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Acquisition by Terra Firma Investments (GP) 2 Ltd of United Cinemas International (UK) Limited and Cinema International Corporation (UK) Limited

The OFT's decision on reference under section 22 given on 7 January 2005

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**PARTIES**

1. **Terra Firma Investments (GP) 2 Ltd (Terra Firma)** manages a number of private equity funds. On 2 September 2004, Terra Firma acquired Odeon Equity Co. Limited (**Odeon**), the largest cinema exhibitor in the UK, with 95 cinemas.
2. **United Cinemas International (UK) Limited** and **Cinema International Corporation (UK) Limited** (collectively **UCI**) operate multiplex cinemas in the UK. Prior to the merger, UCI was the fourth largest cinema exhibitor in the UK, with 32 cinemas nation-wide. Its UK turnover in the year to 31 December 2003 amounted to £123 million.

**TRANSACTION**

3. On 28 October 2004, Terra Firma acquired sole control of UCI through its wholly-owned subsidiaries. The transaction completed on 28 October 2004. The administrative deadline expires on 7 January 2005.

**JURISDICTION**

4. As a result of this transaction, Terra Firma and UCI have ceased to be distinct. The UK turnover of UCI exceeds £70 million, so that the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes that it is, or may be the case, that a relevant merger situation has been created.

**RELEVANT MARKET**

## Product market

5. The parties overlap in the supply of cinema exhibition services in the UK, in the acquisition of film exhibition rights from film distributors, and in the provision of facilities for film premieres.
6. Both parties also offer cinema screen advertising services. The only two customers for this service are Pearl and Dean and Carlton Screen Advertising. Relative to this strong buyer power, the merger changes the parties' market power little and the customers have a number of strong alternative suppliers. We received no substantiated concerns about this sector. In light of these considerations we do not believe that the merger will substantially affect competition in this area and so it is not considered further.
7. As to cinema exhibition services, the first point to consider is how far other distribution channels for films, such as the rental or purchase of video or DVD, or television broadcast, provide alternatives to watching a film at the cinema. We have not seen sufficient evidence that cinema prices are competitively disciplined by these other channels. Cinema has, although for a limited period, the exclusive right to exhibit a film before it is released on video/DVD or broadcast on television. Cinema-going retains some unique features in terms of viewing experience which clearly differentiate it from other forms of film watching (for example, large screen, sound equipment and communal viewing). This appears to be reflected in the significant price difference between a cinema ticket and rental for video or DVD, as well as increasing cinema attendance over the last decade that has coincided with an increase in the range of options for watching films. The parties accepted that other means of viewing films – and other leisure activities generally – while exercising some competitive constraint on the behaviour of exhibitors, are not close substitutes to visiting the cinema. Other forms of viewing films are therefore not considered to be within the same frame of reference for competition assessment as film exhibition at cinemas. In considering this issue in previous investigations, the OFT and the then Monopolies and Mergers Commission<sup>1</sup> (now the Competition Commission (CC)) considered the supply of cinema exhibition services generally.
8. The OFT has therefore taken cinema exhibition as the appropriate frame of reference with which to consider the competitive effect of this merger.

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<sup>1</sup> Decision of the Director General of Fair Trading in relation to the notification by the Film Distributors' Association Ltd of its standard conditions for licensing the commercial exhibition of films (February 2002) Case CP/1321-00S and the Monopolies and Mergers

## **Geographic market**

9. On the demand side, cinema exhibition services have strong local characteristics since customers are only willing to travel relatively short distances to cinemas. On the supply side, where national chains exist, certain parameters of competition (for example, negotiation with distributors for access to film content and for screen advertising fees and branding) take place at the national level. However, even national chains appear to see competition operating at a local level since they vary price, content and facilities according to local conditions. The OFT has therefore analysed competition both nationally and locally.

## **COMPETITIVE ASSESSMENT**

### **National issues**

10. As a result of the merger, Terra Firma has a share of cinema exhibition of 25-35 per cent (increment around 10 per cent) in the UK whether measured by box office receipts, number of screens or number of seats. It has 17 per cent (increment 5 per cent) of sites in the UK.
11. The supply of cinema exhibition services remains fairly concentrated, although significantly less concentrated than it has been in the past. Pre-merger, the six largest chains (Odeon, UCI, Vue, UGC, Cine-UK and National Amusement) accounted for over 80 per cent of cinema box office receipts in the UK in 2003. Upstream, cinema distribution is similarly concentrated with the top eight distributors accounting for over 95 per cent of UK box office receipts. Most of the large distributors are vertically integrated with Hollywood studios.
12. Some third parties considered that the merger was pro-competitive at a national level, giving greater power to exhibitors in negotiations with distributors. However, others expressed concern about the increase in Terra Firma's bargaining power when negotiating for access to film content. It was argued that Terra Firma could obtain more favourable terms from distributors that would reduce the availability of prints for small exhibitors, or even that it would demand exclusivity in certain localities.
13. The OFT does not have reason to believe, on the basis of the evidence provided, that the merger may be expected substantially to lessen competition nation-wide. Distributors have, and will continue to have, a strong negotiating position relative to the exhibitors depending on the attractiveness to audiences

of the films that they have to offer. Furthermore distributors retain a strong incentive to distribute as many copies of a film as possible. The competition concerns arising from the merger are local rather than national.

#### **Local issues**

14. In areas where Terra Firma (Odeon) and UCI competed with each other pre-merger the OFT has considered whether there will be sufficient post-merger constraints to ensure no substantial lessening of competition. The OFT has adopted a conservative approach to identify those areas where it is or may be the case that competition may be expected to be substantially lessened by the merger. This is appropriate for the first phase of a merger inquiry.
15. In developing its approach the OFT has broadly followed that taken by the CC in the Supermarkets Report,<sup>2</sup> with Terra Firma providing isochrone maps (verified by the OFT) based on drivetime around the parties' cinemas or population centres in areas of overlap. The OFT considers that such an approach is the most appropriate practicable basis for assessing local competition in this case. Unusually, the OFT has in this case been able to place greater reliance on the accuracy of the generated isochrones than in other cases at the OFT stage of review due to the robustness of the underlying assumptions and consistency of the isochrone maps with other information from the parties and independent sources. The assumptions behind the OFT's methodology for analysing the merger are set out below.

#### **Assumption 1: Drivetime**

16. The size of local area for competition assessment depends on the distances consumers are able or willing to travel to the cinema. Terra Firma contended that the typical catchment area for cinemas is a drivetime of 20 minutes, but with a 30 minute drivetime to provide a sensitivity check on the primary results.
17. Business documents provided by Terra Firma and third parties support the conclusion that a 20 minute drivetime is the core catchment area for exhibitors but they also consider consumers up to 30 minutes away. On the basis of the evidence provided, the OFT therefore considers it generally reasonable to use a 20 minute isochrone, using a 30 minute isochrone as a sensitivity check of the outcome. The exception to this approach was Central London where the prevalence of other modes of transport and the more diverse nature of West End audiences make isochrone analysis a less reliable proxy.

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<sup>2</sup> The CC report on the proposed acquisition by Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); WM Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc – A report on the mergers in contemplation (Cmnd 5950, September 2003).

## Assumption 2: Size of effective competitors

18. The next step of the OFT's analysis was to identify the size of cinema that would effectively compete with the target cinemas.
19. Cinemas vary by size (number of screens and seats) and by the film content they show. A multiplex<sup>3</sup> showing the latest Hollywood blockbusters may be expected to constitute a greater competitive constraint on another multiplex than a two-screen art house or repertory cinema which only occasionally shows the same type of films as the multiplex. Cinema-goers range from those who wish to see a specific film, to those who are prepared to substitute an alternative if their original choice is not available or not on the right terms, and to those who would consider a wide range of films. So competition to sell cinema tickets may not be limited to tickets to specific films. Even if it was so limited, the smaller cinema would only constrain those wishing to see the limited range of films it is showing in competition with the multiplex, rather than the multiplex's full offering.
20. Given that, as noted above, smaller cinemas may not be able to exert such an effective constraint on larger multiplex cinemas, the OFT had to determine the size at which the threshold for an effective competitor should be set. All UCI cinemas are multiplex, while Odeon has a mix of multiplex and smaller High Street cinemas. There is no industry standard for assessing the size of a cinema that should be taken into account when assessing the competitive constraints on a given cinema. However, in the business documents OFT has seen there was no reference to small cinemas being considered as an effective competitive constraint on the target cinemas outside of London. Cinemas with a minimum of three screens and 696 seats (being three times the average number of seats per screen for the top 20 cinema chains) have been considered by the OFT to be able to show a sufficiently broad range of films and have sufficient seating capacity to compete effectively with the parties' cinemas. Such a rule of thumb has not, however, been applied mechanistically; attention has been paid to local conditions, such as whether a slightly smaller rival cinema is adjacent to the cinema under consideration or much further away.

## Assumption 3: Level of effective competition

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<sup>3</sup> Multiplexes are conventionally defined by the industry as cinemas with five or more screens.

21. The loss of competition brought about by the merger at local level in a number of areas may potentially lead to higher prices and/or reduced content and facility range. [ ]<sup>4</sup>. In determining whether such a loss would be substantial, the OFT considered the level of competition in a given area that would impose an effective constraint on the parties. In principle this could be measured a variety of ways, such as number of competing cinema group fascias or number of screens or seats. Given the restriction of attention, at this point in the analysis, to larger cinemas (as explained in the previous paragraph), the number of fascias is a sensible proxy for practical purposes because it appears to reflect how competition works, a complete set of data are available on that basis, and when other measures were tested they made no significant difference. As a starting point, the OFT has therefore adopted the number of cinema fascias within an isochrone as a proxy for identifying the scope of an individual consumer's choice.
22. It would be expected that average ticket price would rise as the number of fascias in an area declined below some level. It is not immediately clear, however, at what point a price increase resulting from a reduction in the number of fascia would be substantial. Placing that point at greater than four fascias would appear to be unrealistic as it is very unusual to find more than four fascias with cinemas above our size threshold within a 20 minute isochrone.<sup>5</sup> Our analysis suggested that average price for areas with four fascias is lower than that for areas with three fascias, which would suggest that a reduction from four to three fascias could result in a material price increase. In considering whether the threshold would be better placed at a reduction from three to two fascias (as suggested by the parties) we found that this only removed one area from the list that resulted if we used areas with fewer than four fascias post-merger as our threshold. On this basis, the OFT took the view that, where there are four or more fascias in a particular area post-merger, there are no grounds to believe that a substantial reduction in competition may result. Conversely, where the merger results in fewer than four fascias remaining within the isochrone (i.e. Odeon and UCI cinemas facing fewer than three other fascias) in a given area, the OFT considers that it has prima facie reason to believe that it is or may be the case that the merger may be expected to lessen competition substantially.

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<sup>4</sup> Confidential information supporting this theory of harm has been excised at the request of the parties for reasons of commercial confidentiality.

<sup>5</sup> According to the parties [less than half] of Odeon cinemas and UCI cinemas, mostly in large urban areas, are in 20 minute isochrones containing four or more fascias. (Information excised at the request of the parties for reasons of commercial confidentiality.)

23. Despite its apparent robustness to sensitivity analysis, the OFT has recognised that in certain areas the application of this assumption requires individual assessment of other factors such as a new entrant that will clearly enter in the near future or a cinema that misses the required size by a very narrow margin that would raise the number of fascia to at least four.

#### Assumption 4: Population re-centring

24. Having the results from the application of the first three assumptions, a further assumption was applied as a check. This again followed the CC's approach in the Supermarkets Report. Where a significant population centre is located between the parties' cinemas but is not served by sufficient other cinemas, an isochrone was re-centred on those specific population centres. This aimed to ensure that there is a check on whether the merger might materially reduce competition for consumers falling between the parties' cinemas even though such a prospect is not indicated by isochrone analysis centred on cinema location.

#### Application of the method

25. The application of the first three assumptions found an overlap and a reduction to fewer than four fascias post-merger within 20 minutes of ten UCI cinemas — namely those at Clydebank, Newcastle Gateshead, Newcastle Silverlinks, Poole, Sutton, Tamworth, High Wycombe, Dudley, Hatfield and Portsmouth. The parties made particular representations about further fascias that should be included in the analysis for Hatfield and Portsmouth.
  - Portsmouth was found to have two further effective competitors in the form of the new Apollo (opening in Portsmouth in early 2005) and Reeltime in nearby Cosham (which has three screens and is only 30 seats short of the rule of thumb for number of seats).
  - For Hatfield the parties argued that the Borehamwood Curzon is a fourth effective competitor, having four screens but only some 500 seats. The OFT rejected this as not only being too small, but also being on the edge of the isochrone and in an area where the parties have a concentration of cinemas. Similarly plans for a new cinema in St Albans appear insufficiently advanced to constitute an effective constraint on the UCI at Hatfield and the Odeon at Hemel Hempstead, which currently serve as the two closest cinemas to population centres at St Albans and Harpenden.

26. The fourth assumption, population re-centred isochrones, was applied in relation to a further eight target cinemas. Application of this assumption to three of these — namely the areas around Bracknell, East Kilbride and Lee Valley — showed that at least four fascias remained in each of these areas post-merger.
27. For the other five cinemas examined using population re-centring, it was clear that fewer than four fascias remained. These were considered further with regard to local conditions.
- **Surrey Quays and Greenwich:** there is a very large population in South East London with no cinemas between UCI Surrey Quays and UCI Greenwich in the north and the Bromley and Beckenham Odeons in the south. Audiences to the north have four fascias (the parties plus Peckham Network, UGC West India Quay and the refurbished Greenwich Picture Palace) within 20 minutes but those in the south only have Vue as an alternative and that is towards the edge of the isochrones around the Odeon cinemas. Population re-centred isochrones within the area between the UCI and Odeon cinemas show a substantial population where the merger would give rise to a reduction in the choice of fascias from two to one. In addition the parties' internal documents suggested that the Odeon and UCI cinemas constrain each other. In view of these considerations, the OFT believes that there is a realistic prospect of a substantial lessening of competition in this area of South East London.
  - **Basildon:** the Odeon Southend is not within 20 minutes drivetime of the Basildon UCI but, on a 30 minute isochrone centred on Odeon Southend or a 20 minute isochrone based on the population mid-point between the parties' cinemas, they would be the only operator of cinemas above the size threshold in the area post-merger and there is no immediate prospect of entry. As such, the OFT believes that there is a realistic prospect of a substantial lessening of competition as a result of this merger.
  - **Swansea:** the UCI Swansea and the Odeon Bridgend are on the edge of a 30 minute isochrone and both are within a 20 minute isochrone centred on the only substantial population centre between the two, Port Talbot. Although the merger reduces the number of fascias in the latter isochrone to two, a new Vue cinema will open in Swansea in 2006, Port Talbot itself has an Apollo cinema and the Odeon Bridgend itself faces three competing fascias just outside the 20 minute isochrone in Cardiff. Both the UCI and Odeon cinemas will, therefore, continue to face effective competition and the OFT does not believe

that there is a realistic prospect that the merger will substantially lessen such competition.

- **Preston:** the UCI Preston and Odeon Blackpool are just under 30 minutes apart. Only the parties and Vue Preston remain post-merger in a 30 minute isochrone centred on Lytham St Anne's/Kirkham. However, the parties' cinemas are not within 20 minutes of each other and only just within 30 minutes. Moreover, Lytham St Anne's and Kirkham are both relatively small population centres. Consequently, the OFT does not believe that there is a realistic prospect of a substantial lessening of competition in the Preston area.

### **Central London**

28. As noted earlier, it is difficult to apply all the same isochrone assumptions to Central London due to the unique features of that area. The parties overlap in two parts of Central London.

- **Leicester Square**

Leicester Square acts as an event destination and launch pad for new films by hosting film premieres. Possibly as a result of this Leicester Square ticket prices are significantly higher than elsewhere in London.

Post-merger, there is a reduction from three to two fascias within Leicester Square itself, with Terra Firma controlling over 50 per cent of cinema capacity in this area whatever measurement basis is used. Higher prices suggest that customers see the Square as a distinct experience from the rest of the West End, where Odeon also has a very strong position. Third parties have also raised concerns that post-merger Terra Firma controls three out of the four Leicester Square cinemas capable of staging large film premieres and, therefore, that the merger has reduced choice for distributors. This may have a knock-on impact on Terra Firma's wider bargaining power with distributors.

The OFT considers that in light of Terra Firma's high share of Leicester Square and/or the West End, and the fact that a new cinema is unlikely to open in the Square, there is a realistic prospect of a substantial lessening of competition particularly with regard to those cinemas capable of staging large film premieres.

- **Whiteleys**

Whiteleys is in the same general area as the Odeons at Swiss Cottage and Marble Arch. It could be contended that Whiteleys competes with cinemas in reasonable proximity in West London alone or with those cinemas plus the West End. The parties face competition from a number of new large Vue cinemas that have opened in West London in the last five years and from UGC, and there has been a significant drop in admission and ticket prices at Whiteleys in that period. The two smaller cinemas in Notting Hill might enhance the competitive constraint on Whiteleys as combined they are above the multiplex size threshold used above. In addition, cinemas in the West End (excluding Leicester Square) appear likely to exert some competitive constraint on Whiteleys. On this basis the OFT does not believe that there is a realistic prospect of a substantial lessening of competition in this area.

#### **Barriers to entry**

29. At the national level there has been a significant number of new cinemas built in the last 10 years — although this trend has fallen off in 2003 and 2004 — and several new groups have entered the exhibition market (e.g. Apollo and Ster). However, in a number of areas there are barriers to entry, such as the difficulty of obtaining planning permission (particularly in city centres). Accordingly, in general, the potential competitive constraint imposed by the threat of new entry is not sufficiently certain to offset the concerns outlined above.

#### **Countervailing buyer and supplier power**

30. Downstream, the buyer power of individual consumers is considered to be minimal.
31. Upstream, the film distribution sector is fairly concentrated with a number of substantial international players.

#### **THIRD PARTY VIEWS**

32. Third party concerns centred on a reduction in choice for consumers at the local level, possibility of foreclosure affecting small cinemas in particular areas via a stronger upstream relationship with the distributors, and the loss of local competition in the prestigious Leicester Square area. These points have been considered above.

## ASSESSMENT

33. Terra Firma, which operates 95 Odeon cinemas in the UK, has acquired UCI, which operates 32. Although other forms of film viewing may provide some competition to cinema exhibition, the OFT considers that cinema exhibition is the relevant frame of reference for competition assessment in this case.
34. The OFT considers that the merger does not raise material concerns about loss of competition at the national level as distributors have, and will continue to have, a strong negotiating position relative to the exhibitors depending on the attractiveness to audiences of the films that they have to offer. Furthermore distributors retain a strong incentive to distribute as many copies of a film as possible.
35. The competition concerns arising in this case are in a number of localities. The localities of concern have been identified by a method based on isochrone analysis (which has been applied to mergers in other sectors – e.g. supermarkets). In accordance with the OFT's role in merger assessment, cautious assumptions have been made. The isochrone analysis has been adjusted to take account of population centres and sensitivity analysis has been conducted. The entry of new competitors has been recognised where it is sufficiently timely and certain, as barriers to entry do not appear to be sufficiently low at the local level generally to offset local competition concerns. On the basis of this analysis the OFT has identified substantive concerns about a loss of competition in the following 11 areas, covering 13 UCI cinemas:
- Clydebank
  - Newcastle Gateshead/Silverlinks
  - Poole
  - Sutton
  - Tamworth
  - High Wycombe
  - Dudley
  - Hatfield
  - Surrey Quays/Greenwich
  - Basildon
  - Leicester Square
36. Consequently, the OFT believes that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

## UNDERTAKINGS IN LIEU

37. 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.
38. The OFT has therefore considered whether there might be undertakings in lieu of reference which would address the competition concerns outlined above. The OFT's guidance on undertakings in lieu of reference state that, 'undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut'.<sup>6</sup>
39. In lieu of reference to the CC, Terra Firma has indicated a willingness to give undertakings to make divestments in each of the 11 localities where Odeon and UCI cinema's overlap and the OFT has a belief that it is or may be the case that a substantial lessening of competition will, or may be expected to, arise as a result of the merger. The OFT considers that this proposed undertaking is capable of clearly addressing the local competition concerns arising from the merger and identified above, subject to the particular cinema offered for divestment being sufficient to address the issue in each area of concern.
40. Accordingly, 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

41. Therefore, on the basis of the information currently available to it, the OFT has decided not to refer this merger to the CC because it is considering whether, instead of making a reference, to accept appropriate divestment undertakings from Terra Firma to address the competition concerns arising from the merger.

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<sup>6</sup> See *Mergers – substantive assessment guidance*, para. 8.3.