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## **Anticipated acquisition by HMV Group plc, through Waterstone's Limited, of Ottakar's plc**

The OFT's decision on reference under section 33(1) given on 6 December 2005. Full text of decision published on 21 December 2005.

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

### **PARTIES**

1. **Waterstone's Ltd (Waterstone's)** is part of the HMV Group plc (HMV). It is active in the sale of books to final consumers via 195 retail outlets throughout the United Kingdom. Waterstone's total UK sales in the financial year ended 30 April 2005 were £416.4 million.
2. **Ottakar's plc (Ottakar's)** is a UK-listed company active in the sale of books to consumers via 132 retail outlets in the United Kingdom. The turnover of Ottakar's in the financial year ended 29 January 2005 was £173.1 million.

### **TRANSACTION**

3. On 8 September 2005, HMV announced its intention of making a public offer for the entire issued share capital of Ottakar's. The offer of 440p per share was later recommended by the independent directors of Ottakar's. HMV, through Waterstone's, then posted its offer document to Ottakar's shareholders on 19 September 2005.
4. The transaction was notified to the OFT on 9 September 2005.

### **JURISDICTION**

5. As a result of this transaction Waterstone's and Ottakar's will cease to be distinct. The UK turnover of Ottakar's exceeds £70 million, so 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 will be created.

## **BACKGROUND**

6. Consumer demand for books in the UK has risen in recent years, and the number of titles published annually has increased. Discounting and the sale of books by non-traditional outlets (i.e. supermarkets) rather than dedicated bookstores has grown, and internet vendors such as Amazon have opened new distance-based sales channels that have gone beyond traditional alternatives to bookshops, book clubs and mail-order. A recent Mintel report<sup>1</sup> noted that 22 per cent of consumers bought a book on-line between June 2004 and June 2005.
7. This transaction should be viewed against the background of the Net Book Agreement (NBA) which until recently influenced the competitive arena in this sector. From the early 1900s until 1997 this collective agreement among publishers prohibited book retailers from selling a book under the publisher's recommended retail price (RRP) apart from limited exceptions. Any retailer who defied the publisher's rules would be refused any future supplies of books from all participating publishers. Following pressure from the Director General of Fair Trading, the European Commission (EC) and internal industry pressure, the NBA was disbanded in 1995 and later outlawed by the Restrictive Trade Practices Court in 1997. Since the demise of the NBA, discounting by retailers has grown, in particular in terms of lower retail prices for popular paperback fiction.<sup>2</sup>

## **PRODUCT SCOPE**

8. The parties overlap in the retail sale of books to final consumers and institutional customers in the UK.

### **Sales to institutional customers**

9. Institutional customers - such as businesses, schools, universities and libraries - are likely to buy direct from the publishers or wholesalers and receive credit terms and quantity discounts unavailable to individual consumers. Previous EC decisions<sup>3</sup> have considered the sale of books to such customers to be a separate market. The parties submitted that sales to institutional customers accounted for [0-10 per

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<sup>1</sup> See *Books, Music and Video Retailing, Retail Intelligence June 2005*, Mintel International Group Ltd p 29.

<sup>2</sup> Stephen Davies et al, *The Benefits from Competition: Some Illustrative UK Cases - A Report to the DTI* (Centre for Competition Policy, University of East Anglia, 5 May 2004) pp. 54-76.

<sup>3</sup> Case IV/ M.1112, *Advent International/EMI/WH Smith*, 24 March 1998; Case IV/M.1407, *Bertelsmann/Mondadori*, 22 April 1999.

cent] of the overall turnover of each of the parties, and no third party raised concerns regarding this customer class.

10. In the light of the above, the OFT does not believe there is a realistic prospect of a substantial lessening of competition in the supply of books to institutional customers, and this segment is not analysed further.

### **Sales to final consumers**

11. OFT guidance makes clear that market definition is not an end in itself; it is a framework for analysing the direct competitive pressure faced by the merged firm. In the context of differentiated product or service markets, the analytical discipline of market definition helps identify the extent of immediate competitive interaction between the parties' value propositions to their customers, which in this case are consumers.<sup>4</sup> The parties have devoted a substantial proportion of their argument to the proposition that the relevant market, and thus appropriate lens for assessing the merger, is the retailing of books to consumers through all retail channels on the basis that all book retailers are substitutable from the perspective of the consumer.
12. That said, the availability of direct evidence on the central question of unilateral effects (discussed below) has rendered market definition in this case less critical to our assessment. We address the parties' arguments on market definition below and under our assessment of unilateral effects where appropriate.
13. The parties provided TNS data on residual spend by consumers to support their argument that different book retailers are substitutable in the eyes of consumers. These data, it was argued, showed that the parties' customers regularly buy books from a wide range of retailers including non-dedicated book sellers such as WH Smith and supermarkets as well as book clubs, the internet, etc. As discussed below, we do not consider this residual spend analysis to be particularly probative, in part because it simply assumes that which it attempts to prove: that all retail outlets that stock books are effective substitutes for one another. While consumers wishing to buy a best seller (defined below) may purchase such a title at the supermarket/smaller WH Smith stores, such outlets cannot be a demand-side substitute for those consumers wishing to browse through a large range of titles or wishing to be given help in choosing a title. It may be that different types of book retailer are actually complements rather than substitutes; in other words, some consumers may shop for a range of different books throughout the year, but view different retailers as different propositions for the purchase of different books.

14. Industry and consumer comment centres in this respect on a narrower range of retailers that might be described as specialist or dedicated bookstores. An important aspect in this differentiation between retailers is the total number of titles stocked. In the previous EC case<sup>5</sup> involving the sale of Waterstone's by WH Smith, the Commission considered the distinction between dedicated bookshops which offer a wide range of titles (often 10,000-25,000 or more) and non-dedicated retailers which stock other products as well as books, and devote only a proportion of their retail space to sales of books, stocking only a comparatively small range of titles (often fewer than 5,000). According to the OFT's more recent analysis, the minimum number of titles stocked by different book retailers in the UK range from around 350 to 43,000 titles. This supports the intuitive proposition that different types of book retailer offer the consumer significantly different product offerings: dedicated bookstores may stock entire categories of titles not stocked by other retailers, and may include substantially more titles within a given category.
15. An important industry distinction with respect to titles stocked by retailers is between 'best-seller' titles and so-called 'deep-range' titles. Books are ranked in the industry in terms of sales. Third parties have supported the view that the top-ranking books or titles (those titles ranked in the top 5,000 are referred to here as best-sellers) are subject to strong price competition (in the form of discounting off the publishers' RRP or placing the titles as part of multi-buy, e.g. '3 for 2' offers). Conversely, those titles which are ranked outside the top 5,000 in terms of sales (deep-range titles) are usually subject to fewer discounts/multi-buy offers and tend in most part to be sold at cover price, i.e., the publisher's RRP printed on the book. The parties have submitted that the majority of book retailers tend to carry some best-sellers, which seems logical due to their obvious sales volumes, while the total proportion of deep range titles stocked is often a function of the total number of titles stocked.
16. In the OFT's view, the number of titles stocked (size of range) is indeed of greater utility to market definition than the best-seller/deep-range distinction, not least because the fluid popularity of titles over time means that the composition of the best-seller and deep-range categories is volatile; by comparison, the differentiated retail experience offered by dedicated bookstores compared to retailers such as supermarkets is relatively constant (repositioning and expansion by various retailers is considered below). The term employed in this decision applicable to retailers stocking a large range of titles is 'large range book retailers'; the respective average ranges of the parties and other retailers is addressed directly when discussing the closeness of competition between the parties and other

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<sup>4</sup> OFT, *Mergers - Substantive Assessment Guidance*, paras. 3.11 and 3.22.

<sup>5</sup> Case IV/ M.1112, *Advent International/EMI/WH Smith* 24 March 1998.

retailers in the competitive assessment.<sup>6</sup>

17. The proposition underlying our competitive assessment is that, absent a narrow focus on price competition on best-sellers, large range book retailers face their most immediate and direct competitive constraint from one another, and a more distant constraint from retailers stocking a smaller range of titles. This is because their value proposition to consumers is *not* a limited range of books at the most competitive possible prices, but a broader proposition: they stock both best sellers *and* deep range and are consequently the most likely to stock a particular book a consumer is seeking if that title does not happen currently to be a (very) best-seller. In addition, to the extent the consumer does not have a specific title in mind, but merely a genre or interest, or is simply looking for 'something to read', the value proposition of large range book retailers is that they are best-placed to provide the consumer with a browsing experience, and to enhance this experience by providing knowledgeable staff able to provide pre-sales service (for example, help in choosing a book).
18. At the more granular level of different categories of books, the EC in previous decisions<sup>7</sup> found that the market should not be narrowly segmented on this basis because although different categories were unlikely to be demand-side substitutes, on the supply side nearly all book retailers sell titles in a range of categories. No evidence suggests diverting from this view.
19. Consequently, for the purposes of this decision, we have distinguished between Large Range Book Retailers (such as Waterstone's, Ottakar's & Borders/Books Etc. and the top 200 WH Smith [High Street] stores in terms of size) and those which tend to stock a smaller range of books (such as the supermarkets and the remaining 339 WH Smith stores). This assists in ranking the relative competitive constraints that Waterstone's would face post-merger. It is important to note that, irrespective of the market definition taken, in this case the concerns identified would still arise. Our analysis of unilateral effects examines a wide range of possible competitive constraints including the extent to which both large range and small range retailers will constrain the parties post-merger. This is examined in greater detail below.

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<sup>6</sup> A minimum of around 12,000 titles stocked is the best-available numerical proxy for this term. In addition to capturing Borders/Book Etc, Waterstone's, Ottakar's and potentially larger independents, this cut-off captures a large number (200) of recently [reconfigured] WH Smith stores that stock a much greater proportion of books than their other stores which stock on average [5,000-10,000] titles. Considerably below this threshold are book clubs with 7,000 titles; and the supermarkets (350-400).

<sup>7</sup> Case IV/ M.1112 Advent International/EMI/WH Smith 24/03/1998.

## GEOGRAPHIC SCOPE

20. The evidence available suggests that consumers will only travel relatively short distances to buy books, making retailing books largely a local business (subject to the parties' arguments on the ubiquity of the internet). On the supply side, many competitive parameters are set primarily at the local level and appear to include a number of non-price factors such as range of titles, quality of outlet and pre-sales service. As discussed below, it is in respect of these parameters that the OFT's unilateral effects concerns arise.
21. In terms of the scope of 'local' competition, the parties' store opening data show that the 'pitch'<sup>8</sup> of the store and [ ] within a particular town are the main factors taken into consideration by the parties when deciding whether to open a new store. In addition, the OFT conducted a revenue impact analysis which examined the effect on Waterstone's revenues following the opening of an Ottakar's store nearby. This analysis suggested that the effect of new entry is most acute on stores within one mile of the entrant (for example in the same high street) rather than stores further away. Further, HMV's internal documents considered that the impact on revenues increased in direct relation to the proximity of the new store.
22. Some third parties maintain that competition at a local level occurs inter-high street as well as intra-high street, such that book retailers in different towns or in different high streets within the same town compete with one another. Consumer surveys were provided which demonstrated that consumers switch between different towns for their general retail sales but third parties were unable to provide specific evidence to support switching between towns in relation to book buying. Nonetheless there is evidence to suggest that Borders' larger out of town stores may pose some constraint on the parties, even though they are located further than a mile away, suggesting that there may be an element of inter-high street competition.
23. Local elements of competition in book retailing may also translate into forms of competition at the national level. The parties supplied evidence that discounting, promotional activity, branding decisions, and decisions relating to overall business strategy, are on the whole taken by national-scale retailers at the national (head office) level, and supports the view that national branding (and promotion) are significant in this industry.

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<sup>8</sup> Bookshops often locate near clusters of other stores containing a few anchor stores such that footfall is guaranteed. The pitch of the store is the location of the store in relation to the amount of footfall that the location expects to achieve.

24. That said, national pricing would appear to be a self-imposed constraint (which can be changed at any time) and the degree of national price constraints may be expected to be affected by the number of times one competitor overlaps with another at a local level: the greater the local overlap, the more its behaviour (on pricing/promotion, for example) is likely to influence 'national' decisions.
25. On this basis, it would appear appropriate to examine the effects of this transaction at both the national and local level; recognising that the most intense competition comes from rivals located within one mile of each other.

## **Scotland**

26. The OFT has received a number of representations from third parties which considered that the effects of this merger would be particularly felt in Scotland. In particular they contend that post merger Waterstone's will control a large proportion of dedicated bookstores that stock a wide range of titles in Scotland. We have no evidence to suggest that Scotland should be looked at as a distinct geographic market. The issues raised are captured in the context of our analysis at the local level.

## **CO-ORDINATED EFFECTS**

27. The OFT's investigation did not reveal any concerns regarding coordinated effects. It would appear difficult to reach terms of coordination on non-price factors. Price coordination in best-sellers would also appear difficult due to sufficient price competition from many types of book retailers. While publishers' RRP could be regarded as a focal point for coordination in deep-range, there is no evidence of pre-merger coordination and there is no reason to believe that the merger would create or aggravate coordinated effects in this sector. Moreover, despite a wide array of concerns being voiced; this issue was not raised by third parties. Accordingly, this theory is not addressed further.

## **UNILATERAL EFFECTS**

28. At the national level, the parties account for approximately [35-55] per cent<sup>9</sup> (increment [10-20] per cent) of books sold by Large Range Book Retailers in the UK. At the local level, the parties overlap in 35-44 locations.<sup>10</sup> Ottakar's stores in existing overlapping areas outside London account for [ ] per cent of its revenue while Waterstone's stores in overlapping areas outside London account for

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<sup>9</sup> The above figures are based on whether internet sales are included or excluded from the relevant frame of reference.

<sup>10</sup> Depending on whether competition is assessed on a high-street or a town basis.

approximately [ ] per cent of its revenue. For this reason the effects of competition are likely to be felt more acutely at the 'head office' level by Ottakar's than by Waterstone's.

### **Closeness of competition between the parties**

29. A focal point of our investigation has been whether - and in which respects - Waterstone's and Ottakar's are each other's closest competitors either at the national and/or at the local level (where they overlap). Before considering individual price and non-price parameters of competition, the following general observations emerged from the evidence.
30. Waterstone's argues that it does not consider Ottakar's a close competitor. It submitted that it competes more closely with WH Smith and Borders/Books Etc., as well as facing strong competitive constraints from Amazon. To support this view, Waterstone's provided TNS data on residual spend<sup>11</sup> by consumers which, it contended, demonstrated that customers' residual spend was primarily accounted for by retailers other than Ottakar's. As noted above (para. 13) this analysis may be misleading because it does not provide confirmation that all bookshops are effective substitutes for one another: Large Range Book Retailers tend to provide a different offering to smaller range retailers, and for consumers seeking to buy a deep range title, small range retailers will not represent an effective substitute for the purchase of books they do not stock. Moreover, consumers can only choose between Ottakar's and Waterstone's in areas where they overlap. Because the parties' estates overlap in no more than 44 out of 132 possible areas, the pattern of residual spend on a national basis is unlikely to reflect true diversion ratio analysis at a local level between the parties.
31. Despite Waterstone's contentions, the weight of evidence supports the view that the parties are each other's closest competitors in a number of respects.
32. First, both parties provide a similar product offering, that of a large 'bricks and mortar' dedicated book retailer stocking a wide range of titles. Each possesses a strong brand, although both parties acknowledge that Ottakar's brand image is less strong at a national level. Data provided by the parties suggested that Waterstone's stocked on average [30,000-40,000] titles while Ottakar's stocked on average [20,000-30,000]. This compares starkly with the majority of other book retailers in the market who stock on average between 400 and 7,000 titles. As discussed below, it would appear that only Borders/Books Etc., some WH Smith stores, and possibly some independents stock a comparable or wider range than the parties among bricks and mortar retailers.

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<sup>11</sup> Residual spend analysis was provided to us by the parties showing where else consumers went to buy books.



33. Second, various third parties, including a large number of consumers who contacted us during the investigation, indicated that they viewed Waterstone's and Ottakar's as close competitors due to the similarity of their offering. These views corroborate the treatment of the parties in a recent Mintel Report<sup>12</sup> as each other's closest competitors with both parties having a similar customer base.<sup>13</sup> Nevertheless, Waterstone's have argued that its customers are more akin to those shopping at Borders/Books Etc. and Amazon rather than Ottakar's.
34. Third, internal documents from both parties supported the view that they consider each other as close competitors. In particular, HMV's internal documents classed Waterstone's and Ottakar's first and second respectively in terms of being an 'authority on books' and Waterstone's brand strength survey noted that [65-75] per cent of Ottakar's customers also visited Waterstone's. Data compiled for HMV [ ] suggested that where there were two stores located in the same high street [ ].<sup>14</sup> This provides further evidence that the parties are close competitors, and this competition may be lost post-merger.
35. Fourth, the OFT's economic analysis supports the view that Waterstone's and Ottakar's are close competitors where they overlap. In particular, the OFT analysed the number of titles sold by both parties. This analysis showed that for deep range titles, where there is an Ottakar's store nearby, Waterstone's sales are significantly lower than would be predicted by the size of the store. These results are consistent with the hypothesis that where the parties do meet at a local level, Ottakar's has a significant effect on nearby Waterstone's stores. Given the fact that there are relatively few such overlaps on a UK scale, however, suggests that they may be weaker competitors at the national level.

### **Price Competition**

36. Both parties argued that price competition (discounting off RRP) is not affected by competition at the local level because prices are set nationally. Waterstone's also stated that it price monitors a number of other competitors more closely than Ottakar's because of their greater presence at local level which makes them stronger competitors at the national level.
37. Price competition appears to be predominantly in the best-seller segment, with a number of different retailers competing fiercely on price. Discounting in the deep

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<sup>12</sup> See *Books, Music and Video Retailing, Retail Intelligence June 2005*, Mintel International Group Ltd p 36.

<sup>13</sup> See *Books, Music and Video Retailing, Retail Intelligence June 2005*, Mintel International Group Ltd p 36. Ottakar's and Waterstone's attract a large number of ABC1s and wealthy achievers.

<sup>14</sup> [ ]

range segment is nonetheless more limited with a large number of titles sold at RRP. Waterstone's provided evidence that it (i) discounts only a small proportion of deep range titles (it discounted less than [ ] per cent of its deep range titles last year<sup>15</sup>); and (ii) discounts [more] titles than Ottakar's.<sup>16</sup> Waterstone's used this evidence to argue that, post-merger, consumers will overall benefit from having access to more discounts, but this assumes that these discounts are not driven by competition with Ottakar's. Some publishers provided evidence that the number of titles promoted by the parties differed substantially suggesting there is some variety in the titles discounted which would be lost post-merger.

38. While the merged entity's incentive to differentiate itself from its competitors by discounting different titles in the deep range may be reduced post merger, the fact that the proportion of these titles that is discounted appears to be very small means that the merger's potential to have a negative impact on price competition in deep range titles is likely to be low. More importantly, competition between the parties, and within Large Range Book Retailing more generally, appears to occur predominantly on non-price factors.

### **Non-Price Competition**

39. It would appear that, the primary dynamics of competition between Large Range Book Retailers occurs on a number of qualitative factors including the range and variety of titles sold and the quality of the retail experience, which incorporates factors such as the level of pre-sales service, the level of marketing activities engaged in (including author signings) and the ability to browse. Competition on these factors occurs primarily at local level, although the effects of competition may be felt at a national level (given that competition at the national level may be determined by the extent to which the parties overlap at the local level).
40. The parties' internal documents support third party views that Waterstone's and Ottakar's seek to differentiate themselves from other book retailers on precisely the variables identified above: by providing a high quality bookshop; with a wide range of titles; specialised pre-sales service; affording customers a browsing experience; and marketing activities to drive footfall into their shops.
41. As to the incremental competitive pressure that the parties directly place on one another, the evidence is much clearer that Ottakar's reacts to Waterstone's than

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<sup>15</sup> It should be noted this calculation does not account for the volume of each title sold. Additionally, the number of titles discounted will depend on the type of book retailer and each retailer's business model, therefore, the data obtained from Waterstone's may not be truly reflective of the level of deep range discounting which occurs across all Large Range Book Retailers.

<sup>16</sup> Waterstone's and Ottakar's provided a list of deep range titles they had discounted in 2004-5 which confirmed that Waterstone's discounted [more] titles [than] Ottakar's.

vice versa. This may in particular stem from the fact that Ottakar's estate is smaller and, as a result, the overlap areas constitute a greater percentage of Ottakar's estate than Waterstone's. In addition, because of Waterstone's stronger national brand image, it may be expected to have a greater impact on Ottakar's, than Ottakar's on Waterstone's.

42. Waterstone's argued that the OFT's investigation should not be concerned with the loss of pre-merger competition exerted by Waterstone's on Ottakar's - but only on any lost competitive constraint that Ottakar's places on Waterstone's - because Ottakar's will become part of Waterstone's post-merger. The OFT does not accept this premise, as it considers that consumers currently derive benefits from the competitive constraint that Waterstone's exerts on Ottakar's, and it is necessary to consider this loss of competition when assessing the impact of the merger.

#### Quality of Service

43. Third parties have stressed that competition between Waterstone's and Ottakar's is strong at a local level, with Ottakar's differentiating its offering through local events such as author signings; quality of outlet and pre-sales service. To the extent that service quality in Ottakar's stores is driven by competition in overlap areas, this may be only a local issue. Nevertheless, third parties have asserted that the merger may lead to a reduction in service quality even in areas where the parties do not overlap, because Ottakar's service levels are high across all its stores and form a significant element of its brand image.
44. While the parties have provided evidence to suggest that staffing levels per square foot are set centrally based on shop size and are not influenced by competition from Waterstone's, the OFT found a positive correlation between Ottakar's staffing levels per square foot and the presence of a Waterstone's shop in the same overlap area (controlling for store size). Waterstone's internal documents place significant importance on having knowledgeable staff in their bookshops and suggest that being an 'authority on books' is important to both parties' brand image, and an area in which other book retailers are notably weaker. Third parties supported the view that Ottakar's competes strongly at a local level in relation to the experience of its staff and level of pre-sales service offered to its customers, and this has been key to customers switching from Waterstone's to Ottakar's.<sup>17</sup>
45. Third parties submitted that Ottakar's also competes at a local level through innovative marketing techniques such as book signings. The OFT found a positive correlation between the number of book signings at Ottakar's shops and the

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<sup>17</sup> This is based on a number of third party responses received, including those from individual consumers.

presence of a Waterstone's shop. These examples are indicators that competition is occurring at a local level between the parties with the results being more evident in Ottakar's shops where they overlap with Waterstone's.

#### Range

46. A key method by which the parties compete in differentiating themselves from their competitors appears to be in the provision of a wide range of titles. The term 'wide range' as used below captures two elements: a numerically high number of titles (size of range) and the variety of titles within the range (variety of range).
47. Some third parties argued that because of its decentralised ordering system, Ottakar's stocks a greater variety of titles in all its stores than Waterstone's and that the adoption of Waterstone's centralised system post-merger will reduce the overall variety of titles stocked in the merged entity's stores. Waterstone's submitted that they only require each shop to stock a small core range with the vast majority of new books being ordered at the discretion of local store managers. Waterstone's submitted that of 390,000 titles sold in 2004, more than two thirds (300,000) were stocked solely on the basis of decisions by local store managers. Waterstone's argued that this variety will not be lost post-merger. This evidence suggests that competition occurs at a local level on range.
48. Waterstone's claimed that despite the fact that it gives local shops a wide discretion on the titles to stock, the presence of Ottakar's is not a competitive constraint on Waterstone's at the local level. Waterstone's produced evidence to show that following the introduction of Phoenix 9 (stock management system) in Waterstone's stores, the greatest increase in range was found in areas where there was no overlap with Ottakar's. It asserted that the opposite should have been the case if Ottakar's had been a competitive constraint to Waterstone's.<sup>18</sup> All the same, an alternative view of this result could be that Waterstone's was competing against Ottakar's in the overlap areas prior to the roll out of its stock management system and these stores had already sought to optimise range more effectively prior to the roll out of Phoenix 9 in response to competition from Ottakar's. This would explain why the increase in range (to achieve the optimum level) was so much lower than in non-overlap areas where this incentive had not been present. It was not possible to ascertain to what extent the presence of other competitors near Waterstone's provided an incentive to optimise its range prior to introducing Phoenix 9.
49. The OFT conducted a regression analysis of the number of titles stocked by Waterstone's in overlap areas. This analysis showed that the number of titles

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<sup>18</sup> Following the roll out of its stock management system, Waterstone's range increased by [5-15] per cent in non-overlap areas as against only [0-5] per cent in overlap areas.

stocked was closely correlated to store size and that there was no significant correlation between the number of titles stocked by Waterstone's in areas where there was an overlap with Ottakar's. Waterstone's has submitted that, in any event, Waterstone's stocks more titles than Ottakar's. Accordingly, post-merger the range of titles in Ottakar's stores will increase due to the introduction of Waterstone's stock management system. Ottakar's was unable to provide precise figures for the number of different titles stocked in each of its stores, yet on the basis of Ottakar's estimates it appears that it may stock on average more titles in overlap areas than Waterstone's.

50. Third parties have argued that without the competitive pressure from Ottakar's, Waterstone's incentive to continue to stock its existing wide range will be reduced post-merger. Waterstone's has provided evidence that where there are two Waterstone's in the same town, when taken together, the range is about [10-30] per cent greater than that of the larger of the stores, suggesting that the incentive to provide a different range for stores in the same town will remain post merger. All the same, there is no guarantee that the merged entity would wish to keep two stores open in each overlap town. [ ]. Further, it was not possible to determine whether the differentiation in range between two Waterstone's stores is as high as that which currently exists between a Waterstone's store and Ottakar's store. Consequently, consumers may still face a reduction in overall range or variety even if both stores are kept open. Publishers provided evidence that each of the parties stocked a significant proportion of different titles (between 30 and 40 per cent) in their stores. However, these data are only supplied with respect to a few publishers and may therefore not be representative of all titles stocked by the parties.
51. Internal documents show that Waterstone's considers its wide range of titles as its biggest competitive advantage. Range is also key to Ottakar's offering. The evidence on the extent to which Ottakar's presence provides Waterstone's with the incentive to maintain its wide range (and vice versa) is unclear. The correlation between Waterstone's and Ottakar's stock levels cannot be tested directly as Ottakar's did not provide us with sufficiently precise data on the number of titles it stocked. On the other hand, Ottakar's as a Large Range Book Retailer and a close competitor to Waterstone's may provide Waterstone's with a greater incentive to maintain a wider range than a smaller range retailer. This merger may, as a result, reduce Waterstone's incentives to maintain its current wide range of titles post merger.
52. Further, from analysis undertaken by the OFT, given that other non-price forms of competition from Ottakar's stores are affected at a local level in overlap areas by the presence of a Waterstone's store, it is reasonable to conclude, at this stage of inquiry, that range may also be affected.

## **Conclusion**

53. The parties appear to be particularly close competitors at the local level on a number of non-price parameters discussed above, and competition arising from this relationship will be lost following the merger. Subject to the remaining constraints imposed by other competitors and barriers to entry (which are assessed below), the merger may lead to a substantial lessening of competition at the local level, which could be expected to lead to a reduction in the range, product variety and service quality offered by the parties post-merger. Competition at the national level may also be impacted by the loss of competition at a local level.

## **COMPETITIVE CONSTRAINTS FROM OTHER RETAILERS**

### **Borders (including Books Etc.)**

54. Borders' value proposition in its Borders-branded bookshops is a mega-store format that stocks the widest range of titles in 'bricks and mortar' retailing holding on average 53,000 titles. It acquired the Books Etc. high street chain and has also grown market share organically in the past few years by providing customers with an enhanced browsing experience and significant pre-sales service. In terms of similarity of offer (that of a Large Range Book Retailer) and national branding, Borders would appear to represent a close competitor to the parties post-merger in some respects, yet, on the issue of brand, the parties' internal documents suggest that it is ranked below both parties as an 'authority on books'. More significantly, perhaps, Borders would appear to be a strong competitive constraint on the parties only where its estate overlaps: it only has 60 stores in the UK. Moreover, some of the Borders-branded shops are out of town and may pose less of a competitive constraint to the parties' than a competitor located on the same high street. As noted earlier, the extent to which a competitor's estate overlaps at the local level, will in part affect the degree to which the competitor constrains the parties at the national level. In short, while Borders/Books Etc. may be a relatively close competitor to the parties in product/service terms, the scope of such competition is geographically relatively limited at present (subject to expansion).

### **WH Smith**

55. The degree of competitive constraint imposed by WH Smith on the parties has been contested. The parties have submitted evidence to suggest that both Waterstone's and Ottakar's consider WH Smith to be a strong competitor and are

influenced in their pricing and promotional behaviour by WH Smith. In addition, the fact that WH Smith overlaps geographically with each of the parties in most towns implies it may provide some competitive constraint to the parties. Certain third parties, on the other hand, have argued that WH Smith does not provide an effective competitive constraint to the parties as its stores are not dedicated bookshops, it does not offer specialised pre-sales service and consumers do not view WH Smith as a Large Range Book Retailer.<sup>19</sup> Some third parties that contacted us argued that at best only those WH Smith stores that stock a larger range of titles are a competitive constraint on the parties.

56. WH Smith has recently [reconfigured] around 200 of its 539 stores in order to increase the range of books stocked in them. WH Smith indicated that these [reconfigured] stores carry on average [10,000-15,000] titles, compared to an average of [5,000-10,000] titles in the non-[reconfigured] stores. Given that the parties' smaller stores also carry approximately 12,000 titles, it would be reasonable to assume that these larger WH Smith stores would represent a competitive constraint to the parties post-merger.
57. The majority of third parties consulted have argued that the smaller WH Smith stores which carry on average significantly less than 12,000 titles would not be considered to exert a strong constraint on the merged entity as they provide the consumer with a limited choice of titles and do not provide the same level of browsing experience or pre-sales service (for example, assistance in choosing a book).
58. Non-price factors such as the range of titles stocked are an important way in which competition manifests itself in this sector. While WH Smith may represent a strong constraint with regard to price, this is not an area of primary concern. WH Smith may represent a varying degree of constraint in terms of the range of titles stocked.

#### **Independent book retailers**

59. Some third parties argued that independent book retailers do not effectively compete as they are often located 'off pitch' away from where most of the competition for books takes place; they may not stock a sufficiently wide range of books; and are unlikely to be able to compete on price as they obtain lower discounts from publishers than the parties.
60. However the OFT believes that independent book retailers that stock a sufficiently wide range of books may be able to provide a competitive constraint to the

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<sup>19</sup> BML: Consumer Reactions to Book Pricing, commissioned for the Publishers Association (January 2005) p14.

parties. In fact, the level of service, and other non-price factors, offered by independents at the local level may even be superior, given that they are generally not able to compete strongly on price in the best seller segment. Furthermore, if independents have a sufficiently strong local brand image it is possible that they could pose a sufficient competitive constraint to the parties at a local level. What is more, independents are able to buy books through wholesalers who obtain discounts from publishers by buying in bulk, suggesting independents may not be significantly disadvantaged given that many deep range titles are sold at RRP. The parties were unable to identify any independent bookshops of sufficient size and offering a sufficiently large range of titles to pose a competitive constraint on the parties in overlap areas. Accordingly, the evidence on local competition in overlap areas does not suggest that there are independent bookstores in the areas affected which would compensate for the loss of non-price competition between the parties.

## Internet

61. Waterstone's provided TNS data which indicated that internet book retailers and particularly Amazon attract similar types of customers to Waterstone's.<sup>20</sup> Internal documents provided by Waterstone's have generally supported the view that the internet and specifically Amazon, acts as a competitive constraint. Third party respondents commented that while internet book retailers competed on range and price, they could not provide the browsing experience and pre-sales service offered by the Large Range Book Retailers and for that reason were not effective competitive constraints.
62. The parties argued that internet retailers such as Amazon offer a superior browsing experience as they have the ability to generate recommendations based on past purchases, and include customer reviews. All the same, despite its increasing share of supply in the retail sale of books, the internet offers a very different experience to that of high street retailer. Indeed, Waterstone's internal documents note that consumers continue to value 'real' experiences as opposed to virtual ones, and enjoy discussing books face-to-face with knowledgeable sellers.<sup>21</sup>
63. As with WH Smith, the internet may form a more important constraint on price and range but may provide less of a constraint on other non-price factors. The main internet book retailer, Amazon, declined to answer questions about its market position and there is limited evidence available to determine the strength

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<sup>20</sup> A recent Mintel Report: *Mintel Books, Music and Video Retailing, Retailing Intelligence June 2005* as well as TNS data shows that both Ottakar's, Waterstone's as well as other Large Range Book Retailers including Amazon appear to attract similar types of consumers (the ABC1 category) of consumer.



of this constraint. At this juncture, the presence of Amazon and other internet retailers does not sufficiently alleviate the concerns posed by the loss of non-price competition between the two (bricks and mortar) parties in areas where they face one another, and to some extent nationally. In particular, given internet retailers' focus on providing a wide range of titles, some at greatly discounted prices, their primary constraint on the parties appears to be on range and price. As a result, they would not be expected to provide a strong constraint to the merged entity in relation to non-price factors other than range.

### **Book clubs and mail order**

64. The parties submitted that book clubs, mail order catalogues and direct selling exerted a competitive constraint on the parties. It was argued that membership criteria only applied to some book clubs and the parties provided evidence that such providers no longer require customers to commit to a minimum number of purchases. The parties further submitted that the distinction between mail order and the internet was becoming blurred as traditional sales methods were being replaced by web-based advertising and ordering. Waterstone's internal documents noted that the internet had taken an important number of sales from book clubs and mail order catalogues in recent years and that their share of supply while still significant was in decline.
65. Nonetheless, the parties also conceded that book clubs often reduced costs by printing on lower quality paper and often sold end of the line stock in addition to some best selling titles. Further, the largest book club in the UK, Book Club Associates (BCA); only offers a range of 7,000 titles suggesting that they may not be considered by consumers an effective substitute for the parties in respect of range. The parties submitted that providers were able to expand their range with minimal effort and/or expense. Nevertheless, there is limited evidence to show that this has occurred in the past. In addition, consumers' purchasing behaviour may be such that high street book retailers are likely to be more of a competitive constraint on mail ordering, book clubs and direct selling than vice versa.
66. Due to their different offer, book club and mail order providers may be expected to exert at best a limited constraint on the parties post-merger. In particular, given their focus on discounting, the primary constraint they provide would be in relation to price. As a result, they would not be expected to provide a strong constraint to the merged entity in relation to non-price factors and particularly range.

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<sup>21</sup> Waterstone's Medium Term Plan 04/05 – 08/09.

## Supermarkets

67. The majority of third party respondents commented that supermarkets are not effective competitors to Large Range Book Retailers, as they stock a narrower range of titles (350 – 400 titles) which are predominately best sellers and do not provide the browsing experience or pre-sales service offered by the parties.
68. The parties argued that the supermarkets imposed a strong competitive constraint not only in relation to best sellers but also in relation to deep range titles, as they had access to a large amount of retail space and could expand their range to stock more deep range titles in the event that the merged entity increased its prices. The parties provided evidence to show that some supermarkets were intending to stock more deep range titles. Nonetheless, for supermarkets, the decision to stock a wider range of books/titles may be affected by any opportunity cost that may be lost from not stocking a different product (for example DVDs). In order to compete on range with Large Range Book Retailers, supermarkets would have to increase their range significantly. It is considered unlikely that in the event of a 5-10 per cent increase in price, the majority of deep range titles would generate sufficient turnover and/or profit, for supermarkets to warrant shifting away from other high turnover, high margin items. More significantly, as discussed above there is currently limited price competition in deep range titles; rather the parties compete on other non-price factors which the supermarkets are unlikely to replicate.
69. As a result, while supermarkets can and do provide strong price competition in the supply of best selling titles and a limited range of deep range titles they are unlikely to pose a significant competitive constraint on retailers in relation to non-price factors.

## Conclusion

70. The parties submitted that competition in this sector is often through differentiation and that stocking a wide range of titles, offering specialised pre-sales service and a high quality of outlet are how they seek to compete with other book retailers. The parties argued that post-merger, the merged entity will still be constrained by other competitors on these non-price factors.
71. In terms of *price* competition on best-sellers, all of the competitors identified pose a strong price constraint on the parties, with the exception of independents. These constraints prevent concerns that the merger will substantially lessen price competition in this respect.

72. The above competitor analysis suggests that while different retailers each appear to pose some element of competitive constraint on the parties, the OFT cannot conclude at this stage that their collective post-merger presence will compensate for the loss of particularly close competition that exists between the parties. More specifically:
- In terms of stocking a *wide range* of titles beyond best-sellers (deep range titles), and in terms of discounting within this category, Amazon and other internet retailers, Borders/Books Etc, and certain WH Smith stores appear to exert a constraint on the parties. It is not clear, however, that these other constraints compensate for the distinct competitive pressure to maintain a large and varied range that the parties place on one another.
  - In terms of competition on *other non-price* factors besides range, the majority of competitors would appear to offer a limited constraint on the parties post-merger, and certainly not as close a constraint as the parties place on one another. The internet does not provide the same level of service and does not provide a tangible or 'real' bookshop experience. Borders/Books Etc. and some independent retailers may still pose a constraint in terms of range and other non-price factors, where they overlap at the local level, but neither Borders/Books Etc. nor independents are present in many of the overlap areas at issue.
73. Given these factors, the OFT retains significant doubts as to whether the loss of close competition between the parties would be offset by the current degree of constraint posed by other retailers post-merger.

## POTENTIAL COMPETITION

74. A number of third parties raised concerns that, in addition to the loss of competition where the parties currently overlap, the merger would eliminate Ottakar's as a potential competitor to Waterstone's in the future. In particular third parties viewed Ottakar's as engaging in an aggressive expansion plan, opening on average 8.2 new stores per annum over the last five years. Waterstone's internal documents supported the view that they regarded Ottakar's expansion strategy as a potential threat.
75. Based on evidence provided during the investigation, it is unclear whether Ottakar's will continue to pose such a strong constraint as a potential entrant into non-overlap areas in the future.<sup>22</sup> Nevertheless, internal documents support the view that Waterstone's intend to expand its estate [and] the competitive

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<sup>22</sup> [ ]

constraint imposed on Ottakar's stores in non-overlap areas by Waterstone's (including the incentive to innovate or differentiate at the local level) may be lost.

76. As a result of the merger, the constraint that both of the parties impose upon each other through the threat of entry into non-overlap areas will be removed. This competitive constraint primarily exists at the local level. While some third parties have argued that Ottakar's continued growth would also make it a stronger competitor at the national level, this decision does not turn on this issue.

## **ENTRY AND EXPANSION**

### **Generic factors**

#### Parties' arguments

77. The parties have argued that barriers to entry are low at both the national and local level. At the local level, they submitted evidence to demonstrate that suitable sized retail space were readily available in a number of the local overlap areas. As books are supplied on a sale or return basis to retailers, the only entry costs, at the local level, consist of suitable rental premises and fit out costs. Of the 20 outlets that Ottakar's has opened in the last two financial years, 14 were 3,000 square feet or less. Generally, retail space of this size is not in short supply or highly specific to book retailing.
78. At the national level, the parties submit that internet retailers and direct sales operations face low barriers to entry because sunk costs are low, with investments usually being recovered in less than three years. The parties also point to examples of publishers entering the internet sector to market their books directly to the consumer (for example, Bol.com). Still, as noted earlier, internet retailers may only be able to exert a limited constraint on the parties' behaviour post-merger, especially with respect to non-price factors.

#### Pitch, branding and wholesale terms

79. Notwithstanding the parties' arguments, several factors may complicate ease of entry.
80. First, the parties and third parties have indicated that the pitch of a bookshop is an important factor in a store's profitability. Given this, it may be more difficult for potential entrants to find retail space of sufficiently high pitch which would provide enough footfall to allow for successful entry.
81. Second, the absence of a nationally-recognised brand (and thus the brand loyalty which goes with it) may constitute a barrier to entry at the national level, but also

the local level. Waterstone's internal documents support the view that brand is important in the book retailing sector.

82. Third, existing national book retailers also enjoy incumbency advantages of established reputations with publishers and economies of scale and scope. As noted above, these retailers negotiate significant discounts from publishers, making it easier for them to compete on price. All the same, it would appear that an important determinant of the Base Discount offered to retailers is volume, thus an established reputation with publishers may not be essential. Furthermore, there is no reason why publishers could not sponsor entry in the retail market by agreeing favourable discounts with a new entrant.

### **The position of specific competitors**

#### Other national chains

83. There appear to be few barriers to expansion by existing national chains of bookshops. This is evidenced by the amount of new store openings that have taken place by Large Range Book Retailers in the past 12 months. Existing national competitors, such as Borders/Books Etc. and WH Smith, may have the potential to constrain the parties post-merger at the local level.
- Borders/Books Etc appears to have the necessary resources and opportunities to expand its existing profile of stores in competition with the parties. There is also evidence to show that, in recent years, the company has been engaging in rapid expansion via the Borders brand and store format, with the parties submitting that Borders has plans to open an extra 175,000 sq ft. Border's own public documents state that the company will occupy over one million square feet of retail space by the end of 2005 and plans continued expansion in the future.<sup>23</sup> It would appear that new entry by Borders/Books Etc. may place a constraint on the merged entity's behaviour. This could include a combination of expansion on the high street via its Books Etc. format and/or opening large bookshops in retail centres out of town via the Borders format. At this stage of inquiry, however, it is unclear whether, even in the presence of rapid expansion of its existing profile, Borders/Books etc expansion would be timely, likely or on a sufficient scale to offset the loss of primarily local non-price competition brought about by the merger.
  - WH Smith. Based on the evidence available, it would appear that WH Smith is already present in most of the towns where there is an Ottakar's or a Waterstone's (or both). WH Smith's ability to expand to constrain the parties post-merger more closely would require re-positioning its brand closer towards

those of the parties, which connote an 'authority on books' and larger in-store range. This re-positioning would necessarily include increasing capacity in its existing stores (either through additional shelving or re-allocating non-book space to books) or by re-locating to a new store site to add range. It might presumably also require additional staff and/or training, as well as appropriate advertising.

In terms of expanding the space available for books in its existing stores, evidence submitted during the investigation indicated that WH Smith has little or no firm plans to materially expand its existing stores. In terms of re-locating to a new site, WH Smith has started to roll out a number of stand-alone bookshops: the first opened in July 2005, a further two have opened since the proposed merger was announced, and another two are due to open by the end of the year. Nevertheless, it would appear that only one of these stores (Kidderminster) is wholly dedicated to book selling with the other stores comprising mostly books, but also with some news, magazines and entertainment. [ ]

The parties argue that WH Smith's new store formats, and its continued expansion would represent a strong constraint on the merged entity. However, WH Smith's roll out of its new format stores is still at an early stage and it would be inappropriate at this stage to place substantial reliance on the competitive threat posed by brand re-positioning and its future expansion plans.<sup>24</sup>

## Independents

84. There is some evidence to suggest that the net number of independent bookshops in the UK has been falling for a number of years. A report published by the Department of Trade and Industry in July 2004 (the DTI Report)<sup>25</sup> identified that although the number of independent bookshops has decreased since the abolition of the NBA, the reduction in number is smaller than anticipated and the transfer in market share has been due to voluntary transfers to the chain book retailers who have been consolidating their position in the market. There also appears to be

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<sup>23</sup> Borders (UK) Ltd, Fact Sheet: History and Background.

<sup>24</sup> WH Smith has indicated that the new format books only store in Kidderminster is an initial 'trial' store and it is unclear [at this time] whether this format will be rolled out on a larger scale.

<sup>25</sup> *The Benefits from Competition: some Illustrative UK Cases A Report to the DTI*; May 5th 2004. Stephen Davies, Heather Coles, Matthew Olczak, Christopher Pike, Christopher Wilson Centre for Competition Policy, University of East Anglia. p 54-76.

evidence of new independents entering the market<sup>26</sup> suggesting that entry at the local level does occur and considerable dynamism still exists in the sector.

85. Third party responses to this inquiry, however, included arguments that new entrants, especially independents, may be reluctant to open a new store in direct competition with the merged entity (for example on the same high street). The parties were invited by the OFT to provide historical evidence to demonstrate instances where an independent had opened in direct competition with them and subsequently captured market share. However the parties were unable to provide any such specific examples. Based on the evidence available, it would appear that entry by independents is usually into areas where they do not face competition from established book retailers. Although independents may in theory be able to replicate precisely those elements of non-price competition that customers of Ottakar's appear to value, there is therefore insufficient evidence that entry by independents would be timely, likely and sufficient to resolve the concerns identified in the local areas at issue.

## Conclusion

86. De novo entry at the national level is unlikely. Overseas bookshop operators such as [ ] may be able to overcome the brand and reputation barriers, yet, based on third party responses<sup>27</sup> it is not apparent that new entry either from within or from outside the UK is likely in the short to medium term.
87. The issue, therefore, is the degree to which UK-based rivals would move more closely into the product and geographic 'space' occupied by the merging parties in response to a substantial post-merger reduction in non-price competition. If this were timely, likely and sufficient in scope, actual entry/expansion or the threat thereof would restore these benefits to consumers or indeed deter the merger entity from cutting back on pre-merger levels of range and service at first instance.
88. As discussed above, the actual sunk costs of entry at local level, and expansion by chains into new geographic areas appear to be low. However, for reasons discussed in relation to specific competitors above, it is unclear at this stage that brand re-positioning or geographic expansion by other national chains, or entry at local level by independents, would be timely, likely and sufficient to resolve our concerns.

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<sup>26</sup> There is evidence to suggest that 57 new independent members joined the Book Sellers Association in 2004 and a further 60 have joined to date in 2005.

<sup>27</sup> [ ]

## OTHER CONCERNS

89. A number of other concerns were put to the OFT by market participants. For the reasons discussed in detail below, a number of theories advanced are insufficiently supported by evidence and therefore remain speculative.

### 'Gatekeeper' issues

#### Stocking of titles

90. Many publishers that contacted us have argued that Waterstone's and Ottakar's fulfil a vital role as the two main 'routes to market' for deep range titles. Publishers claim that there is fierce competition amongst them to get their books stocked by either or both of the parties. Publishers consider that because of the important role played by Waterstone's and Ottakar's in stocking and selling titles, the parties possess market power significantly above what their shares of supply might indicate.<sup>28</sup> Publishers raised concerns that post-merger the merged entity will be the predominant route to market for deep range titles.
91. In particular, publishers are concerned that post-merger there will be fewer decision-makers deciding which titles are stocked. They are concerned that if Waterstone's centralised stocking system were imposed on Ottakar's stores, the number of opportunities for publishers to get their books stocked will be significantly reduced as they would no longer have the opportunity to sell books directly to individual shops. The publishers have submitted that as they will have fewer opportunities to get their books to the consumer, they will be forced to reduce the number of books they publish in order to concentrate on publishing only those titles which have a higher likelihood of being taken by the merged entity. It is argued that the effect will be particularly felt on deep range titles and that the overall range of books available to consumers post-merger will be reduced.
92. It is worth noting that similar arguments were put forward by publishers as a reason for retaining the NBA. Yet in the event, their fears were not borne out. The DTI Report provided evidence to suggest that the number of titles being published has been steadily rising for the last 15 years. Since the end of the NBA, the retail book sector has seen an increase in concentration, as the large chains have expanded and the number of independent stores has fallen. Despite this, the number of titles published has increased at the same rate as before the end of the

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<sup>28</sup> Some publishers argued that there is a separate market for the procurement of book titles in which the parties hold substantial market power. The OFT has addressed the theories of harm raised by publishers in relation to this market as part of the concerns raised by all third parties.



NBA. Based on historical evidence, there does not appear to be a significant correlation between consolidation in the market and the number of titles published. Moreover, there is limited evidence to demonstrate that this will change substantially as a result of the merger.

93. Furthermore, while the parties would appear to account for a material proportion of the books sold in the UK, it appears that there are still a number of alternate routes to market for publisher's books. This may also include publishers' growing ability to market their books directly to consumers via the internet. Additionally, many more books are published each year than are stocked by any one retailer suggesting that even if some publishers went out of business and the range of titles were reduced, the impact on the consumer might be negligible. As a result, it appears speculative to conclude that post-merger there will be a substantial lessening of competition based on these concerns.

#### Promotion of titles

94. Publishers have also argued that it is not sufficient simply to stock a book on the shelf. They considered that in order for it to sell and have the opportunity of becoming a best seller it needs to be marketed (for example, displayed on a table or in the shop window; be discounted; or be part of some other form of marketing). Publishers submitted that each of the parties currently plays a fundamental role in marketing books, particularly in the deep range, to consumers and argued that post-merger, there will be fewer avenues through which to market their titles. They submitted that this will lead to a reduction in the number of titles published, to the ultimate detriment of consumers.
95. While it was not possible to quantify the cost of some of the marketing techniques used by retailers (for example the opportunity cost of placing a book on a table or in the window), some publishers provided figures which showed that between 46-86 per cent of publisher's advertising expenditure was spent on advertising through retailers (as opposed to direct advertising). Although, for a number of publishers, the parties' combined share of that promotional expenditure only amounts to between 24-28 per cent. In particular, these data showed that ottakar's account for a small proportion (ranging from 2.7 to 7 per cent) of advertising through retailers, which was less than that attributed to a number of other book retailers. Furthermore, the data provided to the oft on promotional spend would not appear to support the claim that the parties are the only viable route to market. If this were the case, such high levels of promotional spending on other book retailers would not be expected. It is acknowledged that were these data on promotional spend to be broken down between best sellers and deep range, these figures may be more significant for deep range titles. Nonetheless, based on the evidence available, there would appear to be sufficient other routes

for the promotion of titles, including other forms of direct advertising.

### **Increased buyer power**

Greater discounts will lead to a reduction in the number of titles published

96. Publishers argued that because of the strong market position of the parties as main routes to market, and as important marketing vehicles for deep range titles, the parties are able to negotiate significant discounts with publishers for the volume of books they sell (Base Discount) and an extra percentage discount for the active promotion of certain titles/genres of books (Promotional Discount). Publishers claim they will have no option but to agree to higher discount terms for the merged entity. They argue that if they give the parties higher discounts, then it will be unprofitable for some smaller publishers to stay in business. This will lead to a reduction in the number of titles published and a reduction in choice for consumers.
97. In this market, buyer power will be greatest where a purchaser can credibly threaten to withhold promotion/stocking opportunities from the seller. This might be the case for supermarkets and other non-dedicated book retailers, who can credibly threaten to re-allocate selling space from books to other products. All the same, the parties as dedicated book retailers could not credibly threaten to re-allocate space in this way. Furthermore, in order to compete effectively, the parties need to have access to a publisher's better selling or 'must have' titles, which would imply that publishers would still be able to exert countervailing power post-merger, especially given it is not always possible to identify which new titles will become best sellers in the future.
98. In addition, the DTI Report identified that although there have been falling returns for writers due to retailer discounting, the number of titles published has been steadily increasing since the end of the NBA suggesting that further discounting in the market is unlikely to lead to a reduction in number of titles published.

### **Increase in RRP**

99. Publishers have argued that because of higher discounts the merged entity will be able to negotiate, publishers' costs will increase and they will be forced to recoup this money by raising RRP. Nevertheless, the fact that publishers consider that they can still increase RRP suggests they may continue to hold market power in relation to certain titles or groups of titles following the merger and raises the question as to why the RRP is not currently set to reflect this.

Discounts obtained by retailers will not be passed onto consumers

100. Some third parties have argued that post-merger there will be less incentive to pass any extra discounts obtained from the publishers by the merged entity onto consumers. The main determinant of whether any cost savings are passed through to consumers, either in the form of greater discounting or increased range/service quality, will be the level of competition faced by the parties downstream.
101. As discussed earlier, the parties will still face a strong price constraint post-merger in respect of best sellers. As a result, it is likely that any pass-through of benefit would be more likely to occur in the form of lower prices in best sellers than in deep- range titles. In terms of discounting of deep range titles this is already limited, nonetheless given the existence of price constraints in deep range titles from competitors such as Amazon and Borders, it is likely that at least some benefit will pass through to consumers. In any event, even if this benefit is limited, it would certainly not appear to leave consumers materially worse off than pre-merger.

### **THIRD PARTY VIEWS**

102. The OFT received over 340 letters expressing concerns that the merger would result in a substantial lessening of competition. Publishers also raised a number of concerns regarding the merger, particularly in relation to the parties' buyer power post-merger and their role as a main route to market. The concerns raised have been addressed in greater detail above.

### **ASSESSMENT**

103. The OFT's concerns in this case arise from a realistic prospect of unilateral effects. In other words, the OFT believes that there is a loss of close competition between the parties, primarily on non-price factors at the local level, though it may also have a national dimension in terms of scale and branding – as each party faces pressure from the other to preserve its reputation as the 'authority on books' in multiple locations across the UK. The evidence available was insufficient to conclude that this loss of close competition will be offset by the sum of the relatively more distant constraints posed by other book retailers. This finding applies both in regard to the present, actual constraint posed by the parties' rivals, and likely future constraints post-merger as a result of repositioning of their value proposition (e.g., by increasing their range, staff or other qualitative retail experience factors), or through entry or expansion into new geographic areas.

104. In its assessment of this case, the OFT has received an unusually high degree of complaints. In relation to the complaints from publishers, the OFT is of the view that the available evidence does not support any of the theories they advance, many of which are speculative in nature. In contrast, the concerns from consumers lend additional weight to the following propositions.
- a. First, that each of the parties seeks to differentiate itself from other retail outlets in a similar manner: by stocking a large range of books, by developing a brand for being an 'authority' in books, and through pre-sales service. This creates a closeness of competition between them;
  - b. Second, that consumers particularly value the extra lengths to which Ottakar's goes to distinguish itself from Waterstone's and other retailers, and that the presence of a Waterstone's in the local area, according to the OFT's econometric evaluations, actually increases this drive by Ottakar's to enhance its value proposition;
  - c. Third, that the loss of competitive pressure from Waterstone's on Ottakar's post-merger, including the closure of a large number of Ottakar's stores, will deprive consumers of a distinctive book-buying experience that they value.
105. While Waterstone's may retain an incentive to differentiate itself from other retailers, and may face actual and potential constraints from Borders, WH Smith, Amazon and others, the available evidence did not sufficiently support the view that the cumulative potential of these constraints would redress the concerns identified.
106. 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**

107. Where the duty to make a reference under section 33(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.
108. The OFT has consequently considered whether there might be undertakings in lieu of reference which would address the competition concerns outlined above.

109. [ ].<sup>29</sup> [ ].<sup>30</sup>

110. In lieu of reference to the Competition Commission, HMV indicated a willingness to give undertakings to:

a. [ ].

b. [ ].

111. The OFT's guidance states that undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are 'clear cut and proportionate'.

112. The undertakings in lieu offered by HMV would only be sufficient were the OFT to conclude that [ ] would be sufficient to maintain the level of competition. As the discussion above demonstrates, the competitive interactions between the different retailers in this market are potentially more complex than that which could be captured by [ ] and [ ] fails to alleviate the concerns raised about the removal of what is distinct to Ottakar's. In the absence of additional information the OFT was not satisfied that the proposed remedy could be considered 'clear cut'.

113. In addition, it was not clear that [ ] would be sufficient to remedy the other concerns raised in relation to the loss of potential competition.

114. Accordingly, the OFT has decided not to exercise its discretion under section 73(2) of the Act to accept undertakings in lieu of a reference.

## DECISION

115. This merger will therefore **be referred** to the Competition Commission under section 33(1) of the Act.

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<sup>29</sup> [ ]

<sup>30</sup> [ ]