urban)	23	0.05
B Roundabout (Urban)	20	0.05
Unclassified Roundabout (Urban)	15	0.05
Motorway Roundabout (Metropolitan)	29	0.05
A Roundabout (Metropolitan)	14	0.05
B Roundabout (Metropolitan)	11	0.05
Unclassified Roundabout (Metropolitan)	8	0.05
Congested Motorway	80	0.08
A Dual Carriageway (Rural)	90	0.02
B Dual Carriageway (Rural)	80	0.02
Unclassified Dual Carriageway (Rural)	75	0.02
A Dual Carriageway (Urban)	60	0.10
B Dual Carriageway (Urban)	52	0.15
Unclassified Dual Carriageway (Urban)	46	0.15
A Dual Carriageway (Metropolitan)	40	0.15
B Dual Carriageway (Metropolitan)	30	0.20

Unclassified Dual Carriageway (Metropolitan)	25	0.20
A Dual Carriageway Toll (Rural)	105	0.20
B Dual Carriageway Toll (Rural)	95	0.20
Unclassified Dual Carriageway Toll (Rural)	80	0.20
A Dual Carriageway Toll (Urban)	70	1.00
B Dual Carriageway Toll (Urban)	58	1.00
Unclassified Dual Carriageway Toll (Urban)	46	1.00
A Dual Carriageway Toll (Metropolitan)	50	1.00
B Dual Carriageway Toll (Metropolitan)	41	1.00
Unclassified Dual Carriageway Toll (Metropolitan)	32	1.00
A Road in Congestion Zone	20	0.05
B Road in Congestion Zone	20	0.05
Unclassified Dual in Congestion Zone	20	0.05
A Road Bordering Congestion Zone	10	0.15
B Road Bordering Congestion Zone	10	0.15
Unclassified Road Bordering Congestion Zone	10	0.15
A Dual Carriageway in Congestion Zone	20	0.05
B Dual Carriageway in Congestion Zone	20	0.05
Unclassified Dual Carriageway in Congestion Zone	20	0.05
A Dual Carriageway Bordering Congestion Zone	10	0.15
B Dual Carriageway Bordering Congestion Zone	10	0.15
Unclassified Dual Carriageway Bordering Congestion Zone	10	0.15