

Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson)

No. ME/3387/07

The OFT's decision on reference under section 33(1) given on 11 December 2007. Full text of decision published 20 December 2007.

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

PARTIES

1. **Tesco Stores Limited** (Tesco) is a subsidiary of Tesco plc, a large grocery retailer with a portfolio of stores across the UK. In addition to its UK grocery retailing business (both food and non-food), Tesco has various other operations in the UK, which include petrol retailing, internet shopping and the provision of financial services. Tesco's turnover was approximately £46.6 billion in the year ending 24 February 2007, of which approximately £35.6 billion was generated in the UK.
2. **Kwik Save Stores Limited** (Kwik Save) entered administration on 6 July 2007. **FreshXpress Retail Limited** and **FreshXpress Property Limited** (together FreshXpress) are carrying on Kwik Save's business under licence in continuation of and in succession to Kwik Save and with the right to direct the sale of the Kwik Save stores.

TRANSACTION

3. Tesco proposes to acquire five former Kwik Save stores in Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson (the Acquisition Stores)

from FreshXpress. The turnover associated with the Acquisition Stores in the financial year 2006/2007 is estimated to be around £[] million.

4. The Office of Fair Trading's (OFT) administrative deadline for deciding whether to refer the merger to the Competition Commission (CC) is 11 December 2007.

JURISDICTION

5. As a result of this transaction Tesco and the Acquisition Stores will cease to be distinct. The parties overlap in the supply of grocery retailing, and post-merger will account for over 25 per cent of all grocery retailing in the UK. As a consequence the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. 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.

SUBSTANTIVE ASSESSMENT

Introduction

6. As set out in greater detail below, the Acquisition Stores are all in administration and the OFT is satisfied that there is no serious prospect that the relevant business would be reorganised absent the merger. Indeed, the OFT is satisfied in respect of four stores that the failing firm defence is met - for only the second time under the Act. In the case of those four stores, there were no credible bidders apart from Tesco. A different issue is raised by the Coventry Store, where there was an expression of interest from a rival retailer.
7. Because this case raises the issue as to whether the OFT should depart from its default approach that pre-merger conditions are the best guide to competition absent the merger in respect of the relevant local markets, the OFT sets out a number of general principles in relation to the counterfactual which draw on its analysis in the *BSkyB/ITV* case.¹

¹ OFT *British Sky Broadcasting Group plc / ITV plc - Report to the Secretary of State* 27 April 2007 (the BskyB/ITV case)

Counterfactual - general principles applied by the OFT

8. Merger assessment under the Act considers whether a merger causes harm to competition and its beneficiaries. The Act therefore refers to whether a merger has resulted or may be expected to result in a substantial lessening of competition (see sections 22 and 33 of the Act).
9. The OFT determines causation - the effects attributable to the merger - by comparing the predicated post-merger competitive outcome with the outcome absent the merger, referred to as the counterfactual. As the OFT's Guidance notes, this comparison is 'the core concept of the substantial lessening of competition test'.² In predicting post-merger effects, the Guidance employs a widely accepted analytical framework to predict post-merger effects; the assessment of the counterfactual is largely a question of fact.
10. The Guidance establishes that the best proxy for the counterfactual is generally prevailing competitive conditions (including market structure and dynamics) because these 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).³
11. 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 - notably (i) market exit by a merging party and (ii) possible other transactions, whether between third parties in the same sector,⁴ or more usually, an actual or mooted rival bid for the same target (such as in respect of ITV plc in 2006 (*BSkyB/ITV* case) - see below).

² OFT, Mergers - Substantive Assessment Guidance (May 2003) (the Guidance), paragraph 3.23.

³ Guidance, paragraph 3.24.

⁴ The issue has arisen, for example, in the stock exchange sector, where the OFT considered claims that it should treat the market as more concentrated than the status quo, taking into account possible industry consolidation not involving the merging parties. See OFT decisions in NYSE Inc./Euronext NV, dated 12 October 2006 and Nasdaq Stock Market Inc./London Stock Exchange plc, dated 18 January 2007.

12. The prime example of the first category is the OFT's 'failing firm' line of cases⁵ featuring arguments by merging parties that prevailing conditions are not the appropriate benchmark to assess merger effects, because the target would have exited the market absent the merger.
13. The OFT has adopted a stringent approach in such cases out of recognition that counterfactuals are easily the subject of self-serving speculation - relatively easily alleged but difficult, given the information asymmetries, to verify independently (such as claims that a target company would have exited the market absent the merger). Accordingly, in cases involving alleged exit of a merging party absent the transaction, the OFT has applied the same approach and evidentiary standards whether or not the parties specifically claim that they should benefit from the failing firm defence.
14. The same cautious approach has governed OFT cases where issues are raised with respect to a potential rival transaction to the one before the OFT - for example, the suggestion that, absent the merger, the target assets would likely transfer to another acquirer.
15. In *BSkyB/ITV*, the OFT considered the argument as to whether that transaction should be judged against the counterfactual of an acquisition of ITV by Virgin Media, which some commentators alleged to be pro-competitive. The OFT observed that there is an inherent risk of speculation associated with claims that a rival transaction is pro-competitive relative to prevailing conditions because it is generally far from certain that (i) the rival transaction would in fact proceed but for the merger before the OFT; and (ii) such a transaction would in fact be pro-competitive. The OFT noted further that it would generally want to exercise caution before deciding it would conduct merger analysis by comparing a transaction before it with one, alleged to be pro-competitive, that it is not before it.⁶
16. Since the OFT's report on *BSkyB/ITV*, the CC has published its final report in the recent *Tesco/Co-op Slough* case.⁷ In that case, the CC concluded with reference to pre-merger competitive conditions in Slough that the

⁵ See further *Thermo Electron Manufacturing Limited/GV Instruments Limited*, OFT decision, dated 15 December 2006 citing previous OFT 'failing firm' cases under the Act.

⁶ See further OFT Report to the Secretary of State - *Completed acquisition by BSkyB plc of a 17.9 per cent shareholding in ITV plc*.

target CGL Uxbridge Road store was the closest competitor to Tesco's Brunel Way store; in other words, the acquisition raised concerns relative to pre-merger conditions. However, in evaluating the appropriate counterfactual in-depth, the CC concluded that - although the store was not failing - the seller would inevitably have sold that store and exited from Slough, and that, but for the sale to Tesco, Sainsbury's would have acquired the store from CGL. Accordingly, in the specific circumstances of that case the CC conducted a competitive effects analysis taking into account not only the loss of the pre-merger constraint between Tesco and the CGL store (loss of actual competition) but with reference to the fact that absent the merger, Tesco would have competed with a Sainsbury's store, and not CGL's, operating from the site of the target store (as an aggravating factor, the loss of potential competition over and above that provided by the CGL store). It decided that the latter situation with a Sainsbury's on the former CGL site was the appropriate counterfactual. It also concluded that the post-merger lessening of competition was even greater when compared to that counterfactual - a new Sainsbury's on the nearby site as Tesco Brunel Way's closest competitor - than based on pre-merger conditions with the original CGL store. In other words, the *combined* loss of actual and enhanced competition but for the merger formed the basis of the CC's finding of an anti-competitive outcome requiring a remedy.

17. The OFT considers the *Tesco/Co-op Slough* case wholly exceptional, not least given its long history. While the CC's approach to the counterfactual was justified by the circumstances of that case and was amenable to the in-depth evaluation carried out by the CC, the Slough case should not be regarded as precedent for future OFT application of the counterfactual in grocery or other transactions.
18. It would tend to create an unworkable regime of first-phase merger control if the OFT - as opposed to the CC - were generally obliged to conduct an in-depth fact-based assessment of the inevitability of the sale by the seller and conduct a competitive assessment of the outcome with the preferred bidder against, for example, the seller's second choice.⁸ Nor would such an

⁷ The CC's report on the acquisition of the Co-operative Group's Store at Uxbridge Road Slough by Tesco plc, 28 November 2007 (*Tesco/Co-op Slough*).

⁸ Even in the special case of rail franchise awards, where the competition authorities do for public policy reasons treat award of the franchise as inevitable (in other words, rather than the government running the franchise) the approach of the CC in *First/GWF* was to treat the

approach generally assist merging parties in conducting pre-merger antitrust risk assessments as they would in many cases lack *ex ante* knowledge of the second choice if they came first, and the post-merger plans and efficiency rationales of that rival bidder. Finally, such an approach, if generalised across first-phase merger control, would create some risk of unwarranted interference in the markets for corporate control whereby the OFT might be put in a situation in which it is forced to select its preferred bidder from a competition perspective to judge other bids, rather than permitting the large majority of transactions that do not pose real risks to competition in its pre-merger state.⁹

19. The OFT's general approach, therefore, remains that it relies on pre-merger conditions as the appropriate proxy for the counterfactual and will 'test' the competitive impact of any transaction against such a standard before proceeding to consider whether another counterfactual should be substituted. In general, where the merger raises no concerns relative to pre-merger conditions, nothing will turn on the OFT's adoption of its default counterfactual of pre-merger conditions¹⁰ and there will be no need to consider the detailed factual questions that arise under substitute counterfactuals that, for example, the failing firm defence engages.
20. However, where the merger *does* raise concerns relative to pre-merger, the OFT is slow to clear a transaction based on the 'inevitability' of exit of the target business. That is why, where a seller wishes to exit a market because the relevant business is failing or distressed, 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). It would be perverse to subject a *prima facie*

counterfactual *not* as the bidder who came second - which might also pose competition concerns - but as a hypothetical 'no-overlap' bidder or one whose competition problems had been cured. This 'no-overlap' approach in effect restores the analysis in such cases to the default approach that assumes the seller would in fact have run the target business absent the merger (because the bidder is presumed to have no overlaps with the seller).

⁹ See by analogy the approach to merger remedies, where the OFT does not choose its preferred purchaser from a competition perspective. Instead, it tends to approve any purchaser(s) that can be expected to restore pre-merger competition, and will not reject a candidate on grounds another buyer would be even better for competition than pre-merger conditions.

¹⁰ A rare exception to this will be where the OFT has concerns that the merger eliminates an important potential entrant - including entry by acquisition of the unique assets of target - but for the merger. The evidentiary cautions expressed by the OFT in *BSkyB/ITV* would apply in such cases.

problematic sale of a non-distressed business to a lesser standard of scrutiny by accepting more easily that exit (sale) was inevitable when the business itself is not at or near the point of failure.

21. The approach of first testing the impact of the merger against prevailing conditions as the counterfactual is consistent with the OFT and CC approach in Co-op Slough - both authorities found the transaction created concerns given the actual loss of competition between the CGL store and Tesco Brunel Way - and with the four references made to the CC under the Act in failing firm scenarios:¹¹ in all those cases, the merger was problematic relative to the status quo, and the decisive issue was therefore one of whether the merger was causally connected to the deterioration in competitive conditions going forward.

Approach in this case

22. Relative to prevailing conditions, all five stores fail a fascia/isochrone rule established in previous CC cases. However, in the case of four of the stores, notably those in Handforth, Barrow-in-Furness, Liverpool and Nelson (the Failing Stores) the OFT has - for only the second time under the Act - concluded, as set out below, that the stringent criteria for the failing firm defence are clearly met in respect of the Failing Stores. This means that the deterioration in competitive conditions - of whatever degree - will occur with or without the merger. It is therefore convenient to focus on the application of this defence in lieu of in-depth treatment of the degree of constraint that existed pre-merger between Tesco and the Failing Stores.
23. In contrast, in relation to the former Kwik Save store in Coventry (the Coventry Store) the OFT concludes that the merger raises no concerns relative to pre-merger conditions and has no reason in this case to consider that substitution of a counterfactual involving another buyer is either appropriate, or that, even if it were, that it would change the result.

¹¹ See *Thermo/GVI*, decision of 15 December 2006; *BAI/P&O Ferries*, decision of 7 December 2004; *Arcelor/Corus*, decision of 9 September 2004, *Taminco/Air Products*, decision of 16 July 2004.

APPLICATION OF THE FAILING FIRM DEFENCE TO ACQUISITION OF THE STORES IN HANDFORTH, LIVERPOOL, BARROW-IN-FURNESS AND NELSON

24. In this case, Tesco has submitted that the Failing Stores would have exited the market within a short period of time regardless of the transaction and that the failing firm defence criteria are met.¹²
25. As noted, in order to depart from pre-merger conditions as the appropriate counterfactual for assessment of the merger situation, the OFT considers that sufficient compelling evidence is required, particularly as the postulated counterfactual involves the exit of one of the merging parties. In effect, Tesco is arguing that, to the extent competitive harm may arise, the merger is not the cause of that harm as it would occur in any event. Where this type of absence of causation between the merger and the lessening of competition is argued, the OFT will as a matter of policy seek a high level of supporting evidence (within the parameters of its belief relevant to the reference test of the Act, which entails a comparison of the outcomes with and without the merger). The OFT notes, however, that the standard has been met in previous decisional practice at first-phase,¹³ and following analysis is consistent with that adopted in previous OFT decisional practice under the Act.¹⁴
26. Prior to their entry into administration and the appointment of the administrator (KPMG), the Acquisition Stores were marketed to national and local supermarket chains by a property agent. The OFT was told by Tesco that there were no other bidders for the stores in Handforth, Barrow-in-Furness, Liverpool and Nelson (the Failing Stores), and that there was one other bid for the store in Coventry (the Coventry Store) by a grocery retailer who is not recognised by the CC as an effective competitor for the purposes of market definition (see market definition section below). The following paragraphs will therefore focus on the consideration of the Failing Stores.

¹² See further the OFT's treatment of evidence required to meet the conditions of its failing firm defence (Mergers: *Substantive Assessment Guidance*, para 4.36-39).

¹³ See First West Yorkshire/Black Prince, decision of 27 May 2005.

¹⁴ See above; see also BAI/P&O Ferries, decision of 7 December 2004; Arcelor/Corus, decision of 9 September 2004, Taminco/Air Products, decision of 16 July 2004.

Inevitable market exit of the Failing Stores absent the merger given no serious prospect of re-organisation

27. The OFT has established the following facts based on information provided by Tesco, KPMG, FreshXpress and others:

- Kwik Save went into administration on 6 July 2007.
- FreshXpress, a new company run by the former management of Kwik Save, is provisionally managing the Acquisition Stores until the merger is completed. Although FreshXpress chose a number of former Kwik Save stores to run under a new 'FreshXpress' fascia, it told the OFT that it would not be interested in permanently running any of the stores being bought by Tesco.¹⁵
- Tesco was the only bidder for the Failing Stores, which was confirmed by KPMG and FreshXpress.
- The stores in Liverpool, Barrow-in-Furness and Nelson have now closed and the Handforth store is being restocked on a limited and temporary basis by Costcutter.¹⁶

28. The OFT was told by FreshXpress that if the deal with Tesco is not completed, each of the Acquisition Stores that are still open will be closed. KPMG stated that if the Acquisition Stores were returned to it by FreshXpress, KPMG would have to close them (if they were not already closed) and either sell the leases as stand alone assets or surrender the stores to the landlords.¹⁷ This evidence establishes that it would be unrealistic for the OFT to conclude that there was a serious prospect of reorganisation of the business conducted from the relevant stores.

29. Tesco's submissions have been corroborated by KPMG and FreshXpress which enables the sufficient compelling evidence standard to be met in respect of the first two limbs of the failing firm defence. In the light of the above, the OFT believes that the Failing Stores are in such a parlous

¹⁵ FreshXpress stated that it selected 24 stores to run on the basis of its ability to develop the store and historic profitability, and none of the Failing Stores fell into the top 24 stores. It did not want to run any more than 24 stores.

¹⁶ The store in Coventry is open but no longer being restocked.

position that without the merger the Failing Stores (and their relevant assets) would inevitably have exited the market and this would have occurred in the near future.

No less anti-competitive alternative to the merger?

No realistic acquisition by another grocery retailer

30. Results of our third party investigation substantially confirm in all material respects the information given by Tesco, Kwik Save and KPMG about the marketing process of the Acquisition Stores.¹⁸ In particular, the OFT is satisfied that the major groceries chains were given the opportunity to bid for the Acquisition Stores¹⁹ and that no bids other than that made by Tesco were made for the Failing Stores. The OFT therefore believes that there are no realistic alternative buyers whose acquisition of the Failing Stores (or their relevant assets) would produce a better outcome for competition.
31. Overall, the OFT takes the view that there is sufficient compelling evidence in this case that the Failing Stores satisfy the failing firm defence criteria²⁰ and that the relevant counterfactual as comparator to the post-merger outcome should be the assumed failure of the businesses and subsequent closing down of each of the Failing Stores.

No substantially better competitive outcome following failure of the stores

32. OFT Guidance acknowledges that 'it may also be better for competition that the firm fails and the remaining players compete for its share and assets than that the failing firm's share and assets are transferred wholesale to a single purchaser'.²¹ In this particular case, however, the OFT does not believe that the closure of the Failing Stores and exit of

¹⁷ FreshXpress and KPMG did not mention the alternative bid for the Coventry Store to the OFT and therefore their answer covered the five Acquisition Stores.

¹⁸ We were told by a grocery chain that they expressed interest in the Handforth store but were advised that it had already been sold. However, the grocery chain in question did not provide any documents to the OFT to confirm that it had indeed expressed such an interest in making a bid.

¹⁹ Even if it is not clear that all chains were offered an opportunity to bid for all Acquisition Stores, the OFT believes that this was the case for almost all major chains. The OFT was told by a grocery chain that it was only offered the opportunity to bid for three Acquisition Stores, but its assertions were vague and not supported by evidence.

²⁰ OFT's *Mergers - Substantive Assessment Guidance* (OFT 516, May 2003), para 4.37.

²¹ OFT's *Mergers - Substantive Assessment Guidance* (OFT 516, May 2003), para 4.37, third bullet.

these assets from retail grocery sales in the relevant local markets is a substantially better competitive outcome than the acquisition of the stores by Tesco. The post-merger outcome does not result in a reduction in competing fascia relative to exit of the assets in any event; rather, Tesco proposes to operate a grocery store from the premises, which preserves that store as a local option for consumers and increases 'output' in the sense of the net retail floor space devoted to grocery sales in the relevant area. Nor does it seem particularly plausible that rivalry between the remaining stores is materially stronger and produce a better outcome for consumers via improved retail offers merely due to the exit absent the merger of a single Kwik Save store in each relevant area: in other words, the local consumers at issue cannot realistically be expected to be materially *worse* off with one *more* grocery store in the relevant area than with one less.

Conclusion

33. Based on the above, the OFT does not believe that the acquisition of the Failing Stores raises any competition concerns and therefore the remainder of this decision refers only to the acquisition of the Coventry Store.

THE COVENTRY STORE

Product market

34. The OFT and the CC have drawn distinctions in previous cases between different types of grocery shopping trips and the abilities of different sized stores and fascias to cater for different grocery requirements.²² The types of shopping trips identified include 'one-stop shopping', 'top-up shopping' and 'convenience shopping'. The set of competitor stores relevant to the analysis in previous cases has been identified with respect to both store size and store fascia.

²² OFT's decision on the *Completed acquisition by Somerfield plc of 114 Safeway stores from Wm Morrison Supermarkets plc*, 23 March 2005; CC's report on the *Acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc*, September 2005 (hereafter referred to as *Somerfield/Morrisons*); CC's report on *Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc), Wm Morrison Supermarkets Plc, J Sainsbury plc and Tesco plc*, 18 August 2003 (hereafter referred to as the *Safeway Report*).

35. In past cases the OFT and the CC have broadly classified grocery stores into the following store size categories:

Type of store	Net retail area
One-stop	above 1,400 sq m
Mid-range	280 - 1,400 sq m
Convenience	below 280 sq m

36. In the *Provisional Findings Report*²³ the CC moved away from the shopping mission as the starting point for market definition and referred to store sizes instead. It also proposed a slight change to the geographic market definition for grocery stores. Of particular relevance to this case is that the OFT shares the CC's view, which was reiterated in the *Provisional Findings Report*, that competitive constraints in relation to the supply of groceries are asymmetric - larger stores place a greater constraint on smaller stores than vice versa.²⁴
37. The set of fascia which are considered as effective competitors for one-stop and mid-range stores is more limited than for convenience stores. In respect of both one-stop and mid-range stores the CC in *Somerfield / Morrisons* identified the effective competitor set as incorporating Asda, Booths, Budgens, Co-op, Somerfield/Kwik Save,²⁵ Morrisons/Safeway, Sainsbury's, Tesco and Waitrose. In the *Provisional Findings Report* the CC reiterated that Iceland and the limited assortment discounters (LADs) are not considered effective competitors for mid-range and larger stores, but it included all full-range national or regional grocery retailers and symbol groups of the appropriate size as effective competitors, including Marks and Spencer.²⁶ For convenience stores, all fascias listed above, as well as Iceland and the LADs are considered as being effective competitors.
38. The OFT has no evidence to suggest that it should deviate from this definition of effective competitors. However, the OFT believes that Kwik Save's situation has changed since it ceased to be managed by Somerfield (in particular, supply-side substitution was removed since Kwik Save stores

²³ *Market investigation into the supply of groceries in the UK* Provisional findings report, 31 October 2007 (hereinafter the *Provisional Findings Report*) (published during the course of this investigation).

²⁴ *Provisional Findings Report*, para 4.145.

²⁵ When that report was published Kwik Save was still owned by Somerfield.

²⁶ *Provisional Findings Report*, para 13.

could no longer be converted into a Somerfield fascia), and, based on *Somerfield/Morrisons*,²⁷ it believes that, if assessed separately, Kwik Save would be considered to be somewhere in between the LADs and full-range grocery retailers. In other words, the OFT believes Kwik Save seems to be a weaker competitor than others in the 'effective competitor set'.

39. The OFT has considered the competitive constraint that the Coventry Store provides at both the national and local levels. The OFT has also identified those fascia that might significantly constrain the merging parties' stores in terms of both price and non-price parameters of competition, which the CC abbreviates to price, quality, range and service (PQRS) to capture the complex competitive proposition that rival grocery stores offer to local shoppers.
40. The Coventry store has 400 square metres of net retail area, and is therefore classified, strictly, as mid-range store under the framework for first screen analysis currently used by the OFT.

Geographic market

41. In previous investigations in the grocery retail sector the OFT and the CC have concluded that the scope of the geographic frame of reference is essentially local, as most consumers are prepared to travel only a limited distance for their grocery shopping, and that distance may vary according to the type of shopping trip required.
42. At the same time, on the supply-side, national dimensions of competition such as national advertising, promotional activity and purchasing arrangements also exist. Key decisions affecting the operation of stores and other aspects of their business (such as supplier relationships and general promotional activity) are taken centrally on a national basis.
43. In providing its analysis of this case Tesco supplied information using each of the geographic frames of reference used by the CC in *Somerfield/Morrisons* for mid-range and convenience stores, that is:
 - Mid-range stores - five minute (for urban areas) to ten minute (for rural areas) drive-time isochrones drawn around individual stores.

²⁷ Paras 6.43, 6.45, and Appendix b, para 22.

- Convenience stores - one mile radius.

44. In the *Provisional Findings Report* the CC has proposed a change to the boundaries of the geographic market. In particular, it expands the set of competitors for mid-range stores to include larger groceries stores within a 10 to 15 minute drive time.²⁸ However, the CC noted that the precise delineation of the geographic market will vary across local markets, and indicates that the threshold of 10 to 15 minutes has been adopted for the purposes of collectively analyzing a large number of local markets.
45. In this case, the OFT considered it appropriate to apply the geographic definition used in past cases including *Somerfield/Morrisons* as a starting point for the analysis. However, given the small number of overlaps, the OFT considered whether there was evidence to suggest that specific local features or circumstances may warrant a departure from the approach taken in past cases such as *Somerfield/Morrisons* and the *Safeway Report*. In this case the OFT has taken into account the local circumstances for the Coventry Store, as well as the *Provisional Findings Report* in respect of geographic market definition, in assessing the competitive effects of the merger. This is also consistent with the view the CC took in its report on *Tesco/Co-op Slough*, where the CC took a more case-specific view in defining the appropriate geographic frame of reference.²⁹

Coordinated effects

46. The CC's *Provisional Findings Report* noted the OFT's announced inquiry into explicit coordination in relation to certain dairy products and indicated that, while there was no direct evidence of tacit coordination at present, it was concerned that, given the structure of the grocery retailing market such behaviour could occur in the future.³⁰
47. On a national level, to the extent that co-ordination exists, it is not affected by the acquisition. The failing firm defence establishes that the merger is not the cause of any harm to competition in respect of the Failing Stores

²⁸ *Provisional Findings Report*, para 16.

²⁹ In *Tesco/Co-op Slough*, the CC used evidence on entry analysis, the topographic features of Slough, catchment areas for grocery retailers in Slough, and the identification of key competitors in the internal assessments of both Tesco and Co-op.

³⁰ Paragraph 7.59

and, in any event, the transfer of all the Acquisition Stores has only a *de minimis* impact on a national level.

48. At the local level in Coventry, the OFT could not in this case identify a suitable theory that the merger would affect the potential for coordination on the locally-set competitive variables of the retail offer, nor was this suggested in any evidence received.
49. Given the OFT's inquiry and the CC's findings, the OFT has also considered the fact that there have - in other jurisdictions at least and not involving parties active in the grocery sector - been examples of coordinated market-sharing in the guise of agreements not to enter a rival's local market via by declining to participate (at all, or aggressively) in tenders that would give rise to local market entry by acquisition. In this case, however, there is no suggestion that the tendering process itself was subject to any collusive bidding or non-bidding.

Non-coordinated effects: national level

50. Tesco state that, according to recent TNS data, its current national market share of grocery sales is 27.3 per cent. The increment caused by the merger will be minimal (significantly less than one per cent) based on Kwik Save's current sales. Even if the Coventry Store was thriving, the increment at a national level would still be negligible. Hence, the merger does not give rise to any substantive competition issues on a national basis.

Non-coordinated effects: local level

51. In *Somerfield/Morrisons*, the CC applied a filtering methodology for mid-range and convenience stores which was used as an initial screening for potential competition concerns. Stores which did not pass this filter were assessed in more detail, by considering diversion ratios.
52. For mid-range stores, the first phase filter involves sequentially applying and examining relevant-sized isochrones centred on:
 - a) the target store or alternative acquirer store if already sold (the primary isochrone, which is widened if no overlaps are caught in the narrower isochrone)

- b) each relevant competitor's store located within the primary isochrone (including those of the acquirer if not already covered at (a)
 - c) population centres within the primary isochrone
 - d) census output areas within the primary isochrone.
53. At each sequential stage, the approach identifies isochrones (and relevant stores) subject to a local fascia reduction of four to three, or less, in stores above 280 square metres.
54. There are no other effective competitors within a five-minute isochrone of the Coventry Store. The isochrone was therefore widened to a ten-minute drive time. The ten-minute isochrone includes a large number of one-stop shops (three Tesco, two Asda, two Morrisons, a Sainsbury's and a Co-op), as well as some mid-range stores (a Sainsbury's, an Iceland and another former Kwik Save).
55. Given the large number of fascias within the ten-minute isochrone, the store passes the first three stages of the filter test. However, it fails the last filter (centring on output areas). As a consequence, competition concerns could not be ruled out at a first screening.
56. In previous cases, where stores fail the first phase filters, consumer surveys have been conducted to estimate diversion ratios between the overlapping stores. However, in this case Tesco considered that it would not be possible to carry out a meaningful survey because the vast majority of customers had already diverted from the Acquisition Stores (because they are already either closed or being restocked on a partial basis) and so the remaining customers would not provide an accurate picture of the degree of competition between the Acquisition Stores and Tesco's neighbouring stores.
57. The acquisition of the Coventry Store only fails the output recentring test marginally. [] per cent of the population within a five-minute drive time from the Coventry store would have their choice reduced from four to three fascias or less, but [] per cent of the relevant population would either have their choice of grocery fascia unaffected or have more than four fascia remaining. Moreover, there are a number of other factors which suggest that the lessening of competition caused by this merger, if any, is unlikely to be substantial.

58. First, it is likely that even the figure of [] per cent is an overstatement of the extent to a competitive constraint has existed between Tesco and the Coventry Kwik Save store. This is because the Coventry Store is at the low end of the spectrum for a mid-range store in terms of size (and hence likely to be similar to a convenience store in terms of product range and catchment area) and because it is a Kwik Save, which seems to be a weaker competitor than others in the 'effective competitor set'. Thus the OFT believes that the catchment area for the store is probably substantially smaller than that taken for mid-range stores generally. As a consequence, it is likely that only a modest proportion of customers of the Kwik Save - some smaller subset of the [] per cent of customers which the output recentring filters suggests would have their choice of fascia reduced - would in fact have considered Kwik Save and Tesco to be first and second choices to begin with. Nor is there any evidence that, post-merger, Tesco would have been able to discriminate against that small subset of customers for whom the Kwik Save was the first choice and another Tesco the second choice. All of the above does not suggest that Tesco imposed a particularly important constraint on the Kwik Save that would be lost by the merger.
59. Second, a proportion of those consumers which do (or did) consider the Coventry Store as an alternative to Tesco may also have additional choices, not included in the filter test, if they are prepared to travel to the one-stop shops just outside the five-minute isochrone. The market definition adopted in the CC in the *Provisional Findings Report* indicates that these stores are viable alternatives, as the market for mid-range stores includes larger stores³¹ within a five to ten-minute drive time.³² The output recentring filter applied on this basis indicates that all customers within the primary isochrone would have a choice of four or more fascia post merger and therefore the acquisition of the Coventry Store would have passed this filter. Although the OFT would apply caution in adopting a new market definition for grocery stores based on the CC's still provisional findings, it nevertheless considers it realistic on these facts to take into account the fact that the one-stop shops just beyond a five-minute drive time do, to some extent, represent a constraint to the mid-range Kwik Save.

³¹ Larger than 1,000 to 2,000 square meters.

³² Para 4.150.

60. Third, given its small size, the Coventry Store is likely to be more substitutable with the convenience stores surrounding it than other larger mid-range stores. As a consequence it faces some constraint from these convenience stores. Thus, in addition to the stores identified in the fascia count exercise using the *Somerfield/Morrisons* filters, the store is also constrained to some extent by surrounding convenience stores (as well as the one-stop shops within a ten-minute drive time).
61. Finally, to the extent that there is a lessening of competition, this is likely to be limited to a loss of competitive constraint on the Coventry Store alone and not on the nearby Tesco stores, or on the local market in general. This is because the surrounding Tesco stores are large one-stop shops. Given that the constraint imposed by smaller stores on larger stores and vice-versa is asymmetric, it is to be expected that the Coventry Store does not exert a constraint on these larger Tesco stores. For the same reason, the Coventry Store would not exert a constraint on any of the other surrounding one-stop shops. The Coventry Store might exert a degree of constraint on local mid-range stores, but this is limited due to its size and fascia. The few mid-range stores around are some distance from the Coventry Store (beyond a five-minute drive time), and are likely to face more pressure from surrounding one-stop shops than the Coventry Store. None of the mid-range stores are a Tesco. The Coventry Store would have constrained convenience stores but there is no overlap with Tesco convenience stores, and the convenience store market seems generally well served, with four or more fascias in a one-mile radius.³³ Thus, although the stores in the surrounding area may well constrain the Coventry Store, it seems unlikely that the Coventry Store exerts an important constraint on the surrounding stores.
62. Overall, therefore, the OFT does not believe that acquisition of the Coventry Store raises concerns relative to pre-merger conditions, as the loss of rivalry is minimal. Although the OFT recognises that, even absent the merger, the Coventry Store would not remain a Kwik Save (see failing firm discussion above), the OFT has insufficient evidence to conclude with certainty that, but for the acquisition, a competing grocery buyer would have inevitably acquired the store nor that, even if judged against such a

³³ A similar result is achieved if the geographic market definition suggested by the CC's provisional findings for convenience stores (half-mile radius).

rival transaction as a counterfactual, the result of the competition assessment would have been different.

THIRD PARTY VIEWS

63. Some third parties expressed general concerns about the increasing levels of concentration in the supermarket sector but these were not specific to this particular acquisition. Some competitors raised concerns that the merger could generate competition issues, but these were considered above.

ASSESSMENT

64. Tesco overlaps with the Acquisition Stores in grocery retailing. Due to the very small market share increment, the merger does not cause any concerns at a national level. The OFT believes that, absent the merger, the stores in Handforth, Liverpool, Barrow-in-Furness and Nelson would have been closed down with no serious prospect of re-organisation and that there was no less anti-competitive alternative to the merger. Accordingly, the transaction meets the failing firm defence.
65. In relation to the store in Coventry, this fails one of the filters applied in *Somerfield/Morrisons* marginally, and only [] per cent of people in an extended isochrone facing a reduction in choice of fascia of four to three or less. However, based on the particular factors in this case the OFT believes that the level of competition between the Coventry Store and the local Tesco stores would be expected to be much lower than is suggested by this figure. In particular, the relative weakness of Kwik Save as an independent competitor, the (small) size of the Coventry Store, and the fact that there are a number of one-stop shops just outside the five-minute isochrone around the Coventry store and several convenience stores within it, all indicate that the [] per cent figure is an overstatement of the actual impact of the merger on competition.
66. 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

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