OFFICE OF FAIR TRADING

Anticipated acquisition of the online DVD rental subscription business of Amazon Inc. by LOVEFiLM International Limited

ME/3534/08

The OFT's decision on reference under section 33(1) given on 15 April 2008. Full text of decision published on 8 May 2008.

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

PARTIES

1. **LOVEFiLM International Limited** (LF) is a European online DVD and games rental subscription service with operations in the UK, Germany, Sweden, Norway and Denmark. In the UK, LF offers its services through its website www.lovefilm.com and through a number of 'white label' contractual arrangements with other companies. Under these arrangements, LF fulfils its white label customers' online DVD rental orders using its DVD library and back-office systems and re-brands the LF DVD packaging with the company's brand (although the white label customer's website and/or the DVD packaging may still say 'Powered by LOVEFiLM'). In addition to DVD rental, LF also offers its members downloading to rent (DTR) and downloading to own services (DTO) via its website. LF started to offer DTR services in December 2005 and DTO services in April 2006. In the year ending 31 December 2007, LF achieved sales of £49 million, of which £41 million was in the UK.

2. **Amazon Inc.** (Amazon) is an online retailer of a wide range of products including books, toys and DVDs. Amazon operates a global business with websites in the US, Canada, Japan, China, France, Germany and the UK, and is listed on the US NASDAQ stock exchange. For the purpose of the anticipated transaction (the transaction), LF will acquire Amazon's online DVD rental (ODR) subscription service which operates in the UK and Germany (the Target Business). Amazon

operates the UK part of the Target Business via its UK website www.amazon.co.uk. In the year ending 31 December 2007, the Target Business achieved UK sales of US$17.5 million (approximately £9 million).

TRANSACTION

3. LF will acquire from Amazon the Target Business, together with £ [...] million in cash (plus pre-paid subscriptions) and certain marketing commitments by Amazon in return for granting to Amazon a [...] per cent fully-diluted shareholding in LF.

4. The parties submitted an informal merger notification on 18 February 2008. The OFT's administrative deadline expired on 15 April 2008.

JURISDICTION

5. The transaction qualifies as a relevant merger situation on the share of supply test under Section 23(3) of the Enterprise Act 2002 (the Act) as the parties' combined share of supply in the UK for online DVD rental services exceeds the 25 per cent threshold.

6. 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.

BACKGROUND

7. As a result of the transaction, the parties' main overlap in the UK relates to the provision of ODR services. The provision of ODR services is a recent development in the UK, with providers first operating around 2004.

8. **ODR providers** typically offer subscription services whereby customers pay a fixed monthly fee which entitles them to receive through the post DVDs which they have selected online in advance from a wide range of titles. The number of DVDs a customer receives is determined by the maximum number permitted by the package chosen and the speed with which customers watch and return rented DVDs. Certain ODR providers (Easy Cinema and LF), also offer pay-as-you-go facilities which follow the above model but, instead of paying a monthly subscription fee, customers purchase credits (similar to mobile phone pay-as-you-go tariffs) which they can top up. For both types of ODR, once the customer has watched a DVD, the customer posts the DVD back to the ODR supplier in a pre-paid envelope whereupon the ODR supplier sends the next available DVD on the

customer's list. Customers have no time limits imposed within which they must return the DVD and, accordingly, no late fees are incurred.

9. ODR is only one of a large number of channels by which consumers can access film and TV video content. The other key channels at present include:

- **Bricks and mortar rental:** the traditional DVD rental channel in which customers pay a set fee per disc to hire a DVD for a night and/or a slightly higher fee for hiring for a longer period. In this respect the structure of payments for bricks and mortar is different to that of ODR (payment per DVD versus monthly subscription or pay-as-you-go). Bricks and mortar packages are also offered to encourage customers to increase the number of rentals: for example, Blockbuster (BB) has offered a number of volume-rental packages (such as three rentals for the price of two) across all of its stores nationwide. BB currently operates the most significant bricks and mortar rental chain with approximately 779 stores in the UK,[1] accounting for over two thirds of bricks and mortar rental transactions. Individual bricks and mortar stores traditionally do not offer a back catalogue (i.e. DVDs that are not recent releases) on the scale of ODR providers.

- **DVD Retail:** consumers can purchase DVDs from a number of alternative retail channels, including generalists such as Woolworths and WHSmith; specialist stores such as HMV and Zavvi (formerly Virgin); rental stores such as BB; supermarkets such as Tesco, Asda and Sainsbury's; and online retailers such as Amazon, Play and eBay. Despite recent price reductions in DVD retail, permanent purchases are still substantially more expensive on a per-unit basis than ODR and other rental but have the benefit of permanent access to the content.

- **Pay per view (PPV):** dedicated television channels show films at scheduled intervals that consumers can pay for in addition to the television subscription packages of which PPV channels are a part. With PPV the film is shown at the same time to everyone ordering it, as opposed to video on demand (VOD) systems, which allow viewers to see the event at an individual time of their choosing. For example, with Sky's 'Box Office' PPV service (available only to Sky subscribers) customers can watch a film for £3.95. Traditionally the number of films on offer at any time is small compared to ODR, and access is on a one-off basis (i.e. PPV films do not tend to be re-broadcast after their initial PPV broadcast period) but has the advantage of convenience inasmuch as consumers do not need actively to search and select titles in the way required by ODR or bricks and mortar rental.

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[1] This number takes into account the recent acquisition of 59 stores from Choices UK.

- **Specialist film channels,** where consumers can subscribe to basic and premium channel packages from cable operators (e.g. Virgin Media), satellite providers (e.g. Sky), telephone companies using cable or IPTV (e.g. BT and Tiscali), and other multi-channel distributors through monthly subscription packages (e.g. Top-UP-TV on the Freeview platform). Sky has over 8.3 million subscribers in the UK[2] while Virgin Media has approximately 3.2 million subscribers.[3] Choice is relatively limited and titles are usually available to consumers later than they are available to buy or rent but, like PPV, specialist film channels have convenience advantages.

- **Video on demand services (VOD):** VOD operates through a computer server and enables viewers to access content at any time from a pre-determined list of films and TV programmes. Unlike PPV, VOD allows consumers to watch a film/TV programme at an individual time of their choosing. VOD systems either 'stream' content, allowing viewing in real time, or 'download' it, in which case the programme is transmitted in its entirety to a set-top box before viewing starts. In the UK, Tiscali, Virgin Media and BT Vision (through its BT On Demand service) all offer VOD. Choice of back catalogue with VOD may be significantly restricted by comparison to ODR but titles can be purchased on a one-off basis rather than by subscription only.

- **Free to air TV:** traditionally, terrestrial free to air TV was limited to five channels. However, recently the number of households with Freeview boxes has increased to 14 million.[4] Via the one-off purchase of a set-top box, Freeview gives access to a further 40 free television channels, including Film4. Given free to air TV does not require subscription or incremental payment above the cost of the Freeview box, there is no incremental cost for each viewing of content but choice is relatively limited and titles are usually available to consumers later than they are available to buy or rent.

- **Internet download:** consumers can also gain access to films on their computers via the internet. There are many alternative providers, including Vizumi, Wippit, Apple, 4OD, Amazon, Sky Anytime,[5] Tiscali, LF and BT Vision. Once purchased, customers typically have 24 hours to view the programmes/films. In January 2008, Apple also announced that it is to revamp the film offering at its iTunes online store. The new service will see films available to download only 30 days after their DVD (rental and retail)

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2 See Sky Trading Statement for the half year ended 31 December 2007.
3 See Virgin Trading Statement for the quarter ended 30 September 2007.
4 See Freeview press release of 20 November 2007.
5 Unlike Sky PPV, consumers do not need to be Sky subscribers in order to access Sky Anytime online.

release, with new titles available for US$3.99 and back catalogue titles for US$2.99. Although technological systems are already in place (e.g. Apple TV) to transfer the content downloaded from a computer to a TV, these systems are still in their infancy and are expensive.[6] Notwithstanding this, there has been a considerable increase recently in the number of internet downloads that are being transferred from computers to mobile devices such as iPods or mobile phones.

MARKET DEFINITION

Product market

10. The OFT will generally seek to define the relevant market before proceeding to an evaluation of the strength of the competitive constraint within that market that is removed by a merger and the degree of competition (if any) presented by suppliers outside the market. The purpose of market definition is stated in paragraph 3.22 of the OFT's substantive assessment guidance for mergers:

    'Market definition focuses attention on the areas of overlap in the merging parties' activities. This is particularly the case in differentiated products markets where the parties' products or services may not be identical, but may still be substitutes for each other. In this context, the analytical discipline of market definition is helpful in identifying the extent of immediate competitive interaction between the parties' products. Once the overlap in the merging parties' products or services has been identified, along with the 'market' in which those products or service compete, the OFT can focus attention on the competitive assessment.'

11. In this case, the parties overlap in relation to the supply of ODR services. The OFT therefore considers whether ODR services could be said to form a separate relevant market or whether the appropriate market extends to encompass some or all of the other differentiated channels for accessing video content.

12. In order to assess competition between ODR and other delivery channels, the OFT relies in this case upon two surveys commissioned by the parties, carried out by TNS and analysed by OXERA, prior to notification of the merger to the OFT.

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[6] However, Apple has recently announced a reduction in the price of the Apple TV set top box in the US and an upgrade in software (free to existing owners) that allows downloads direct to the set-top box rather than via a computer.

13. The first survey, conducted during the course of November 2007 (Survey 1) canvassed the views of 1,000 respondents in an online survey of whom 501 respondents rented DVDs online. A second survey (Survey 2) was commissioned to extend the sample size, canvassing the views of 2,207 respondents of whom 1,500 respondents rented DVDs online.

14. To identify candidate product markets in this case, the OFT uses critical loss analysis. Critical loss analysis uses estimates of variable costs saved in response to an arbitrary loss of business to calculate how much business would have to be lost to render a 10 per cent price increase unprofitable—this is the 'critical loss'. If estimates of the actual loss of business in response to a 10 per cent price increase exceed this critical loss, then the market may be wider than the narrow candidate market considered (i.e. wider than ODR). In the OFT's critical loss analysis, estimates of variable costs saved are based upon LF's gross margins (i.e. sales less the direct cost of sales) and estimates of the actual loss of business come from the surveys.

15. In both Survey 1 and Survey 2, respondents were asked if they would switch away from their existing ODR provider following a 10 per cent price increase, and—if so—to which alternative channel they would switch. In Survey 1, [30 - 40] per cent of customers said that they would switch away from ODR. In Survey 2, [30-40] per cent of LF customers and [10-20] per cent of Amazon customers said that they would switch away from ODR. When the different numbers of LF and Amazon customers in Survey 2 are taken into account, these percentages are consistent with that from Survey 1.

16. According to these estimates, the actual loss of [30-40] per cent exceeds the critical loss implied by LF's gross margins ([20-30] per cent) but not by much. Consequently it would appear appropriate based on this evidence to draw the relevant market wider than just ODR but not much wider. However, given the various alternative means of accessing video content, and in the absence of a clear second choice of content-delivery channel suggested by the surveys, the OFT is not in a position to identify how much wider the market should be drawn.

17. In applying critical loss analysis, the OFT uses its standard approach of asking whether it would be profitable for a hypothetical monopolist of ODR to raise all ODR prices by a small but significant and non-transitory amount (an 'all price SSNIP'). However, post-merger LF and Amazon would have a combined market share (given BB's small share) essentially approaching a monopoly of the narrowest candidate market—ODR (see Table 1 below). Consequently, the merging parties in the present case are the hypothetical monopolist. In this regard, the parties indicate that according to Amazon's pre-condition to the sale, LF will

be required to offer the acquired Amazon subscribers their same existing rates and packages post-merger.

18. The OFT therefore considers that—in terms of market definition—it may be appropriate to ask in the present case whether it might be profitable for a hypothetical monopolist of ODR (i.e. LF plus Amazon) to raise LF's ODR prices by a small but significant and non-transitory amount (a 'one price SSNIP'). Using this 'one price SSNIP' version of the hypothetical monopolist test makes the critical loss in the OFT's analysis higher because the total loss in sales of the hypothetical monopolist is reduced when some sales divert between the products it has monopolized when only one of their prices is increased. In this case, based on LF's gross margins, the 'one price SSNIP' critical loss is [30-40] per cent.[7] Comparing the actual loss from the surveys ([30-40] per cent) to this higher 'one price SSNIP' critical loss ([30-40] per cent) suggests that it may be appropriate to define a market no wider than ODR given that the actual loss no longer exceeds the critical loss.

19. Ultimately, however, the OFT's closely-related assessment of market definition and competitive effects–both based on the relative closeness of competition between the parties and other suppliers of video content–considers the overall weight of all evidence at the OFT's disposal, and is not limited to a conclusion based simply on the evidence underpinning the critical loss analysis. Given the unusually strong evidence of constraints from suppliers not utilising the ODR business model to supply video content to consumers, and the unusually close relationship between market definition and the effects analysis in this case, it serves little purposes here to draw hard and fast conclusions on product market definition to frame the competitive assessment. It is clear that post-merger LF would enjoy a near monopoly on the provision of ODR in the UK. However, the critical question for the OFT's duty to refer is whether that raises a realistic prospect of a substantial lessening of competition leading to higher prices, reduced service or other presumed adverse effects on consumers. For the reasons set out below, the OFT does not believe this to be the case.

Geographic market

20. It is not in dispute that the relevant geographic market is UK-wide. In particular:

- both parties operate a national pricing structure with national advertising and a national website

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7 For details of the calculation used, see O. Daljord, L. Sorgard and O. Thomassen (2008) 'Making sense of market delineation with the aggregate diversion ratio', Journal of Competition Law and Economics, doi:10.1093/joclec/nhm032.

- there is no evidence of price discrimination by geographic area
- all ODR suppliers operate on a UK-wide basis, and
- customers cannot import services from other countries.

SHARES OF SUPPLY IN SEGMENTS WITHIN VIDEO CONTENT DELIVERY

21. Shares of supply for the merging parties and their competitors are given in Table 1 for a number of candidate market definitions. The shares in Table 1 are given on a volume basis (i.e. they refer to the quantity of films supplied but do not account for differences in price), given the OFT has reservations about the accuracy of market share estimates supplied by the parties on a value basis.

22. The table shows that in ODR-only the merged entity will have a combined share in excess of 92 per cent with an increment of 13 per cent. BB represents the third largest supplier of ODR, with a share of four per cent. In this candidate market, the parties submit that there are at least 12 alternative ODR providers such as BB, Cinema Paradiso and MyMovieStream. According to the table, however, these alternative ODR suppliers currently account for only a very small share of the candidate ODR-only market.

23. LF's market share includes sales through its white label customers, which account for approximately [20-30] per cent of LF's sales. The OFT considers that it is appropriate to include within LF's own share of supply the volume of sales accounted for by companies operating white label arrangements with LF. This reflects the fact that the underlying back-end service provided to customers is supplied by LF and the contractual arrangements between LF and its white label partners preclude them from determining their competitive offers independently of LF's. As such, white labels cannot be said to provide the same degree of constraint on LF as wholly-independent ODR providers.

24. On a wider candidate market that includes all DVD rentals (that is ODR plus bricks and mortar) the parties' combined market share is substantially lower, at 27 per cent with an increment of just under four per cent. BB has the largest share of this candidate market with 37 per cent.

25. Adding PPV rental to the wider all DVD rental market, the parties' combined market share amounts to some 25 per cent, also with an increment of less than four per cent. BB also has the largest share of this candidate market with 34 per cent.

26. On the widest plausible candidate market that includes ODR, bricks and mortar, PPV (rental and retail) and DVD retail, the parties' combined market share is nine per cent. In this candidate market, DVD retail is by far the largest segment, representing approximately 62 per cent of sales. BB accounts for approximately 12 per cent of sales in 2007.

Table 1: Shares of supply based on volume, 2006–07 (per cent)

	ODR		All DVD rental—ODR and bricks and mortar		All DVD rental and PPV		All DVD rental and PPV, and DVD retail	
	2006	**2007**	**2006**	**2007**	**2006**	**2007**	**2006**	**2007**
Lovefilm	77.9	79.7	17.6	23.2	16.5	21.4	6.9	7.7
Amazon (rental only)	12.3	12.9	2.8	3.8	2.6	3.5	1.1	1.2
LF/Amazon combined	*90.2*	*92.6*	*20.4*	*27.0*	*19.1*	*24.9*	8.0	8.9
Other ODR	1.5	3.0	0.3	0.9	0.3	0.8	0.1	0.3
BlockBuster	8.3	4.4	38.5	36.9	36.1	34.0	15.1	12.2
Choices			8.3	5.9	7.7	5.4	3.2	1.9
Global			4.0	1.3	3.8	1.2	1.6	0.4
Other video chains			2.5	2.3	2.3	2.2	1.0	0.8
Independent video stores			12.2	14.0	11.5	12.9	4.8	4.6
Libraries			6.8	5.5	6.4	5.1	2.7	1.8
Newsagents			1.2	0.9	1.1	0.8	0.5	0.3
Convenience/Supermarkets			4.8	3.3	4.5	3.0	1.9	1.1
Other bricks and mortar rental			1.0	2.1	1.0	2.0	0.4	0.7
PPV films					6.2	7.9	17.7	2.8
Retail – Music/Video specialists							8.8	16.4
Retail chains/multiples							17.6	9.5
Retail - Supermarkets							1.6	22.2
Retail - Mail order							9.7	1.5
Retail - Internet							2.5	12.0

Notes:

2006 shares of supply refer to the 48-week period from 2 January 2006 to 3 December 2006.
2007 shares of supply refer to the 48-week period from 4 December 2006 to 4 November 2007.
DVD rental and retail includes all genres (i.e., blockbusters, catalogue titles, TV, sport, etc).
PPV includes only films (i.e. no sports or special interest).

27. It is apparent from Table 1 that the combined share and increment for the merging parties is very sensitive to the candidate market adopted. As noted, it is therefore critical for the OFT to assess closely the competitive constraints placed on the

parties by delivery channels other than ODR providers. To that end, the OFT looks to assess the closeness of competition firstly between LF and Amazon and secondly between the parties and alternative delivery channels. For that purpose, the OFT has regard, in particular, to the survey evidence but also to a large volume of internal business documents provided by the parties to assess how closely, in the commercial realities of operating their ODR model, the parties take account of each other relative to other suppliers of video content to UK consumers.

PRESUMPTION OF UNILATERAL EFFECTS

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

28. Unilateral effects concerns can arise in differentiated markets, such as video content delivery, where the merger combines two close choices for a substantial proportion of customers, and the countervailing constraints are not sufficient to militate against the potential loss of competition. In particular, other choices of customers would need to offset the fact that the merged firm is likely to recoup sales lost when it raises the price—or reduces the non-price offer—of a customer's first choice, when it owns that customer's next-best choice. While customers may indeed (be able to) switch to third, fourth or more distant choices, there may, nevertheless, be latitude for the merged firm profitably to raise price or reduce non-price factors by a small but significant amount before this happens to any significant extent.

29. In order to assess the probability of a loss of competitive rivalry arising as a result of a merger, the OFT will, when available, examine two sources of evidence in seeking to arrive at an illustrative gauge to quantify the closeness of competition between merging firms and identify the change in incentives that the internalisation of this rivalry would bring post-merger:

   o *Gross margins* – The ability for firms to mark-up prices to a substantial degree over their cost of sales suggests to the OFT that the collective competitive pressure from rivals is relatively low (suggesting a narrower market) because otherwise price-sensitive 'marginal' customers of the firm would switch to these rivals and oblige the firm to lower its margins (lower prices or increase its non-price offer), as such, gross margins are a proxy for the degree of rivalry in absolute terms between all market participants *ex ante*, and,

   o *Diversion ratios between the merging parties* – The diversion ratio between the merging parties is the proportion of switching customers in response to a increased price/worsened non-price offer that would divert from one merging party to the other, a significant diversion ratio suggests relatively close competition between the parties that the merger would remove. It also suggests that the merged entity, having internalised this rivalry, would have the incentive to raise prices or worsen its non-price offer.

30. Accordingly, the combination of gross margin data and diversion ratios is a valuable measure of the change in incentives brought about by a merger. Due to the general probative value of this combination of evidence, the OFT applies a rebuttable presumption that a merger between firms with (i) high margins and (ii) significant diversion ratios between them raises a realistic prospect of a substantial lessening of competition through unilateral effects.

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

Rebuttable presumption of unilateral effects in this case

Gross margins

32. Generally, the OFT will view gross margins to be correctly estimated when all relevant and attributable costs of sales have been subtracted from net revenues. In this instance, the OFT considers it appropriate to include retention marketing within the category of direct costs of sales as well as collection costs, costs of exchanges, customer service and library expenses.

33. On this basis, LF's gross margins on ODR are [20-30] per cent for 2007. Amazon's gross margins on ODR in the UK and Germany are [30-40] per cent for the same period. The difference is almost entirely due to lower costs of retention marketing for Amazon customers when compared to LF customers on similar packages.

Diversion ratios

34. Diversion ratios from the parties to other ODR providers from Survey 2 are set out in Table 2.

Table 2: Diversion ratios to other ODR providers (per cent)

To	From LF	From Amazon
LF	-	[30-40]
Amazon	[0-10]	-
Blockbuster	[0-10]	[0-10]
Other	[0-10]	[0-10]
Don't know	[50-60]	[30-40]

Notes:

Diversion ratios do not sum to 100 per cent because Survey 2 also allowed diversion to non-ODR providers.

35. The table shows that of those customers who would switch away to other ODR providers from LF following a 10 per cent price increase, [0-10] per cent indicated that they would switch to Amazon, [0-10] per cent to BB and [0-10] per cent to all other ODR providers. Further, [50-60] per cent of customers indicated that they would switch to another ODR provider but did not know which one.

36. The table also shows that, of those customers who would switch away to other ODR providers from Amazon following a 10 per cent price increase, [30-40] per cent would switch to LF, [0-10] per cent to BB and [0-10] per cent to all other ODR retailers. Further, [30-40] per cent of customers indicated that they would switch to another ODR provider but did not know which one.

37. The high proportion of LF and Amazon customers who said they would switch to another ODR provider but did not know to which one is striking, and at odds with previous OFT experience of considering customer surveys of this type in merger control (the consistency between the 'actual' loss estimates discussed above derived from Survey 1 and Survey 2 give some comfort that these results are not an artefact of the design of Survey 2.) In customer surveys of this type, it is usual to pro rate the (much smaller) proportion of 'don't knows' according to the diversion ratios of those who 'did know'. This operation results in the diversion ratios represented in Table 3 below.

Table 3: Diversion ratios to other ODR providers apportioning 'don't knows' (per cent)

To	From LF	From Amazon
LF	-	[70-80]
Amazon	[30-40]	-
Blockbuster	[30-40]	[0-10]
Other	[0-10]	[0-10]

Notes:

Diversion ratios do not sum to 100 per cent because Survey 2 also allowed diversion to non-ODR providers.

38. The table shows that of those customers who would switch away to other ODR providers from LF following a 10 per cent price increase and did know to which other ODR provider they would switch, [30-40] per cent indicated that they would switch to Amazon, [30-40] per cent to BB and [0-10] per cent to all other ODR providers. The table also shows that of those customers who would switch away from Amazon to other ODR providers following a 10 per cent price increase and did know to which other ODR providers they would switch, [70-80] per cent would switch to LF, [0-10] per cent to BB and [0-10] per cent to all other ODR retailers.

39. In this regard, the parties submit that pro-rating such a substantial proportion of customers may significantly affect the results, and could perhaps lead to an overestimation of diversion ratios between the parties. However, the parties were unable to quantify this effect or demonstrate why it should result in an overestimation rather than an underestimation of diversion between the parties.

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

40. In its report on the acquisition by Somerfield of 115 supermarkets from Wm Morrison,[8] the CC combined gross margins and diversion ratios in a formula to give 'illustrative price increases', which it essentially interpreted as an index of the extent to which a loss of rivalry gives incentives post-merger to increase price or equivalently worsen non-price factors. Adopting the CC's nomenclature, Table 4 gives the 'illustrative price increases' for LF and Amazon using the four diversion ratios in Tables 2 and 3 and the gross margins presented above.

Table 4: Illustrative price increases for LF and Amazon given different diversion ratios and gross margins (per cent)

Diversion of…	LF	Amazon
LF to Amazon of [0-10] per cent	[0-10]	-
LF to Amazon of [30-40] per cent	[0-10]	-
Amazon to LF of [30-40] per cent	-	[0-10]
Amazon to LF of [70-80] per cent	-	[40-50]

Notes:

Calculated on the basis of symmetric, single-good differentiated Bertrand competition with linear demand and no brand re-positioning post-merger.

Calculated on the basis that LF's gross margin is [20-30] per cent and Amazon's is [30-40] per cent.

8 Somerfield plc / Wm Morrison Supermarkets plc: A report on the acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc, 2 September 2005.

Calculated as md/2(1-d) where m=gross margin and d=diversion ratio.

41. Taken at face value the illustrative price increases in Table 4 create a presumption of adverse unilateral effects as a result of the loss of rivalry between LF and Amazon following the merger, although three out of four illustrative price increases are under 10 per cent. In this regard, given LF will be required to offer the acquired Amazon subscribers the same existing rates and packages, it may be more appropriate to consider only LF's illustrative price increases of [0-10] per cent, [0-10] per cent, depending on the LF-Amazon diversion ratio used. In respect of these LF-Amazon diversion ratios, the OFT considers it appropriate to place more weight on the diversion ratios in Table 3 as the risk of arriving at a skewed picture by excluding all 'don't knows' from switching between the parties is significant.

42. It is therefore clear to the OFT that a presumption of unilateral effects is created in the circumstances of this case. The remainder of this decision therefore focuses on testing propositions that, together, rebut this presumption.

43. In summary, this presumption may be rebutted, by the OFT itself or by the parties, on the basis of evidence suggesting a contrary interpretation: for example, that the parties are not, in fact, close competitors pre-merger despite this evidence, or that other rivals are close third and fourth choices for diverting customers, or that countervailing constraints from supply-side responses (entry, expansion or repositioning) or buyer power would discipline away any such incentive to worsen the merged firm's offer post-merger.

44. The thrust of the parties' response, in summary was, firstly, that the above analysis significantly overstates the competitive constraints that the parties place on each other and secondly, that the merged entity will face competitive constraints from a range of current and future sources detailed below. The principal body of evidence relied upon to substantiate these arguments were presentations, reports, email exchanges and other documents internal to the parties and created in the ordinary course of business, which carry much greater probative weight than qualitative assertions of constraints provided in the context of an OFT investigation.

EVALUATION OF ARGUMENTS IN REBUTTAL

Amazon places a relatively weak constraint on LF pre-merger

45. The parties submit that in practice, Amazon places a weaker competitive constraint on LF than is suggested by the diversion ratios between them.

46. In support of this, LF supplied, among other documents, monthly board reports from July 2006 to February 2008. Each monthly report contains an update on the competitive environment in the provision of video content services that records the activities of Amazon and a number of other providers. Taken as a whole, these documents suggest to the OFT that LF does not seem to monitor Amazon more closely than other providers. Indeed, these board reports even describe Amazon as less of a competitive threat than other video content providers.

47. In addition, the references made to Amazon in these documents always occur in the context of broader comments or comparisons relating to other providers of video content. In this respect, the OFT notes that these documents suggest that Amazon's competitive behaviour rarely appears to give LF cause for concern and, critically, that there is no evidence that LF has responded, for example, to an intensified period of Amazon marketing with a recorded change in any aspect of its price or non-price offer to customers, or indeed with a marketing response of its own. Indeed, the documents corroborate LF's arguments that it has not engaged in material promotion of its activities by reference to Amazon and that in turn, Amazon's marketing activity focuses on its own website, primarily promoting its service to existing Amazon retail customers.

48. Finally, the parties submit that whilst Amazon focuses on its existing customer base, LF actively competes with other ODR providers for marketing partnerships. The parties indicate that these third-party partnerships account for over 10 per cent of LF's sign-ups (excluding white label), in relation to which Amazon does not provide any competitive threat.

49. The above evidence presents the closeness of competition between LF and Amazon in a substantially, if not wholly, different light and suggests that the diversion ratio analysis overemphasizes the closeness of competition between the parties before and absent the merger.

50. The evidence presented in the next section further suggests that LF reviews, anticipates and addresses the actions of other ODR providers with at least the same (if not more) effort than it does for Amazon.

LF will continue to face a degree of constraint from rival ODR providers other than Amazon

51. The parties submit that LF actively competes with other ODR providers and notably with BB and MyMovieStream.

52. Several of the board reports suggest that LF is concerned by BB's ODR activity and in particular about its Total Access strategy in the US:[9] '*[...]*'. In the light of this, the parties argue that the combination of online and offline DVD rental in the Total Access strategy demonstrates that online and offline DVD rental are substitutes in an overall rental proposition.

53. As an illustration of a tactical response by LF to the competitive threat from BB, the parties provide an internal LF email exchange announcing the launch of a new marketing scheme developed by BB and the need to pre-emptively react by organising a similar scheme first: '*[...].*'

54. Additionally, the parties provide a number of internal emails indicating that LF actively competes with BB and MyMovieStream for marketing partnerships, for example:

- unsuccessful negotiations with [...] in relation to a marketing partnership which in the end, was lost to [...],
- competition with [...] for a partnership with [...],
- negotiation (run in competition with [...]) with [...] to replace [...] as a rental partner on [...]. In this instance, the parties mention that, prior to starting negotiating with [...], LF had to trade-off working with a potential competitor against leaving the opportunity for [...] to access a potentially valuable marketing partner.

55. On the basis of the documentary evidence summarised above, ODR providers other than Amazon appear to place current competitive pressure on LF, including the threat of expansion by means of marketing partnerships with third parties.

LF's competitive monitoring suggests it considers non-ODR rivals to be at least as close competitors as Amazon and other ODR providers

56. In LF's monthly board reports, the OFT notes that—in addition to other ODR providers—LF recurrently monitors the changes in strategy, new marketing activities, new product launches and price changes of a number of other players such as Sky, Virgin, BT and VOD providers. LF's monitoring of these activities is often followed in the board reports by a comment about their likely impact on LF.

57. Additionally, the parties point to recent (2006-2008) internal emails discussing marketing presentations on the consumer propositions of a broad range of non-

[9] Online customers are permitted to drop off their watched DVDs in-store and exchange them on the spot for new DVDs rather than waiting for new DVDs to be sent by mail.

ODR providers (bricks and mortar rental, Sky, BT, AOL, other VOD providers) and assessing these propositions against LF's customer offer.

58. The parties further point to a December 2005 report on brand communication strategy produced at LF's request by Albion. The report says that '*content is increasingly accessed via a new variety of platforms – consumers are constantly presented with new modes and models of access and a wide variety of brands (including all sorts of delivery channels) is jostling for position*'. The report reviews the different strategies used by the main video content providers to promote their brands (e.g. Sky, Freeview, downloading) and suggests, in the light of these, improvements that LF could make to increase its brand awareness and to better respond to the marketing of these other video content delivery channels.

59. Other pieces of internal correspondence provided by the parties further indicate that LF examines the advertising strategies of other video content providers. Examples include pay TV providers and detailed descriptions of the number of campaigns, media used, most likely buying audience, and expenditure for BB's bricks and mortar DVD rental business. This internal correspondence also reviews major marketing actions by other video content providers (e.g. the appointment of a new media agency by BB).

60. Furthermore, the OFT notes that in May 2006, LF commissioned its media agency M2M to track the marketing spend and the activity of a wide range of operators (Amazon, BB, Sky, Channel 4, NTL, Telewest, Turner Broadcasting) over 2005 and 2006. The parties provided the data compiled by M2M in this respect, in addition to an email from M2M to LF, referring to Sky and other video content providers as competing with LF but as being capable of investing substantially more in their marketing strategies than LF.

61. Finally, the internal documents show that LF's Chief Marketing Officer regularly requests '*full reviews of the competitive activity of all players competing for LF's customers' eyeballs*', including ODR and non-ODR video content providers, in particular Sky.

62. On the basis of the above, the OFT considers that LF monitors non-ODR video content providers on a consistent and substantial basis.

LF's internal documents suggests it reacts to the actions of non-ODR rivals

63. The parties submit that, in addition to consistent and substantial monitoring of non-ODR video content providers, LF also reacts to their initiatives. In this regard, the parties put forward the following arguments:

LF's day-to-day operations take place in the context of a wider video content market

64. Internal documentation indicates that LF's day-to-day operations take place in the context of a wider video content market, including not only ODR providers but also alternative delivery channels. By way of example, the parties refer to an email from [...] advising in the context of [...] discussions not to share information '*with a competitor such as [a non-ODR provider]*'.

65. In addition, the parties point to another internal email reporting LF's plan to run an advertisement expressly targeting [two non-ODR providers'] customers. The parties explain that such a plan was finally aborted as LF considered attacking [one non-ODR provider] head on to be too risky.

66. Furthermore, LF's response to a recent Ofcom investigation into the impact of a new VOD consumer proposition confirms its approach towards the various alternative channels active in the sector.[10]

67. Finally, the parties indicate that the company's third-party sales agency, Unanimis, is not permitted to sell LF advertising inventory to any satellite or cable broadcasters, any DVD rental/retailers, or any VOD or download providers. More specifically, the parties provided an exclusion list agreed upon by LF and Unanimis referring in particular to [seven non-ODR providers] on the basis that these are considered to be direct competitors to LF.

LF takes actions aimed at addressing the competitive constraint imposed by non-ODR providers

68. The parties submit that LF's commercial and marketing strategy consists of taking actions to address the competitive constraints arising from a number of different alternative channels. In support, the parties provide several illustrations:

Commercial partnerships

69. The parties provide emails referring to several partnership agreements contemplated by LF in reaction to the competitive pressure posed by non-ODR video content providers, in particular:

- discussions with [a non-ODR provider] regarding the launch of a joint [...] offering, expressly envisaged in competition to [another non-ODR provider],

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[10] On this occasion LF explains to the regulator that '*we are essentially in the market competing against all other forms of home entertainment. [...]*'.

- discussions with [a non-ODR provider] to cooperate against the threat posed by the VOD segment, by building a link between LF's website and [the non-ODR provider], and
- discussions between [a non-ODR provider], LF and other commercial partners ([non-video content service delivery providers]) about tactical marketing actions to be taken against [another non-ODR provider's] competitive threat.

New price packages

70. The parties submit that LF's Capped Packages were launched in November 2006 in response to consumer offers made by bricks and mortar DVD rental. In particular, LF's £9.99 unlimited offer at the time appealed only to customers wanting to watch a relatively large number of films per month, in particular meaning it was competitive against bricks and mortar DVD rental prices only for customers renting more than three DVDs per month.

71. Similarly, the parties submit that LF's pay-as-you-go (PAYG) offer, by which customers can rent less than one DVD per month, was launched to attract more casual renters and to compete more effectively with bricks and mortar DVD rental and retail. In this respect, the parties point to an internal email reporting a discussion on how to set PAYG prices in relation to services offered by other video content providers. In addition, the parties provide a draft business plan that was presented to LF's board, which reports on the progress made in developing PAYG. The presentation reports the results of a survey of PPV customers and DVD renters (both bricks and mortar and ODR) carried out in advance of launching PAYG.

Win-back flyers specifically targeted against Sky and cable TV

72. The parties provide copies of win-back flyers on which LF specifically compares its product offering with that of Sky and cable TV: 'You can't get that from Sky or cable who offer limited choice, lengthy contracts and over-priced packages'.

The activities of non-ODR video content providers constrain LF's growth

Impact of TV advertising campaigns by non-ODR video content providers on LF's subscriptions

73. The parties further argue that companies who offer a range of services including PPV, subscription film and other TV channels, bricks and mortar DVD rental and DVD retail have a direct and tangible competitive impact on LF. To support their argument, the parties provide a competitor impact analysis carried out by marketing consultants OHAL, for the period from April to August 2007, showing

that the TV advertising campaigns of these non-ODR video content providers[11] had reduced LF's subscriptions by [0-1,000] per week during the five month period when compared to the same period in 2006.

74. In line with this, the parties submit that alternative delivery channels (e.g. bricks and mortar DVD rental and VOD providers) address the competitive constraint posed by ODR providers. Examples provided by the parties of direct competitive activity which would act to constrain LF include:

[…] changing its pricing strategy

75. The parties argue that [a non-ODR provider] revised its pricing of back catalogue titles, with offers such as '[…]', reducing […] and promoting a £[…] per movie price point, a pricing point which LF identifies as focal.

[A non-ODR provider] targeting its advertising strategy at DVD supply

76. The parties also refer to […]'s promotion of its […] service as being 'like a DVD': '*[…]*.'

[A non-ODR provider] adopting a £[…] price point for its […]

77. […] recently introduced a £ […] price point for its […] service. LF notes in email correspondence that '*[…]*'.

Convergence in pricing across video content delivery channels

78. The parties further submit that the constraints placed on ODR by other content providers are evidenced by the convergence of the average price per film across the sector as a whole. Specifically, they argue that the average price paid per rental, which is directly monitored by LF, acts as a benchmark against which customers can measure the value of competing services. The parties submit that LF's prices are therefore set by reference to the average price per rental.

79. The parties point to the wide range of competing services that promote content at approximately £2 per film. For example: […] promotes its […] as being 'like a DVD' with prices starting from £2 (increasing to £3.50 for new releases), iTunes is offering film rental in the US at $2.99 to $3.99 and is expected to launch shortly in the UK at equivalent prices, and bricks and mortar DVD rental prices range from £2 to £4.

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[11] […].

80. In 2007, LF's price per rental was [over £1-3] but LF's own internal analysis demonstrates that to be as competitive in the UK with respect to bricks and mortar rental and DVD retail as Netflix is in the US, LF's price per rental would need to reduce to [less than £1-3]. The parties submit that LF's long run objective is to [...].

81. Considering the above, the OFT is satisfied that LF competitively reacts to the actions of non-ODR suppliers.

The nature of demand for ODR will continue to constrain LF post-merger

82. The parties submit that LF's customers are well informed and have a tendency to shop around easily, comparing product quality and prices. The parties submit that this is evidenced by the degree of customer churn in the ODR market, where LF currently loses approximately [0-10] per cent of its customer base every month through churn, or [...] per cent annually.

83. In addition, the parties submit that some [20-30] per cent of LF's new sign-ups come from either word of mouth or from refer a friend activities, where LF is dependent on its reputation as a means of winning customers, making it commercially irrational to lower service standards. Moreover, the widespread and growing impact of blogs and online discussion forums means that consumer dissatisfaction can be disseminated quickly and widely.

84. As an illustration of the importance of price and value propositions, the parties refer to LF's experience in Norway which, they argue, shows that a high price position in the provision of ODR services is not sustainable even where it is the sole ODR provider or even one of only a few. LF recently reduced prices by 25 per cent in Norway in order to improve its value proposition for customers and to be more competitive with other entertainment services. This has delivered an immediate and viable payback in terms of improved customer retention, on the order of [40-50] per cent according to the parties.

85. The significance of price and service quality factors is further highlighted by the parties via customer exit survey data. Of the [...] customers who responded to exit surveys in the period from July to December 2007, [20-40] per cent indicated that price or service issues were the primary reason for leaving the service (see Table 5).

Table 5: Reasons given for LF customer cancellations (July-Dec 2007)

Reason*	Per cent
Price	[10-20]
Service	[10-20]
Competition	[0-10]
Usage	[20-30]
Total 'Controllable'	**[50-60]**
Circumstances	[20-30]
Moving/holiday	[0-10]
Total uncontrollable	**[30-40]**
End of free trial	[0-10]
Other	[0-10]
Total	**100**

* Mutually exclusive responses.

86. In terms of service quality, LF provides board reports indicating that it has focussed significantly over the last 18 months on improving service quality in the UK and, as a consequence, has been able to reduce its customer churn.

87. Video content delivery services appear to be developing quickly. In this regard, the parties submit that many consumers currently do not understand how ODR works, and provide the conclusions from recent focus-group market research undertaken on LF's behalf by Sparkler suggesting that the great majority of non-LF members have no understanding '*of the brand or of the service offer*'. On this basis, the parties submit that ODR—rather than continuing to be a viable video content delivery service business model itself—is a way for LF to develop its brand, widen its customer base and improve its reputation with the aim of becoming a large scale platform and expanding its business into online video content delivery. The parties provide evidence that they are actively developing both bricks and mortar DVD retail and digital download services in an attempt to mitigate the loss of ODR sales to other channels. In that context, the parties argue that the longer-term implications associated with disappointing current ODR customers by lowering service quality or raising prices are dire.

88. Considering the above, the OFT believes that the nature of demand for ODR is likely to continue constraining LF post-merger.

FURTHER MITIGATING FACTORS

89. The OFT assesses below the various other types of countervailing constraints which the merged entity is likely to face post merger. To that end, the OFT considers, ranked by order of strength/likelihood, (i) the negotiating strength of commercial partners such as Tesco, (ii) the potential expansion of existing players such as BB, (iii) possible entry by non-ODR content providers with substantial

existing customer website traffic and a strong brand and (iv) possible *de novo* product entry into video content delivery.

Negotiating strength of commercial partners

90. The ability of the merged entity to raise prices may be constrained by the countervailing power of buyers. In this case, the parties have different categories of buyers at two different levels of the supply chain, namely, downstream customers and white label operators.

91. Given that the parties are downstream retailers and that their direct customers are all individual consumers, there is no scope for these individual customers to exercise buyer power.

92. However, the six current white label ODR providers (who are buyers insofar as they choose to contract with an ODR provider for distribution of the ODR service through their own retail platform) may have some degree of buyer power, as they account for approximately [10-30] per cent of LF's sales by volume and approximately [10-30] per cent of its sales by value.

93. Buyer power relies upon buyers having a choice of suppliers and/or the ability to sponsor new entry, and on the incentives of buyers to exert downward pressure on 'wholesale' prices in negotiations by virtue of the scale of their business with the parties.

94. There are alternative ODR suppliers capable of providing white label customers with a similar library (including back catalogue) to LF. These include BB, MyMovieStream and Cinema Paradiso. Further, the merger does not reduce the number of active providers for white label suppliers as Amazon does not provide such services at present.

95. In general, buyer power can be greater when a retailer is a supplier's competitor as well as its customer. For example, such a justification is often given for supermarkets' buyer power with respect to their suppliers of branded groceries, when the supermarkets also sell competing own-label products to these brands. In the present case, LF informed the OFT that—although their white label DVD packaging may be co-branded with the LOVEFiLM logo—the co-branding is minimal, and that its white label customers exert such 'customer/competitor' buyer power.

96. In this regard, the parties submit that [...], in the negotiation of its original white label contract with LF, prompted LF [to revise its offering]. The parties argue that [...]'s sales proposition meant that it would continue to constrain the level of the

prices LF charged customers for ODR services, regardless of the level of competition provided by other ODR suppliers.

97. The OFT notes, however, that LF appears to be able to charge more for its ODR services than [...] is charging for the equivalent service. This may suggest that the buyer power exerted by [...], which is reflected in the lower prices charged to [...] customers, does not act as a constraint on the prices that LF charges its customers.

98. Notwithstanding this, [...] currently accounts for approximately [10-20] per cent of LF's sales, and the parties submit that, going forward, [...]'s substantial customer website traffic makes it a valuable joint venture partner for LF in expanding ODR. Accordingly, the OFT considers that negotiations such as these will continue to act in an appreciable manner going forward to constrain LF's behaviour post-merger.

99. Consequently the OFT considers that buyer power from white label suppliers does represent a relevant additional constraint on the new entity post merger.

Expansion by existing ODR providers

100. The parties submit that, to date, BB has not invested heavily in growing its ODR service in the UK but has demonstrated that it has the capability to do so in the US market. In particular, BB's Total Access program was launched in the US as a way to use its stores and online facilities to re-establish a competitive advantage over its main US competitor, Netflix. This enabled BB to take substantial market share from Netflix in the ODR segment.[12]

101. It appears plausible to the OFT that the same strategy could be successful in the UK, not least in response to Amazon's exit. Alternatively, another operator such as MyMovieStream or Cinema Paradiso could acquire BB's customer base and use this as a platform for expansion. However, the OFT notes that BB has been active in ODR in the UK for some time and that, far from expanding, its share of ODR has fallen significantly between 2006 and 2007.

102. The parties submit that, despite its recent and small-scale entry, MyMovieStream has been able to match LF's stronger reputation, citing a recent *Which?* customer survey rating MyMovieStream as '*the UK's best online DVD rental service*'. In addition, the parties emphasize MyMovieStream's conclusion of a number of marketing agreements with well-known brands, for example The Sun, Egg, Mastercard, Grundig, and Ipoints.

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[12] Approximately 30 per cent.

103. On balance, however, the OFT has seen limited evidence to suggest that any of these smaller ODR providers would be capable of expanding, or be likely to expand, without such expansion being sponsored by a white label operator or another retailer with a substantial existing volume of customer website traffic.

Entry by non-ODR video content providers

104. During the course of its investigation the OFT was made aware of 12 instances of entry into ODR, 7 since 2005. On the basis of this, and evidence from the parties, the OFT considers that physical investment into DVD back-catalogue, technology and other upstream capabilities necessary to enter ODR are not insurmountable barriers to entry.

105. However, very few entrants have been able to develop and sustain much market share and, indeed, 17 firms have exited the market or been acquired since 2004. This is consistent with barriers to entry in the form of sunk customer acquisition and retention costs being high.

106. Marketing and free trial costs accounted for approximately [30-40] per cent of LF's total sales and [60-70] per cent of its gross margins in 2007, and [...].

107. Such apparently high sunk costs make *de novo* entry on a large scale unlikely, but would not impede entrants with substantial existing customer website traffic and a strong brand who would not have to invest in marketing and advertising to the same extent. As noted by the parties, Amazon provides an example of such entry, having developed a substantial share of ODR sales primarily via traffic on its existing non-ODR websites. However, the OFT notes that through this merger, Amazon has chosen to exit the market as an independent supplier of ODR services (albeit retaining a financial interest in the merged firm).

108. The parties also submit that potential entrants may include video content providers such as Sky and BT ([...]), as well as large-scale international ODR operators such as Netflix. Indeed, Netflix considered entering the UK ODR market in 2004, but decided instead to focus on US opportunities. However, the parties have not been able to identify any specific existing providers that are actually planning to enter ODR in the UK within the next two years.

109. Sponsored entry into this segment also appears possible. In particular, large white label operators with substantial customer website traffic such as Tesco could sponsor new ODR suppliers (or indeed existing small scale suppliers) to develop wholesale operations to supply them. Such a relationship would bring together the customer traffic necessary to negate the need for substantial investment in

marketing and advertising on the one hand, and on the other, the existing upstream architecture (that is DVD back-catalogue, technology and related capabilities) required to provide the ODR service.

110. The OFT notes in this respect that the contractual relationship between LF and its largest white label customer, Tesco, will expire in [...], after which Tesco would be free to sponsor a new entrant into ODR if it were dissatisfied with the proposition offered by LF. Although Tesco would appear well placed to sponsor a rival ODR provider to the merged entity given the sizeable volume of its internet customer base, the OFT has been provided with no evidence as to whether Tesco actually would be prepared to sponsor entry (or launch its own ODR service). That said, the OFT observes with interest a recent press report, which it has not confirmed with Tesco, that Tesco plans to move into digital downloads with Tesco Digital, a music and film digital download service to compete with Apple's iTunes and hmv.co.uk.[13]

Entry into the wider video content delivery sector

111. As discussed above, the parties are aware of developments in the wider video content delivery sector and are taking actions to address such developments. In addition, the parties note that LF is actively developing its strategy to take advantage of technological developments in the delivery of digital film content. This is consistent with the notion of entry into the wider video content delivery sector acting as a constraint on the parties. In this regard, the OFT has been made aware of the recent example of the introduction of Virgin's VOD service, which has a library of 500 film titles.

112. Further entry into the wider video content delivery sector is expected to take place in the form of Project Kangaroo. According to the parties, Project Kangaroo is a proposed joint venture between three free to air terrestrial TV broadcasters (Channel 4, ITV and the BBC) to launch an on-demand television service (including films). The service will initially only be available via a computer but is expected to eventually be extended to television.

113. Having regard to all of the above, the OFT is satisfied that the overall evidence on other mitigating factors corroborates the rebuttal evidence discussed above. The potential competitive response from white label customers such as Tesco appears in the OFT's judgment to be material, [...]. Further, these customers offer the most plausible, but by no means only, potential source of non-ODR entry via joint venture partnerships with those that could supply eyeballs (that is, web traffic, thus overcoming sunk marketing costs for a *de novo* online entrant). Entry from

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[13] See *The Daily Telegraph*, 15 April 2008, 'Tesco moves into digital downloads', page 1.

other sources, whilst ranked less likely in this instance, is still relevant to the OFT's overall judgment on the probability that the loss of rivalry caused by this merger is substantial.

THIRD PARTY VIEWS

114. In the course of its investigation, the OFT contacted numerous companies active in the provision of video content delivery services. None of them raised any concern in relation to the anticipated transaction.

115. However, the OFT received four unsolicited complaints from customers. All four identified concerns regarding the lack of consumer choice that could arise as a result of the merger, as well as potential service quality reductions for Amazon customers. One noted that other channels of video content do not offer viable alternatives for consumers.

ASSESSMENT

116. As a result of the transaction, the parties' main overlap in the UK relates to the provision of ODR services. According to a critical loss analysis, the relevant frame of reference may be wider than only ODR. However, given the various alternative means of accessing video content and in the absence of a clear second choice of content-delivery channel suggested by the analysis, the OFT does not conclude on a precise definition of how much wider than only ODR the relevant product market may be. The geographic market is UK-wide.

117. The parties' share of supply varies significantly according to which candidate product market is considered: from 92 per cent with a 13 per cent increment on the narrowest plausible candidate market (ODR only), to 8.9 per cent with a 1.2 per cent increment on the widest plausible candidate market (all DVD rental, PPV and DVD retail). The OFT therefore focuses on assessing the closeness of competition (i) between LF and Amazon directly, and (ii) between the parties and alternative delivery channels. To that end, the OFT relies in the first instance on quantitative analysis of customer survey evidence provided by the parties and then subsequently on a large volume of internal business documents provided by the parties.

118. The quantitative analysis gives an estimate of the loss of competitive rivalry likely to arise as a result of the merger on the basis of (i) the parties' gross margins and (ii) diversion ratios between them. The OFT's estimate of the loss of competitive rivalry in this instance suggests a rebuttable presumption that the merger causes a realistic prospect of a substantial lessening of competition, giving rise to adverse unilateral effects.

119. In rebutting this presumption, the parties have provided documentary evidence of a sufficiently high evidentiary standard, given its volume and consistency, to suggest that Amazon is just one of many competitors—both ODR and non-ODR—which LF consistently and substantially monitors and responds to. The documentary evidence suggests that Amazon is not a principal constraint upon LF among those many competitors.

120. Additionally, considering the nature of demand for ODR services and LF's high customer churn rate, the OFT appreciates the importance of price and value propositions in the provision of ODR services. Furthermore, the OFT takes into account the relative immaturity of the ODR segment. Finally, the OFT also gives credence to the argument that ODR is a way for LF to develop its brand, widen its customer base and improve its reputation, in order to become a large-scale platform for online video content delivery. For these different reasons, the OFT acknowledges that the merged entity is unlikely to have an interest in worsening consumer propositions post-merger.

121. Lastly, the OFT also finds as a result of its investigation that the merged entity is likely to face various types of countervailing constraints post-merger in the form of the negotiating strength of powerful commercial partners and the potential expansion of existing ODR providers. The OFT also considers to be credible the possibility of entry by non-ODR video content providers, with substantial existing customer website traffic and a strong brand—potentially in partnership with smaller existing ODR or other players.

122. Consequently, the OFT does not believe 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.

DECISION

123. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.