OFFICE OF FAIR TRADING

Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd

ME/3427/07

The OFT's decision on reference under section 22(1) given on 15 April 2008. Full text of decision published on 12 May 2008.

PARTIES

1. **Home Retail Group plc (HRG)** is the parent company of Homebase Limited (Homebase) and Argos Limited (Argos), both active in retail operations, and ARG Financial Services. Post-merger, Homebase operates a national chain of 338 home-enhancement and DIY stores.[1]

2. The acquired business comprises a portfolio of **27 leasehold properties** (**the Leasehold properties**) from **Focus (DIY) Ltd.** (**Focus**). The transaction also includes the transfer of over 750 employees pursuant to the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE). The OFT has confirmed that the aggregate UK turnover of the Leasehold properties in 2006 was over £71 million.

TRANSACTION

3. HRG completed the asset acquisition of the leasehold properties on 31 December 2007. The OFT examined this merger on its own initiative, following which the parties submitted a satisfactory notification on 3 December 2007 (including accurate turnover information). The extended statutory deadline expires on 17 June 2008.

[1] Argos Limited operates a catalogue showroom retail model with over 680 stores in the UK selling a large range of general merchandise, including DIY products such as hand and power tools, furniture and bathroom accessories.

JURISDICTION

4. The test for the OFT is that it should reach the required level of belief that it is or may be the case that a relevant merger situation has been created, that is, that two or more enterprises have ceased to be distinct and either the turnover test or share of supply test set out in the Enterprise Act 2002 (the Act) is met.

5. HRG argued that the Leasehold properties do not amount to an enterprise for the purposes of the Act. It described the Leasehold properties, at the point of sale, as 27 empty shells incapable of being carried on for gain or reward without stock, fittings or branding.

6. The transfer of physical assets alone may constitute an enterprise in some cases.[2] In this case, the OFT notes that immediately prior to this transaction, the Leasehold properties were trading and generating turnover from business activities very similar to and, indeed, claimed to be in competition with, those of the acquirer. This appears to the OFT to be representative of the activities of an enterprise and may also suggest that the locations carry some element of goodwill since customers for DIY/home enhancement products will inevitably have some expectation that such activities are carried on from the Leasehold properties. In addition, the OFT notes that the TUPE Regulations applies and some 750 employees have been transferred from Focus to HRG as a result of this transaction. In the OFT's view, the application of TUPE is a strong indicator in favour of a finding that an enterprise has been transferred.

7. Moreover, the OFT considers the substance of a transaction over its legal form. In this case the transfer of the leases (together with the goodwill attached to those particular locations) as well as the employees would enable HRG to carry on the same business activities from those premises with little interruption. Thus, the OFT believes that it is or may be the case that each Leasehold property, and the portfolio of 27 as a whole, forms an enterprise for the purposes of the Act.

8. The OFT accordingly believes that it is or may be the case that enterprises have ceased to be distinct and that the turnover test in section 23 of the Act is met. Therefore, a relevant merger situation under section 23 of the Act has been created.

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[2] See paragraph 2.8 of the OFT Mergers Substantive Assessment Guidance.

INTRODUCTION AND PRELIMINARY ISSUES

The national DIY sector

9. In its March 2008 report on the DIY sector, the independent market research company Mintel notes that '[t]he number of different major DIY specialists has declined over the years and for some time now the market has been concentrated in the hands of four major players', referring to the four national DIY sheds of B&Q, Homebase, Focus and Wickes.[3]

10. Mintel adds that the UK DIY market is 'highly mature [and] with limited opportunities for growth.'[4] It also notes that this growth constraint is forcing many of the leading players in the traditional DIY market, such as Homebase, to expand the range of products they sell to maintain sales growth, which in turn is bringing these players into competition with an increasingly wide array of retailers from supermarkets to department stores through to category specialists.[5]

11. Among the national DIY sheds, B&Q is the largest with a 56 per cent share of total DIY shed turnover of approximately £7 billion, followed by Homebase with 24 per cent and Focus and Wickes with around 10 per cent each. Of the approximately 1,000 stores that the national DIY sheds operate in the UK, Homebase's share of stores nationally is higher (32 per cent) than B&Q's (30 per cent) with Focus and Wickes at around 19 per cent, but the average size of B&Q stores is substantially larger (close to 77,000 sq ft) than that of Homebase (47,000 sq ft) or Focus and Wickes (each around 26,000 sq ft). Overall, B&Q has around 26 million sq ft of total retail floor space nationally, well ahead of the other major players.

The transaction and rationale

12. As indicated, this transaction involves the acquisition by one of the four national DIY chains, Homebase (with 311 DIY sheds pre-merger) of a relatively modest number of stores (27) from another of the four, Focus, whose planned remaining estate of 176 sheds will compete at national level with Homebase post-merger. This merger will not result in a reduction in the

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[3] DIY Review, Leisure Intelligence, March 2008, page 39.
[4] Mintel, DIY Retailing UK, Retail Intelligence, January 2008, page 41.
[5] Mintel, DIY Retailing UK, Retail Intelligence, January 2008, page 41.

number of chains of DIY sheds that operate at the national level, although Focus' rationalisation of its estate makes it smaller.

13. The acquisition of these 27 stores therefore takes place in the context of a programme of store disposals and closures by Focus; its stated rationale is that this programme will allow it to retain and concentrate on the more profitable aspects of the business and compete more effectively with the other DIY shed chains. HRG argued that Focus had been relatively less successful than rival DIY shed retailers in achieving sales and had therefore represented a relatively weak competitive constraint prior to the merger.

14. The data on turnover and number of stores which have been transferred from Focus to HRG suggests only a negligible impact on shares of supply under any reasonable consideration on a UK-wide basis, because the increment is too low. As such, the merger cannot be said to have a material impact and this rules out the need to conduct a detailed evaluation of competitive effects at national level. The remainder of this decision therefore focuses on a variety of issues relevant to the presence of local competition issues created by the merger.

Outline of substantive issues

15. Ultimately, as will become apparent, the OFT determined that a realistic prospect of a substantial lessening of local competition as a result of the merger arose only in the Woking area. In reaching this result, the OFT considered several substantive issues, the most significant of which may be summarised as follows.

    1) the degree of competitive constraint, individually or cumulatively, that retailers other than the three rival national DIY sheds, B&Q, Focus and Wickes, impose on Homebase (see **product market**)
    2) the extent to which the parties compete on locally-set or -adjusted rather than nationally-set parameters, and therefore how much local competition could be lost post-merger in a given area (see **geographic market**)
    3) the extent to which the answer to 2) should colour the weight given to various evidence ordinarily probative of close local competition between the parties (see **local unilateral effects**), and

4) the appropriate counterfactual to the acquisition of the Focus store at St. Albans, given that it raises concerns relative to pre-merger conditions (see **St. Albans counterfactual**).

16. These issues are considered in detail below.

PRODUCT MARKET: COMPETITION BETWEEN DIY RETAIL CHANNELS

17. Homebase stores and the acquired Focus properties are DIY shed sites from which a large range of home enhancement and DIY products are sold.

18. In addition to stocking the core DIY product categories (notably materials for repair and maintenance of the home, power tools, and building materials and equipment) the UK's DIY sheds also stock non-traditional categories of products such as household utensils, lighting, flooring, furniture, kitchens and bathrooms. These can generally be described as home improvement products. Within the retail proposition of DIY sheds, a distinction may be drawn between the hard end of the DIY market, referring to products and services closer to those supplied by builders' merchants (such as building materials in larger quantities with trade payment facilities), which attract mostly DIY enthusiasts and small traders, and the soft end of the DIY market pitched more towards home improvement and products and services attracting amateur and occasional DIY consumers.

19. HRG contends that the relevant market for this case is the wider DIY market whatever the nature of the retail channel. It argues that DIY and home enhancement products are distributed through a wide range of retail channels. These include:

- the four DIY shed players
- category specialists, such as garden centres, and bathroom, flooring, furniture and kitchen specialist retailers
- builders' merchants
- high street generalists, such as Robert Dyas and Wilkinson
- regional and local DIY or hardware suppliers of all descriptions, and
- others, increasingly including national supermarkets.

20. In HRG's view, the DIY market should also be viewed in light of the competitive constraints in individual product categories (for example kitchens),

because the DIY sheds, including Homebase, may face different competitive constraints within each specific category.

21. Based on the evidence before the OFT, it believes the narrowest candidate product market to be the DIY shed retail channel comprising the four national DIY players only. For the reasons given below, the OFT considers it is reasonable to assess this merger first on this narrowest candidate product market and then, if the merger may give rise to competition concerns on that basis, consider the strength of competition from other retail channels in that particular location.

22. HRG commissioned two empirical surveys of DIY shoppers in January and February 2008, respectively, to shed light on market definition and other issues derived from relevant customer preferences (see further, **Annex: Evidentiary Issues**). In line with their retail propositions, this empirical survey evidence suggested that the DIY sheds are closer competitors to each other than to any other type of retailer. However, even within the set of the four national shed chains, product positioning differentiates the players and the closeness of competition, all else equal, between them.

23. For example, Wickes is often described as being positioned at the hard end of the DIY retail spectrum, with Homebase and Focus at the soft end and with B&Q reaching across most, if not all, of the spectrum with its deep product range and large stores. Accordingly, it appears that in terms of their national retail offers, Homebase and Focus are closer competitors to each other than is either to Wickes, whereas B&Q is a close competitor to each of the three other players.

24. This general proposition is corroborated by an array of local evidence, including the January and the February surveys as well as market share data and independent market research commentaries. Assuming locally-adjusted parameters of competition (see **geographic market**, below), these factors suggest that the competitive constraint B&Q places upon any other DIY shed is particularly significant in those locations where it is present, typically with a store larger than that of local rival DIY sheds.

25. Outside the four national DIY sheds, other retail channels appear to constrain the four DIY sheds to a certain extent in some categories. In the February survey, around 20 per cent in aggregate of Focus and Homebase DIY customers replied that other retail channels would be their second choice for

DIY shopping. On a category-by-category basis,[6] around 2 per cent of Focus and Homebase customers in each category stated they would use other such retail channels. These results are consistent[7] with figures from the January survey and from recent independent market research reports.[8]

26. There may be limits on the constraint provided by other retail channels on a hypothetical monopolist of DIY sheds either nationally or locally (the issue of national versus local competition is detailed in **geographic market**, below):

- Firstly, assuming the monopolist sets some competitive variables such as prices at the national level, nationally-active retailers stocking DIY products may not sufficiently constrain the monopolist, if the geographic distribution of their chain of outlets does not overlap closely enough to prompt the monopolist to take them into account.[9]
- Secondly, assuming the monopolist sets some competitive variables at the local level, those retail channels would need to be present in the same locations to impose a constraint.
- Thirdly, whether the variables are set at the national or local level, a hypothetical DIY shed monopolist would not be constrained from say, a SSNIP in product categories not covered by those other retail channels: for example, competition in bathrooms from non-DIY retailers will not constrain prices of DIY tools in the DIY shed.

27. Critical loss analysis allowed the OFT to measure the constraints on DIY sheds from outside the set of four national players. Critical loss analysis uses

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6 That is, regional DIY chains, national category specialists, supermarkets, builders' merchants, local DIY/hardware stores and garden centres.

7 The January survey shows a similar significant distance between the national DIY sheds and other distribution channels. The main difference relates to Wilkinson, which is considered in Mintel's 'DIY Retailing-UK, January 2008' to rival other high street retailers such as Woolworths and department stores. [ ] per cent of respondents identified this high street retailer as an alternative to DIY sheds. It is interesting to note that Wickes' presence in the January survey is minimal ([ ] per cent), which may be a product of the survey having been conducted in high street locations. Local builders' merchants and category specialist stores appear more often (though not substantially) than in the February survey ([ ] per cent as opposed to [ ] per cent). B&Q ([ ] per cent), Homebase ([ ]per cent) and Focus ([ ] per cent) were the most frequently mentioned DIY retailers.

8 UK DIY & Gardening Retailers 2007, Verdict, October 2007 notes that while non-specialists remain a threat to DIY and gardening specialists, these are 'better placed than many other retail sectors to repel the attack' (page 19). Verdict notes that while high street retailers (such as Wilkinson) have gained market share in DIY, however, 'their largely high street portfolio of stores are unsuitable for the retailing of many core DIY categories such as building materials and kitchens and bathrooms'.

9 For further details on this issue, see the OFT's submissions to the CAT in *Celesio v OFT*, 2006 CAT 9, in relation to national competition between the Boots and Alliance Unichem pharmacy chains.

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 (i.e. wider than DIY sheds only). In the OFT's critical loss analysis, estimates of variable costs saved were based upon the gross margins by DIY product category of the Focus stores, obtained from their management accounts, and estimates of the actual loss of business by DIY product category came from the February survey.

28. In the 12 areas covered by the February survey, the OFT's critical loss analysis indicates that only in two areas, Bodmin and Towcester, was a market definition wider than DIY sheds only justified across all of the main DIY product categories. That is, in the other areas, the other retail channels could not be relied upon to provide a constraint across all categories without some further examination of local market conditions. The OFT's area-by-area analysis therefore starts by analysing competition between DIY sheds, and if any loss of competition between DIY sheds is found, constraints provided by other retail channels are examined on a category-by-category basis. In practice in this case, in only one area, Bodmin, did the constraint from one or more competitors other than one of the four national DIY shed chains play a material role in the result of the competitive effects analysis, and that competitor was a regional chain of DIY sheds.

29. Consequently, the most appropriate candidate product market in this case does appear limited to the retail channel of overlap, that is, the supply of DIY and home enhancement products by DIY sheds. At least for the assessment of local competitive effects, this would include any local stores of B&Q, Focus (retained by Focus), Wickes and, where applicable, other DIY sheds (such as Trago Mills) belonging to a sub-national player.

30. At the same time, as OFT Guidance states, market definition need not be determinative in merger control, and frequently is not, especially when the merging parties' products are differentiated. Cognisant of the binary fallacy, the OFT would not treat each unit of competition (for example, each fascia or percentage point of market share) from within the market as an equal competitive constraint on all other units within the market but discount all units of competition outside the candidate market as having no competitive

effect at all.[10] Instead, the OFT gives less but nonetheless appropriate weight to competition from other retail channels outside this candidate market where circumstances justify it, just as within the DIY shed market it appears that not all rivals should be assumed to impose the same degree of competitive constraint on each other.

GEOGRAPHIC MARKET: DIY SHED COMPETITION AT THE NATIONAL AND LOCAL LEVELS

31. This merger involves the transfer of retail outlet sites from one national chain, Focus, to a competing one, Homebase. Mergers involving national chains of retail outlets across the UK raise the specific issue of the extent to which price and non-price parameters of competition are set by suppliers at the national as opposed to the local–or perhaps regional–level. This assessment is conducted by the OFT on a parameter-by-parameter basis to the extent possible, though complexities arise in adopting an exhaustive approach (see below).

Parameters of retail competition

32. The OFT's merger experience of retail markets, supplemented by the work of the CC in, for example, the groceries market investigation, suggests that suppliers often compete for customers with a complex retail proposition that, beyond the convenience of store location itself, might include such in-store parameters of competition such as:

    - pricing set individually at the level of the retail outlet or, alternatively, pricing set at the (national) chain level but with local flexing, such as store-level discounts, including local price-matching policies or promotions, such as stock clearances
    - product range and in-store product availability, driven by frequency of restocking of out-of-stock items, or special-order items
    - product quality, most notably for perishable or retailer-label products
    - service quality, such as the quality of pre-sales service and number of store staff (affecting expertise of advice given, waiting times at checkout)
    - after-sales service, such as return or exchange policies, maintenance and repair terms
    - product or service innovations in-store, such as free samples, product

[10] See also OFT report to the Secretary of State, Acquisition by BSkyB of 17.9 shareholding in ITV plc, 27 April 2007.

demonstrations, and so forth and

- other factors to which customers may attach significant value in the retail experience, such as store layout, ambience (affected, for example, by frequency of refurbishment and repair, and cleanliness) and the quality of ancillary amenities (for example, parking, café, toilets).

33. The value consumers attach to these various aspects of the retail offer may of course vary across markets and across consumers. For example, making (say) a 15-minute roundtrip to an outlet only to discover the sought-for item is out of stock may be regarded by a consumer as a greater detriment in terms of lost time than is paying (say) over five per cent more for that product in stock. Moreover, depending on the nature of the visit and the duration of the customer's time in the outlet (compare, for example, a cinema visit to a pharmacy visit), elements such as dedicated parking and store environment may take on more or less significance.

34. In the following, price, quality, range and service will on occasion be abbreviated as PQRS following the CC in Somerfield/Morrisons.

OFT's starting assumptions about competition between local stores that are each part of national UK retail chains

35. In assessing the geographic ambit of competition in order to examine the impact of a merger involving national retail chains, geographic market definition is the first step.

36. The hypothetical monopolist test starts from the demand-side perspective and typically considers the narrowest conceivable geographic market within which to assess the merger. It then inquires whether customers, in response to a SSNIP or an equivalent worsening of non-price factors such as quality, range or service, would switch to suppliers outside the candidate geographic market to render the SSNIP(QRS) unprofitable, applying an iterative approach to gradually widen the market.

37. From the demand-side perspective, consumers shopping in retail outlets obviously do so locally, within a given travel time from their place of residence or work. In doing so, they experience choice and competition between suppliers as a local choice between the options within the catchment area of those outlets, with the geographic size of those catchments varying according to the nature and frequency of the shopping trip. Notwithstanding this

variation, geographic markets in local retail considered by the OFT have typically been expressed as no further than a few miles (one, three, five or 10 miles), or a short drive-time (five, 10, 15 or 20 minutes).

38. Consistent with a demand-side focus of the narrowest conceivable geographic market, the OFT's strong starting assumption for consumer goods and services markets has therefore been—and will continue to be—that there will be material local competition across the relevant area to attract and retain customers, even if not on every parameter of PQRS. In some cases, overall competition is very heavily weighted to locally-adjusted factors: for example, in the OFT's numerous merger investigations in the cinemas sector, it was generally uncontested, based on price-concentration analysis and a host of other evidence, that suppliers set ticket prices and other competitive variables to account for local competition, as well as demographics, on a cinema-by-cinema basis.[11]

39. Substantial local retail competition need not, however, preclude material or greater competition at the national level in various respects. A binary approach to defining the geographic market as entirely local or entirely national may unduly simplify the way in which rival national retail chains compete. For example, notwithstanding that, in a sense, retail outlets sell locally (because the purchase mostly requires a physical visit to the outlet) much advertising and brand positioning of national chains might occur at the national level. Common prices or service standards may also be set centrally for the entire chain, to ensure consumers experience a consistent retail proposition and maintain brand equity, especially given the relative homogeneity of an online retail proposition. Indeed, online competition from third parties, which is available in every locality (internet penetration levels and variation in shipping costs aside) could in principle also have a standardising effect on the PQRS offers of retail outlets and move at least some parameters of competition, such as pricing, to a national proposition.

40. The most recent and comprehensive examination of local versus national competition in an industry with national retail chains is the CC's market

[11] See Anticipated acquisition by CineWorld Group plc of the cinema business operating at the Hollywood Green Leisure Park, Wood Green, OFT decision of 17 March 2008; Anticipated acquisition by Terra Firma Investments (GP) 2 Ltd of United Cinemas International (UK) Limited and Cinema International Corporation (UK) Limited, OFT decision of 10 January 2005; Completed acquisition by the Blackstone Group of UGC Cinemas Holdings Limited, OFT decision of 27 April 2005; and, Completed acquisition by Vue Entertainment Holdings (UK) Limited of A3 Cinema Limited, CC report of 24 February 2006.

investigation of UK grocery retailing. The CC found that substantial grocery retailing competition by national chains occurs at national level. At the same time, it determined from econometric margin-concentration analysis that increasing the number of local competitors from zero (a local monopolist) drives down individual store margins in a given location, reflecting the fact that at store level it becomes more costly to acquire and retain customers when those customers can turn to other local rivals instead. Even if the national pricing policies of some retailers were to preclude the lowering of prices to gain customers locally, stores could invest more in product quality and range, staff service, refurbishments and so forth in reacting to local competition, therefore incurring higher costs and driving down margins but improving the shopping experience for customers.

41. This is consistent with the OFT's standing intuition, derived from experience, that when a rival enters a local market and steals customers and therefore profits from an incumbent, it would not appear, as a general matter, for it be profitable for the incumbent store's management to devise no strategy to adapt to that local rival. Inaction and passivity by the incumbent management would fail to arrest and potentially reverse declining profitability. Even if local management were not to be authorised to deviate from centrally-set chain-wide pricing (for example, were local management unable to discount to match a confirmed lower local price from a rival) the OFT assumes it would profitable, in the face of new local competition, to make that store's retail proposition more attractive to customers on other fronts, relative to taking no action: for example, a store refit or refurbishment, expansion to increase product range, greater staff service training, and so forth. The OFT further assumes that local management's performance would be judged and remunerated based on its ability to respond to a competitive situation and improve the store's bottom line.

42. In this case, the general approach underlying the OFT's presumption of local competition is corroborated in the DIY sector by Focus' own price-matching policy which covers a radius of up to five miles around its own stores. B&Q also recently advertised a 10 per cent discount promotion within the M25.

Homebase's arguments that this merger does not give rise to adverse effects locally, because the only relevant–and unaffected–competition is at the national level

43. Notwithstanding the apparent local competitive interactions in which other

DIY sheds such as Focus and B&Q engage, HRG submitted that this merger should be considered exclusively on a national basis where, as described above, no OFT concerns arise.

44. HRG argued that the only relevant issue is the impact on Homebase's pricing and other competitive non-pricing decisions, because the issue under a unilateral effects theory is whether the **acquirer**–as the merged firm–would raise price or reduce its non-price offer post-merger. As for Homebase itself, HRG argued that its competitive conduct across all relevant parameters is determined at the national level and the acquisition of the Leasehold properties does not change Homebase's incentive to do so, given the 27 Leasehold properties will contribute less than one per cent to its national revenue. (As noted, the OFT does not believe the merger will impact national competition and therefore excludes a theory of harm based on a shift from national to local pricing or other forms of competition.[12])

45. To substantiate its claims that Homebase adopts a purely national strategy unaffected by the merger, HRG argued that it presently faces little or no competition from DIY sheds in 35 per cent of the locations in the UK in which it operates, but exhibits no material difference in its current pricing or non-price offer, suggesting that any theoretical incentive that Homebase might have to locally flex PQRS already exists but has not been acted upon. In terms of non-price variables, HRG notes that its staff remuneration system includes a nationally-implemented service quality control element based on the general shopping experience, which is implemented by way of a mystery shopper scheme that assesses the most relevant non-pricing competitive variables in each store. The score that each store obtains (known as its ABA score) is taken into account when setting each store's staff bonuses. Furthermore, with regard to stock range or store layout, HRG has submitted that the goods or services each individual store supplies depend upon its size and not upon its location or upon any local competitive factors.

46. HRG submitted an econometric analysis that sought to demonstrate that there was no relationship between ABA scores and either the presence of a local

[12] Accordingly, the OFT does not therefore ascribe to this merger one possible manifestation of a national merger effect: that the merger itself may change incentives in terms of the level at which Homebase sets competitive variables. For example, a merger with national effects might not only affect national prices but might in principle cause a shift to more local pricing or price-flexing to price discriminate more effectively, or likewise on non-price factors, to invest less in its in-store non-price retail offer where the merged firm faces less local competition as a result of the merger.

Focus or the number of rival DIY fascia locally (i.e. that there was no relationship between ABA scores and local concentration) for a sample of 269 Homebase stores.

47. In HRG's view, departing from such strict national PQRS policies has substantial cost implications in terms of its brand, reputation, IT systems and marketing expenditure, amongst other things. In short, the combined costs of pursuing a price or PQRS discrimination strategy at the local level are claimed to outweigh the combined benefits, as demonstrated by its pre-merger conduct across all localities.

48. HRG further argued that customers increasingly use the internet as a way of comparing prices between different DIY retailers. To the extent that a retailer's in-store price was less attractive than its internet price, this would damage customer confidence in the brand. In addition, HRG argued that customers on occasions compared prices between Homebase stores, providing an additional incentive for it to adopt a uniform national pricing strategy.

OFT's assessment of the locally-driven constraint that each party's local store may impose on the other

Local unilateral effects concerns premised on the loss of an asymmetric competitive constraint post-merger

49. As a preliminary point, in previous cases in which the OFT explored unilateral effects theories of harm in a differentiated market setting, the OFT has not taken the view that, for a realistic prospect of a substantial lessening of competition to arise, the OFT must necessarily expect a loss of a competitive constraint on the acquirer's products or retail proposition. Competitive constraints imposed by merging parties on each other may be **symmetric** (two-way, that is each party constrains each other) or **asymmetric** (one-way, one constrains the other but not vice versa), and the loss through merger of an asymmetric constraint may in some circumstances be sufficiently concerning to the OFT to warrant reference, including where the constraint lost is on the target business alone.

50. The basis for an asymmetric theory is that the competitive threat posed by one party on the other incentivises that threatened party to offer lower prices or a better overall non-price offer to attract and retain customers, and that the loss of asymmetric rivalry may itself be sufficient to constitute a realistic prospect of a substantial lessening of competition, because that rivalry will be

internalised in respect of the proposition offered by one of the parties (for example, the non-price offer at the target stores).

51. The most recent (and recurring) example is of rail franchise acquisitions, where the theory of harm arises from the loss of a competitive constraint imposed by rail on competing coach or bus services on the relevant overlap routes but *not* vice versa.[13] The issue also has also arisen, for example, in retail chain mergers, including acquisitions by one national chain of a small number of stores from another,[14] and in mergers between manufacturers of retail products.[15]

Loss of the locally-driven constraint imposed by a Homebase store on a Focus store

52. In this case, not least given Focus' local price-matching policies, the OFT considers that it has insufficient evidence at its disposal to conclude that merging a local Homebase store and a Focus store could not in principle result in a substantial lessening of **localised** competition, if only on the basis that the Homebase store imposed an asymmetric competitive discipline on the Focus store. For this reason alone, the OFT considers it justified to examine the potential loss of competition at local level.

Loss of the locally-driven constraint imposed by a Focus store on a Homebase store

53. As for the potential for a symmetric merger effect via the loss of a locally-driven competitive constraint on a given Homebase store, the issue is more

[13] The constraint is asymmetric in this case because the rail service is regulated, and the limiting effect that this has had on the scope of the merger effect has been taken into account in the magnitude of the issues raised by the merger and the application of the *de minimis* exception to the duty to refer. See *Acquisition by National Express Group plc of the Inter City East Coast rail franchise* OFT decision of 20 December 2007 (*NEG/ICEC)*; and, *Completed acquisition by Stagecoach Group plc of the East Midlands Franchise,* OFT decision of 4 February 2008 *(Stagecoach/East Midlands*).

[14] For example, in HMV's acquisition of Ottakars' the OFT's reference related to the asymmetric competitive constraint potentially lost by the merger whereby acquirer Waterstone's bookstore chain, owned by HMV, appeared on available evidence to constrain the target Ottakar's bookstore chain – but not vice versa. See *Anticipated acquisition by HMV plc, through Waterstone's Ltd, of Ottakar's plc*. OFT decision of 6 December 2005 Similarly, in Tesco acquisition of certain Somerfield stores, a theory of harm tested by the OFT was that the Tesco 'Extra' superstore in Wick, in far north Scotland, constrained the mid-sized Somerfield Thurso, but not vice versa. See*, Completed acquisition by Tesco plc of five stores (Thurso, Bedlington, Little Lever, Ramsbottom and North Hykeham) from Somerfield plc*, OFT decision of 4 December 2007 *(Tesco/Somerfield)*.

[15] See *Completed acquisition by Heinz of HP,* OFT decision of 26 October 2005 where the evidence suggested to the OFT that Heinz ketchup imposed a substantial competitive constraint on various HP sauce products, but not vice versa.

finely balanced, because HRG has presented substantial evidence suggesting that its competitive conduct is unaffected by increased concentration at local level; for example, its Homebase monopoly DIY sheds do not appear to exploit this local monopoly in terms of the variables measured and presented by HRG.

54. On balance, the OFT's reservations are sufficient to conclude that a local merger effect on a Homebase could not be ruled out. Unavailable to the OFT, for example, was margin-concentration analysis of the calibre examined by the CC in its groceries inquiry, so it is possible that Homebase's store-level margins–and imputed investment to enhance the customer experience–may vary based on local competition. Nor, in the time available in first-phase merger control, could the OFT satisfy itself, on the econometric evidence of the relationship between ABA scores and local concentration that was presented (see paragraph 46), that local concentration was measured appropriately, given it was not clear that the right size catchments of local the 269 Homebase stores had been analyzed, nor whether non-DIY sheds should have been included as local competitors in some of the 269 areas analysed. In addition, the OFT could not rule out that a relationship might have been found for individual components of the ABA score, even though this was not the case for the aggregate ABA score.

55. Further, the OFT considers that the non-price variables included within the Mystery Shopper survey and ABA score, while probative of HRG's arguments, cannot be regarded as exhaustive of all the potential QRS variables that could be locally flexed in response to local competitive conditions. Further, the inherent limitations of the Mystery Shopper data mean that it is difficult to establish to the degree required by the OFT that none of these QRS variables are flexed in response to competition at the local level.

56. In this respect, in terms of the argument HRG advanced concerning the need for national pricing given that customers used the internet to check pricing, the OFT notes that Homebase's website advises customers that the prices appearing there may be different to those found in-store. The OFT also notes HRG's representations that there is local pricing to a limited extent in respect of stock clearances (although HRG argued that this was not in response to local competition). The difficulty in establishing to the requisite standard that these points do not represent local competition is magnified when flexing of QRS variables, rather than pricing, is considered.

57. Overall, while not ruling in principle out the prospect of any merger effect on a local Homebase in an area of overlap, the OFT accepts that such effect may be significantly weaker than the effect on the Focus store. This will be relevant to the weight the OFT has given to local evidence that is consistent with close competition between the parties (see below).

Conclusions

58. For all the reasons above, in the present case, the OFT has explored the possibility of local unilateral effects in every overlap area on the starting premise that local competition could be lost by this merger.

59. For the purposes of its local competitive assessment, the OFT considers that the relevant market is the supply of DIY products through DIY sheds (which, in terms of competitors included in the market, are in all but one case simply the four national players, but in Bodmin also includes Trago Mills, a regional chain). As appropriate, however, the OFT has also considered the area-specific constraint that other distribution channels impose on DIY sheds on a category-by-category basis. The scope of the local geographic market in assessing local overlaps is discussed further under **locations with some fascia reduction** below.

UNILATERAL EFFECTS AT THE LOCAL LEVEL

60. Unilateral effects concerns can arise in differentiated markets such as DIY retailing, where the merger combines two close choices for a substantial proportion of customers, and the countervailing constraints are not sufficient to remove the potential for a 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 reduces the PQRS 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 equivalently reduce QRS by a small but significant amount before this happens to any significant extent.

Rebuttable presumption of adverse merger effects arising from a loss of competition evidenced by high margins and high diversion ratios between the parties

61. In order to assess the probability that there will be a loss of local competitive

rivalry between national retailers, the OFT will, when available, examine two sources of evidence in seeking to arrive at an illustrative quantitative gauge of the closeness of competition between merging firms, and thereby the change in incentives that the internalisation of this close rivalry would bring post-merger:

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

- **Diversion ratios between the merging parties** – the diversion ratio is the proportion of switching customers in response to a worsened offer that would divert from one merging party to the other; when this ratio is significant, this suggests relatively close competition between the parties that the merger would remove, and suggests that the merged firm, having internalised this rivalry, would have an incentive from the merger to raise price or worsen its non-price retail offer.

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

63. This presumption is stronger the greater the illustrative changes in incentives brought about by the merger, and can usefully serve as a ranking mechanism for the concerns created by a set of multiple local overlaps. 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, whether in respect of the acquiring firm's products (or store offer, such as Homebase) or target products (or Focus store offer).[16] At

[16] In a high margin business, each lost customer pre-merger is a significant loss (the entire margin per customer), amounting to a significant constraint on the firm not to improve margins further

the same time, this presumption will be weaker if the reliability or probative value of the margin or diversion ratio evidence is in doubt.

64. In this particular case, the presumption is weakened to a degree given the unusually comprehensive scope of Homebase's evidence on its national approach to setting price and non-price variables, which has led the OFT to interpret local evidence on the closeness of competition, including the margin/diversion ratio data, in this light (see further, paragraphs 71-72, below).

65. More generally, 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.

Locations with no fascia reduction after application of preliminary filters

66. Fascia reduction can be used to screen to determine which areas should be treated as overlap areas and—in the absence of more probative data such as gross profit margins and diversion ratios—may also be considered an appropriate tool to assess the impact of a merger if read in conjunction with the geographic or spatial distribution (closeness) of the merging parties' and rivals' stores.

67. In order to concentrate this assessment on those areas that might be expected to raise potential competition concerns, the OFT applied three preliminary filters. These filters assessed whether the merger had led to any fascia reduction within radii of five miles and ten miles, or within a 20-minute drive-time isochrone, all centred on the target Focus store, on the basis of a candidate product market of only the national DIY sheds (i.e. B&Q, Homebase, Focus and Wickes).

(for example, by raising price) because the lost revenue of losing marginal customers will make it unprofitable. However, if diversion ratios show that a significant proportion of that lost margin will be recouped once the firm owns the competitor to which those customers divert, then the incentive to improve margins–by raising price or lowering quality, range or service–is significant.

68. The OFT has concluded, on this basis, that this merger has not led to a fascia reduction on any of these filters in 15 locations and that these locations do not warrant any further analysis as they do not raise any competition concerns. These locations are: Bedford-St Johns Centre, Blackpool-Parkinson Way, Cardiff, Castleford, Evesham, Horwich, Keighley, Kidderminster, Liskeard, Macclesfield, Nottingham-East, Oswestry, Stafford, Warwick, Yeovil.

69. These areas are therefore not addressed again in this decision. The remaining 12 locations are each considered below.

Locations with some fascia reduction after application of preliminary filters

70. With respect to those areas where a fascia reduction has resulted from the merger, the OFT has been able to assess the impact of this merger more closely using an array of different evidence.[17] This includes diversion ratios, gross margins, fascia reduction data and two tailor-made consumer surveys. The OFT has employed data from Homebase's own Spend and Save loyalty card to provide evidence on the appropriate catchment areas of each location. The OFT has also had regard to the geographic nature and characteristics of each location.

71. In assessing the prospect for a substantial lessening of competition occurring in each of the 12 overlap locations discussed below, the OFT has had regard to the fact that the evidence provided by HRG on the limited degree to which Homebase responds to local competitive conditions is relevant to the determination of whether there is a realistic prospect of a substantial lessening of competition in each locality.

72. Although the evidence presented was insufficient to persuade the OFT that there was no competition that could be lost through the merger at local level, the quality and quantity of the evidence was sufficient to qualify the OFT's assessment of the scope of local rivalry that could be lost by the merger. As noted, the OFT believes the merger could lessen local rivalry from Homebase threatening Focus and, to a lesser degree, vice versa. In terms of the constraint potentially lost on Homebase, to the extent that any lessening of competition would be reflected in the flexing of a non-price QRS variable – potentially one not reflected in the ABA score – there is a limit to the extent of the adverse effects that customers would experience from a lessening of competition, and therefore impact on its significance or materiality (or, in other

[17] See further Annex below, paragraphs 140 to 144.

words, the 'S' in SLC).[18] In a number of areas below, this assisted the OFT's conclusion that close competition from B&Q in particular, as well as other sources, would discipline any Homebase to exploit any post-merger reduction in rivalry between the parties in the form of a worsened retail offer at either its existing or the acquired store.

WOKING

73. Critical loss analysis, based on the gross margins by DIY product category of the Focus store and on estimates of the actual loss of business by DIY product category from the February survey, suggests that a product market definition including only the four DIY sheds is appropriate in Woking.

74. The merger has led to a three to two fascia reduction in DIY sheds, Wickes being the other remaining fascia, on the basis of a 5-mile radial catchment and a four to three fascia reduction, with both Wickes and B&Q, on the basis of a 15 minute drive-time isochrone both being centred on the Focus store.

75. HRG, however, submitted that the merger has not created any fascia reduction in Woking. It based its assertion on a [more than 15]-minute drive-time isochrone centred on the former Focus store to the east of Woking, which covers an additional Focus store at Weybridge. This represents only minimal flexing to the [more than 10]-minute drive-time isochrone that itself captures 80 per cent of the Woking Homebase's customers, according to its Spend and Save card data. HRG also argues that the most significant population centres near Woking (Guildford, Weybridge, Camberley and Ashford) form a chain of substitution by which the merged entity in Woking itself could be disciplined if HRG sought to increase price or reduce QRS following the merger. In this regard, HRG identified the following DIY sheds in the area: Wickes in Woking; B&Q in Guildford, (5.5 miles away) and Focus stores in Weybridge, Aldershot, Camberly and Ashford.

76. Homebase's Spend & Save loyalty card data shows that 80 per cent of the customers of its Woking store come from within [less than 10] miles. Were the OFT to apply this radial catchment centred on the acquired store, this would exclude the Homebase store at the west of Woking and therefore

[18] Compare the approach of the CC in respect of author book signings in HMV/Ottakars, where a statistically significant relationship emerged between the presence of a Waterstone's and book signings by Ottakar's. The CC considered this presumed adverse effect to be economically insignificant for its purposes.

remove any overlap. However, given other evidence, the OFT considers that this geographic is too narrow for a town of the size of Woking. Moreover, the diversion ratios from Focus to Homebase ([more than 50] per cent) and from Homebase to Focus ([more than 25] per cent) indicate close pre-merger competition between the parties.

77. HRG has argued that evidence from both the January and the February surveys and from Homebase's Spend and Save card suggest that many shoppers in Woking are willing to travel for at least 15 minutes and specifically to the 35,000 sq ft B&Q store located in Guildford.

78. While some parties have commented that B&Q already serves a part of the Woking market from its Guildford store the OFT has also received evidence that B&Q's Guildford store is not a substitute to a store in Woking. Consequently B&Q may provide only a limited constraint, post merger, on HRG in Woking.

79. Overall, the high diversion ratios from Focus to Homebase, and to a lesser extent from Homebase to Focus, suggest that they are each other's closest competitors in this location. The diversion ratios to the (distant) B&Q are much lower. This, together with the lack of compelling evidence showing that other retailers will provide sufficient competitive constraints on Homebase post-merger, has led the OFT to believe that Homebase's acquisition of the Focus store in Woking gives rise to a realistic prospect of substantial lessening of competition relative to pre-merger conditions. In this respect, unlike in St. Albans, the Focus Woking store was not a so-called Tactical store (see below), and HRG did not advance a different counterfactual.

ST. ALBANS

Merger analysis relative to pre-merger conditions

80. The merger has given rise to a three to two fascia reduction (Wickes being the other fascia) on the basis of a five-mile radial catchment. Data from Homebase's Save & Spend loyalty card in this area indicate that 80 per cent of Homebase customers live within [less than 10] miles.

81. The February survey results for St. Albans indicated high diversion ratios ([more than 50] per cent) from Focus to Homebase and vice versa ([more than 25] per cent). Homebase is a much more popular second choice for Focus

customers, despite the fact that Wickes is the nearest DIY shed to the acquired former Focus store. This seems to support the argument that Homebase and Focus are much closer competitors to each other than is either to Wickes. This is consistent with the results of the January survey and with the views of some third parties in the market.

82. Based on the above, the merger raised substantive competition concerns with reference to the default counterfactual of the pre-merger status quo ante.

Substitution of an exiting store counterfactual

OFT policy on the counterfactual in market-exiting asset scenarios

83. The counterfactual is the competitive situation that would exist absent the merger and provides the benchmark against which any adverse effects arising from the loss of competition following the merger will be assessed. In this case, HRG has not explicitly argued a failing firm defence or otherwise contended that all the Leasehold properties would have shut in any event, absent the merger, and without a rival DIY operator acquiring them.

84. However HRG has maintained that the counterfactual should take account of the fact that, absent the merger, three of the Leasehold properties (identified by Focus as forming part of a group known as Tactical stores) would inevitably and imminently have been closed due to their loss-making character and negative financial contribution to the overall results of Focus.

85. The OFT's general approach in considering the relevant counterfactual against which to assess a merger is that it relies on the pre-merger conditions of competition as the appropriate proxy, because prevailing competitive conditions (including market structure and dynamics) are observable and subject to verification from multiple sources. The effect of the merger is then safely judged against a benchmark of having held all else constant; however, the OFT Guidance notes that it will also take into account 'likely and imminent changes in the structure of competition' (the likely and imminent standard).[19]

86. In its decisions under the Act that have potentially turned on whether the status quo ante is appropriate as (that is, the best proxy for) the counterfactual, the OFT has in practice applied a rebuttable presumption in favour of the status quo ante, by reading the likely and imminent standard strictly when the risk of speculation applies to a critical finding of the case –

[19] Guidance, paragraph 3.24.

notably, market exit by a merging party. The OFT will test the competitive impact of any transaction against such a standard before proceeding to consider whether another counterfactual should be substituted, requiring rebuttal of a strong presumption in favour of the status quo ante as the best guide to competition absent the merger.

87. More specifically, the OFT will not lightly depart from judging the impact of such a sale as against pre-merger conditions, and will only do so when it has sufficient compelling evidence that exit is inevitable, in line with the first two criteria of the failing firm defence (see further below). The reason for the OFT's stringent evidentiary policy in such cases stems from a recognition that outcome-determinative counterfactuals, such as claims that a target company would have exited the market absent the merger, are easily the subject of self-serving speculation – relatively easily asserted but difficult, given the information asymmetries, to verify independently. Accordingly, in cases involving alleged exit of one merging party's competitive assets absent the transaction, the OFT has applied the same approach and evidentiary standards whether or not the parties specifically frame their claim as a failing firm or failing division defence. In practice, the OFT has applied the same standard to divisions or stand-alone business units, such as individual stores, as to an entire firm.[20]

Application in this transaction

88. This merger resulted from Focus' publicly stated strategy of disposing or closing loss-making stores in order to reduce its debt-burden, increase financial stability and so be able to concentrate on the profitable stores to develop a differentiated proposition concentrating in core DIY products. HRG's publicly stated strategy in line with the rationale for this acquisition is to increase its portfolio of stores in order to offer its home furnishing business proposition to more consumers.

89. The merging parties provided documentary evidence to the OFT that confirmed that, on or around June 2007, HRG had identified 52 Focus stores as Tactical stores that were to be disposed of or closed if a transfer of each of them was

[20] Compare Tesco/Kwik Save (failing firm defence met in respect of individual local grocery stores) with, for example, First/Black Prince (failing firm defence met in respect of a bus business as a whole). See at *Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson)*, OFT decision, 11 December 2007 (Tesco/Kwik Save); and, *Anticipated acquisition by First West Yorkshire Limited of Black Prince Buses Limited*, OFT decision, 26 May 2005 (First/Black Prince).

not achieved by 31 March 2008. The list of Tactical stores included three stores considered closely by the OFT, including St. Albans, Weston-Super-Mare and Tamworth, but the only area that turns on the issue of the counterfactual is St. Albans.

90. The evidence presented to the OFT with regard to the Tactical stores confirmed the parties' submissions in respect of the poor financial performance of those stores[21] It further leads to the OFT to conclude that, substantially before and unconnected to the merger, Hilco, a restructuring company specialising in the retail sector, was commissioned by Focus to manage the Tactical stores until their disposal or closure. Property agents were also instructed with this aim. There is compelling evidence that, if the Tactical stores could not be disposed of or handed back to the landlord, then they would have been closed on 31 March 2008. In reaching its judgment on whether its evidentiary threshold has been satisfied, the OFT's analysts specifically reviewed the loss-making financial performance of the Focus store at St. Albans; the OFT also considered the nominal consideration (£[ ]) paid by HRG, and corroborative evidence from other market participants that the size and location of the store were such as to make it particularly unattractive financial proposition, despite St Albans, at large, being an attractive market for DIY retailers.

91. The OFT has sufficient compelling evidence, on the basis of the evidence presented and on the basis of its own subsequent inquiries with other DIY shed operators and other third parties, that the loss-making St. Albans store would have been disposed of by Focus absent the merger, and therefore serious prospects of its reorganisation or revitalisation by Focus can safely be ruled out. Moreover, the process under which the Tactical stores have been offered for sale has been open and involved retailers of many different kinds, including each of the other three national DIY sheds. Accordingly, given that it is untenable to conclude that, absent the merger, another DIY shed would have operated a store from this site in competition with Homebase, the OFT is confident that a counterfactual involving a competitively-preferable (in other words, a substantially less anti-competitive) purchaser than HRG is unrealistic.

92. Consistent with the OFT's position in other retail chain mergers, the OFT has considered whether the closure of the St. Albans store and exit of these assets from retail DIY sales in the relevant local market—with the remaining competitors competing for its customers—is a substantially better competitive

[21] The financial loss of the 52 Tactical stores in the last financial year has been estimated to be some £ 9 million. [Source: UK DIY & Gardening Retailers 2007, Datamonitor, (Published 10/2007)(page 77).]

outcome than the acquisition of the St. Albans store by HRG.[22] However, the OFT does not believe this would provide a more competitive outcome. Accepting closure of the St. Albans Focus as the relevant counterfactual would have led to a three to two fascia reduction but also a significant reduction in supply as one competing PQRS proposition and its capacity was taken out of the local market. Against that counterfactual, HRG propose to operate a Homebase DIY shed[23] that preserves that store as a local option for DIY customers and maintains the net retail floor space devoted to DIY sales in the relevant local market. It cannot be said that such an outcome is substantially less beneficial for customers in the local DIY market than no DIY store whatsoever.

93. Based on the above, the OFT does not believe that, against the relevant counterfactual of closure of the store, the acquisition of the St. Albans Leasehold property gives rise to a realistic prospect of substantial lessening of competition.

REDRUTH (TUCKINGMILL)

94. The merger has led to a three to two fascia reduction (B&Q being the other fascia) on the basis of a five-mile radial catchment. Homebase's Spend and Save loyalty card data suggests that the catchment area should be wider than five miles in this location as 80 per cent of the customers of its Redruth store come from within [less than 10] miles. Applying a [less than 10]-mile radial catchment, there is another Focus store within this geographic market.[24]

95. HRG submits that the only evidence from Redruth suggesting that Focus and Homebase might be particularly close competitors is the diversion ratio from the Homebase store to the Focus store in the February survey (which shows that [more than 25] per cent of the Homebase customers would choose Focus as their second choice). In HRG's view, this figure is biased upwards due to the fact that—notwithstanding that survey respondents were asked about what alternative they would have chosen before they left home had they known that the Focus was shut—respondents at the Homebase store were visually prompted to choose Focus as their second choice, as the closed-down Focus store was next door, and maintained its Focus signage at the time of the survey.

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[22] See further Tesco/ Kwik Save; paragraph 32.
[23] [HRG has told the OFT that it intends to operate a 'Home Store & More' homewares store.]
[24] The Focus at Threemilestone near Truro.

96. However, another interpretation of this high diversion ratio could be the fact that the acquired former Focus and the Homebase stores are very close to each other (literally, next door) and therefore, they might be expected to represent each other's closest competitors for customers shopping on a localised basis. The OFT notes, on the other hand, that the B&Q store is also close by, is larger than either the Homebase or Focus stores and featured very significantly ([more than 50] per cent of respondents replied that they had purchased a DIY product from B&Q in the previous six months) in the January survey.

97. The OFT accepts that the rural nature of this location is likely to make the typical drive time substantially higher than in other parts of the country. It is important to note that each of the target Focus, the B&Q and the Homebase stores are all located in Tuckingmill, midway between Redruth and Camborne. HRG has noted that Homebase's Spend and Save loyalty card data shows that 80 per cent of the customers of its store in Redruth come from within [less than 30] minutes' drive-time, a catchment which if applied would include Truro to the North east (with a Homebase, Focus and Wickes) and Penzance to the South West where B&Q has another store.

98. The January survey showed the second highest percentage of respondents ([more than 50] per cent) choosing B&Q as their DIY store but [less than 15] per cent also had shopped at Wickes, which is 17 minutes' drive-time away. Third parties have also told the OFT that B&Q competes strongly with the merged entity in Redruth. While the OFT has expressed reservations with respect to the high street location and content of this first consumer survey,[25] the OFT believes that the evidence overall shows that B&Q represents a sufficient competitive constraint on the merged entity in this area given, in particular, its proximate location and size, reflected in the diversion ratios to it. On balance, it does not seem realistic to the OFT that Homebase will have sufficient latitude, in these circumstances, to exploit any reduction in rivalry from the merger given the closeness of competition from B&Q and, to a lesser extent, from competition from the more distant Wickes. Therefore, the OFT considers that the merger does not give rise to a realistic prospect of substantial lessening of competition in Redruth.

[25] See further Annex below, paragraphs 140 to 144.

HULL WILLERBY

99. The merger has given rise to a 3 to 2 fascia reduction (B&Q being the other fascia) on the basis of a 5-mile radial catchment. Data from Homebase's Save & Spend loyalty card in this area indicates that 80 per cent of Homebase customers live within [less than 10] miles.

100. In HRG's view, the appropriate catchment area should extend to a [more than 15]-minute drive-time isohrone centred on the acquired Focus store. Based on this, the merger has not led to any fascia reduction in Hull since there is another Focus store at Beverley, to the north of the acquired store. HRG submits that a [more than 15]-minute drive-time isochrone captures 80 per cent of Homebase customers.[26]

101. In this case, the presence of two large B&Q stores located within roughly six miles of the acquired Focus store is particularly significant. The total floor space of both B&Qs within this area is around 170,000 sq ft. This may explain why the diversion ratio from Focus to B&Q ([more than 25] per cent) is much higher than that from Focus to Homebase ([more than 15] per cent).

102. The OFT questioned the probity of the February survey in this location because it showed a surprisingly low diversion ratio from Homebase to Focus (0 per cent), even though Homebase is geographically the closest store to Focus (notwithstanding that B&Q is the closest store to Homebase).[27]

103. Other evidence has led the OFT to dismiss its concerns in this location, however. In particular, it is satisfied that sufficient close competitive constraints would remain from B&Q (which also appeared significantly in the January survey) based on its two stores in the area. Thus the OFT believes that the merger has not given rise to a realistic prospect of substantial lessening of competition in Hull.

TAMWORTH

104. The merger gives rise to a three to two fascia reduction (B&Q being the other fascia) on the basis of a five-mile radial catchment. Data from Homebase's Spend and Save loyalty card indicates that 80 per cent of its customers in this

[26] Based on data collected by Homebase's Spend and Save loyalty card.
[27] The parties suggested that this low diversion ratio from Homebase to Focus might reflect the fact, at least in part, that Focus did not have a garden centre.

area live within [less than 10] miles. In this case, if the drive-time criterion HRG has suggested is applied, the fascia reduction is the same. The remaining closest fascia is a B&Q store located two miles from the acquired former Focus store and next to the existing Homebase store.

105. The diversion ratio from Focus to Homebase is [more than 15] per cent, and is [more than 15] per cent from Homebase to Focus. However, the much higher Focus-B&Q diversion ratio ([more than 50] per cent) suggests that, despite the fact that the B&Q and Homebase stores are equidistant from the acquired store, B&Q imposed a greater pre-merger constraint on the Focus store in this location. It is reasonable to conclude, on the basis of the evidence before the OFT, that this close constraint remains post-merger. Thus, the OFT considers that the merger has not given rise to any realistic prospect of substantial lessening of competition in Tamworth.

SWINDON

106. The merger has given rise to a four to three fascia reduction (B&Q and Wickes are also present) on the basis of both five- and 10-mile radial catchments. In this case, if the drive time criterion HRG has suggested is applied, the fascia reduction is the same.

107. HRG also suggested that the constraint from other local and category specialist retailers is particularly strong in Swindon. HRG referred to the results of the January survey where Wilkinson and Robert Dyas appear particularly strong compared to their apparent impact in other locations. The OFT believes that this might also be explained by the high street location of the January survey. The critical loss analysis undertaken by the OFT[28] indicates that a product market definition including only the four national DIY sheds is appropriate in Swindon and therefore our analysis has assessed primarily the constraint DIY sheds impose on each other in this location.

108. The diversion ratio from Focus to Homebase is [more than 25] per cent, and from Homebase to Focus it is [less than 15] per cent. The diversion ratios to B&Q in both cases are higher; [more than 25] per cent from Focus to B&Q and [more than 25] per cent from Homebase to B&Q. This suggests that Focus was not a significant alternative for Homebase customers and that the large

[28] Based on diversion ratios from the February survey and data on gross margins supplied by Focus.

B&Q store in the catchment area (120,000 sq ft) represents a substantive constraint on the merged entity.

109. In summary, the high diversion ratios to B&Q, which the OFT believes can be explained by the large B&Q store located in the city, is the main reason why the OFT believes that this merger has not given rise to any realistic prospect of a substantial lessening of competition in Swindon.

WESTON-SUPER-MARE

110. The merger has given rise to a four to three fascia reduction (B&Q and Wickes are also present) on the basis of a five-mile radial catchment and a 20 minute drive-time isochrone. Data from Homebase's Save & Spend loyalty card in this are indicates that 80 per cent of Homebase customers in this area live within [less than 10] miles or [more than 15] minutes' drive-time.

111. The survey results indicate a high diversion ratio from Focus to B&Q ([more than 25] per cent) and a much lower diversion ratio to Homebase (more than 15] per cent). This suggests that B&Q is the main competitive constraint on the merged entity, which seems reasonable given B&Q is the closest store to Focus and is a relatively new store of 24,000 sq ft. The January survey showed similar results with respect to the strength of B&Q in this location.

112. In summary, because of B&Q's competitive strength in Weston-Super-Mare, the OFT believes that this merger has not given rise to any realistic prospect of a substantial lessening of competition in Weston-Super-Mare.

POOLE

113. The merger has given rise to a four to three fascia reduction (B&Q and Wickes are also present) on the basis of a five-mile radial catchment. Data from Homebase's Spend and Save loyalty card indicates that 80 per cent of its customers live within [less than 10] miles.

114. However, both the January and February surveys revealed the importance of B&Q in this area. The diversion ratio from the February survey from Focus to B&Q is [more than 50] per cent compared to the much lower diversion ratio from Focus to Homebase ([less than 15] per cent). This may be due to the existence of several B&Q stores within a 10-mile radial catchment with a

combined floor space of approximately 170,000 sq ft. In addition, there is also a Wickes store between the Homebase and the acquired Focus store.

115. In light of the above, the OFT does not believe that the acquisition of the former Focus store in Poole raises any competition concerns.

OTHER AREAS NOT RAISING COMPETITION CONCERNS

116. The customer survey suggests that in **Bodmin**, both Trago Mills and B&Q are closer competitors to Focus than Homebase. The diversion ratios from Focus to B&Q and Trago Mills indicate that they will continue to impose sufficient competitive constraint on the Homebase store in this area post-merger.

117. In **Formby**, the OFT has confirmed that a new Focus store has been opened recently in Ormskirk. This is located 8.5 miles away, or within 20 minutes' drive time, from the former Focus store—within the boundaries of the catchment based on Homebase's Spend and Save data for its stores in nearby towns. This removes any fascia reduction in this area.

118. In the case of **Towcester,** the merger has given rise to a four to three fascia reduction on the basis of a 10-mile radial catchment, which includes the Homebase store in Northampton. However, we note that there is another Focus store in Northampton, just outside the 10-mile radial catchment but close to the Homebase store. This seems to suggest that for consumers in Towcester the merger represents a change of sole DIY retailer from Focus to Homebase, while DIY customers in Northampton can continue shopping at the Northampton Focus store as before. Moreover, the diversion ratio from Focus to Homebase is very low. On this basis, this merger does not raise any competition concerns in Towcester.

119. In **Stockport** there is a fascia reduction from four to three within a five-mile radial catchment. The negligible diversion ratio between the merging parties (one per cent) suggests that any competition between them that is lost in this location is very limited.

ENTRY AND EXPANSION

120. New entry and the threat of entry can also represent important competitive constraints on the behaviour of a merged entity. The entry must, however, be timely, likely and sufficient to restore the loss of competition arising from the

merger.[29] In this case, the OFT has not received any evidence suggesting that there is any likelihood of a new DIY shed entrant either nationally, or locally where a substantial lessening of competition has been found.

121. New entry among the category specialists has been more frequent in recent years. However, in order to restore the competition lost between Homebase and Focus, such entry would have to be sufficient across all product categories. In this regard the OFT notes that in certain categories (for example core DIY products) the trend in recent years has been towards exit and not entry.[30] Therefore, the OFT cannot be confident that the loss of competition arising from the merger in Woking would be likely to be remedied through timely, likely and sufficient entry.

THIRD PARTY VIEWS

122. The OFT received comments from around 20 companies active in the affected markets but none raised competition concerns regarding this merger.

ASSESSMENT

123. Homebase and the 27 acquired Focus stores overlapped in the supply of DIY and home enhancement products through national DIY retail chains in 12 overlap areas across the UK.

124. HRG submitted that the OFT, in considering the relevant counterfactual in this case, should take into consideration that those stores included by Focus in its list of Tactical stores were to be closed in the absence of a sale. It argued that, for the Leasehold properties included in the Tactical stores, there was no alternative buyer.

125. In line with its stated approach, the OFT has first assessed any expected loss of competition against the benchmark of the pre-merger competitive status quo. In those cases where this comparison could lead to a realistic prospect of substantial lessening of competition, the OFT has then considered whether this is the correct counterfactual to apply. An adjustment to the default counterfactual is relevant only in respect of the St. Albans Focus store.

126. Based on available evidence, the OFT considers that the relevant market definition in this case is the supply of DIY and home enhancement products

[29] See Mergers – substantive assessment guidance (OFT516), paragraphs 4.17-4.26.
[30] See paragraph 10 above.

through national (and, where applicable regional or local) DIY sheds, assessed nationally as well as locally. The constraint that other retailers through different distribution channels exercise on the national DIY sheds on a category-by-category basis has been analysed in the competitive assessment of each local market although none of the OFT's conclusions turned on this issue.

127. At the national level, this merger has not resulted in a reduction in the number of national DIY shed chains. Based on the minimal increment to HRG's turnover (less than one per cent) or the number of its stores, the OFT does not believe that this merger raises any national competition issues.

128. For reasons set out in detail above, the OFT considers that local competition could be lost by the merger, but took into account the relative asymmetry of the constraints between the parties in its approach to local evidence. In particular, the OFT had concerns that the constraint from Homebase on Focus stores lost by the merger could be significant. At the local level, in order to concentrate its assessment on areas raising potential competition issues, the OFT has applied three preliminary filters to identify those areas where the merger would lead to a fascia reduction. The application of these three filters removed 15 non-overlap locations that did not raise any competition concerns.[31]

129. In respect of the 12 locations where the merger did give rise to a reduction in fascia, the OFT considers that the test for reference is met only in relation to Woking, although it would also have been met in St. Albans but for the counterfactual against which the OFT judged the merger effects in this area.

- In Woking, the February survey shows a high diversion ratio from Focus to Homebase ([more than 50] per cent) with a higher diversion ratio from Homebase to Focus than from Homebase to B&Q. This can be explained by the lack of a B&Q store in Woking. With respect to other category specialists, the critical loss analysis the OFT produced based on the February survey results shows that the relevant product market in Woking includes only the four DIY sheds. Thus, the OFT believes that the merger has led to a realistic prospect of a substantial lessening of competition in Woking.

[31] These locations are listed in paragraph 68.

- In **St. Albans,** the merger gives rise to a fascia reduction from three to two with high diversion ratios (Focus to Homebase [more than 50] per cent and Homebase to Focus [more than 25] per cent) and therefore the potential for a substantial lessening of competition. However, in this case the OFT has received compelling evidence that, absent the merger, the acquired Focus store would have closed given the absence of any other realistic potential purchaser. Closure would have reduced the number of fascia and taken capacity out of the market. The OFT does not believe that simply allowing the store to close would have provided a less anti-competitive outcome. Therefore, the OFT believes that, compared to the appropriate counterfactual of closure of the Focus store, the merger does not give rise to a realistic prospect of a substantial lessening of competition.

130. New entry and the threat of entry can also represent important competitive constraints on the behaviour of the merged entity. However, entry must be timely, likely and sufficient in scale or character to replicate the competition lost by the merger. Based on the evidence before it, the OFT does not believe that entry in Woking is timely, likely or sufficient.

131. Consequently, the OFT believes that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom; that is, the supply of DIY and home-enhancement products through DIY sheds in Woking.

EXCEPTIONS TO THE DUTY TO REFER

Undertakings in lieu

132. Where the duty to make a reference under section 22(1) of the Act is met, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, accept from such of the parties concerned undertakings as it considers appropriate 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.

133. The OFT's guidance states that in order to accept undertakings in lieu of reference '[...] the OFT must be confident that the competition concerns identified can be resolved by means of undertakings without the need for further investigation. Undertakings in lieu of reference are therefore 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 [...].'[32]

134. HRG proposed on a without prejudice basis the divestment of the acquired Focus or the existing Homebase store in Woking.

135. This proposed undertaking removes the overlap in the Woking locality. Therefore, the OFT believes it constitutes a clear-cut remedy, making it appropriate for the OFT to suspend its duty to refer. The OFT considers that, in the circumstances of this case, in particular given the prima facie limited number of suitable potential purchasers, a necessary requirement to suspend the duty to refer and consider undertakings in lieu is that divestiture of one of the above stores should be to an upfront buyer.

136. HRG proposed a series of further undertakings to resolve concerns in other areas. However, it was not necessary to consider such undertakings given that the OFT's duty to refer applies only in respect of the acquisition in Woking. 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.

137. In light of these considerations, the OFT is currently of the view that the proposed undertakings in lieu–assuming they are capable of being implemented–will restore competition to pre-merger levels, and that the undertaking offered is sufficiently clear cut to remedy the concerns identified, namely the substantial lessening of competition in the supply of DIY and home-enhancement products through DIY sheds in Woking.

138. Therefore, the OFT has decided to exercise its discretion under section 73(2) of the Act to consider whether to accept undertakings in lieu of a reference.

DECISION

139. The OFT's duty to refer the completed acquisition by HRG of the Leasehold properties to the Competition Commission pursuant to section 22 of the Act is **suspended** because, on the information currently available, the OFT is considering whether to accept appropriate **undertakings in lieu of reference** from Home Retail Group pursuant to section 73 of the Act.

[32] See paragraph 8.3 of OFT Mergers Substantive Assessment Guidance.

ANNEX: EVIDENTIARY ISSUES

140. The OFT's assessment in this case has drawn upon a substantial base of qualitative and quantitative evidence. The former was derived from views expressed and internal documents provided by the merging parties, third parties, and independent market research. The latter principally comprises customer location data (derived from loyalty card databases) and gross margin data from the parties, and two tailor-made customer surveys commissioned by HRG in January 2008 (the January survey) and in February 2008 (the February survey).

141. The combination of data on gross margins and on consumer switching (from the surveys) played a key role in defining the product market (via critical loss analysis) and in assessing the closeness of local competition (in principle) between the parties' overlapping stores—in particular by measuring the indicative post-merger incentives of Homebase to adjust price or non-price variables to the detriment of consumers (see further below).

142. Given the potential utility of stated-preference survey data, HRG took the initiative to commission the January survey to provide evidence of which different retail outlets are used by consumers for purchases of core DIY products, and of which other outlets consumers also visited to compare products, prices, etc. This survey was carried out in high street locations in those 12 overlap areas that the OFT had identified as potentially problematic.[33]

143. However, upon review, the OFT had substantial reservations about the probative weight of this survey, given its design. In particular, the OFT was concerned that by asking consumers in the high street where they had bought DIY products in the previous six months, the survey provide a poor proxy of the preferences of the merging parties' customers, and therefore of the closeness of competition between them, in any given area. The OFT was also concerned that the fact that the interviews took place at high street locations might have biased the results, by showing a larger number of respondents

[33] These were the areas that might have been expected to raise potential competition concerns in light of the various fascia reductions resulting from the merger based on three preliminary filters: (a) five-mile and (b)10-mile radial catchments, and (c) 20-minute drive-time isochrones. See further paragraphs 66 to 69 above.

identifying high street retailers as choices than would have been the case had the survey been carried out in out-of-town retail parks, where the parties' DIY sheds traditionally have been located.

144. Given the OFT's support for a customer survey, but its reservations on the probative value of the January survey in particular, HRG commissioned the February survey, which was designed in conjunction with the OFT. A key difference was that the surveys were of exiting customers at the locations of the former Focus stores or overlapping Homebase stores, wherever possible (some sites were not trading, requiring the use of a nearby proxy site). Further, the OFT considered that the structure of the survey script and the wording of the questions used in this survey were more appropriate for assessing the competitive constraints between the merging parties pre-merger. In particular:

- in terms of the structure of the script, the February survey first asked questions aimed at getting respondents to re-live their DIY purchasing decisions, so that respondents' views on the hypothetical questions later in the survey that the OFT used to assess the closeness of competition between HRG and Focus were likely to have been better informed, and
- in terms of the wording of the questions used, the February survey—instead of simply asking where else respondents had looked for and/or bought DIY products in the previous six months—asked about what they would have done had the Focus been shut, a question that is more consistent with both the hypothetical monopolist test that the OFT uses for market definition and with assessing the degree of closeness of competition between HRG and Focus.