Anticipated acquisition by Asda Stores Limited of Netto Foodstores Limited

ME/4551/10

The OFT's decision on reference under section 33(1) given on 23 September 2010. Full text of the decision published on 20 October 2010.

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

PARTIES

1. **Asda Stores Limited** (Asda) is one of the UK's largest supermarket chains and is a wholly owned subsidiary of the US retailer Wal-Mart Stores Inc. Asda operates around 350 stores in the UK, almost all of which are large supermarkets (that is, having more than 1,400 sq m of sales space). Although groceries are its core business Asda also sells (among other products and services) clothing (through the 'George' range), general household items, financial products (for example, insurance products and credit cards), travel agency services and in-store pharmacy services.

2. **Netto Foodstores Limited** (Netto), a wholly owned subsidiary of Dansk Supermarked A/S which in turn is 68 per cent owned by the Danish company AP Møller-Maersk A/S. Netto operates 194 stores in the UK. It is a limited assortment discounter (LAD) offering fewer product lines than similarly sized mainstream supermarkets but at generally low prices.[1] Unlike Asda, Netto does not offer non-grocery products to a significant extent.

[1] Other LADs operating in the UK include Aldi and Lidl.

THE TRANSACTION

3. On 27 May 2010 Asda entered into a sale and purchase agreement with Dansk Supermarked A/S to acquire the entire issued share capital of Netto.

4. Once the deal is completed Asda intends to convert the Netto stores to trade under the Asda fascia by around [ ]. Asda submitted that once the conversion process is complete the number of product lines sold in the former Netto stores that will be retained by Asda will increase from around 1,650 today to 5,000–6,000 in the smaller stores and over 10,000 in the larger stores.

5. After extensive pre-notification discussions the parties provided the relevant information to the Office of Fair Trading (OFT) on 12 July 2010. The OFT's administrative deadline in this case is 22 September (extended by agreement with the parties).

JURISDICTION

6. As a result of the proposed merger the enterprises Asda and Netto will cease to be distinct.

7. For the year ending 31 December 2009 Netto had a UK turnover of around £745 million. Therefore, the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is met.

8. Consequently, the OFT considers that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation.[2]

THE COUNTERFACTUAL

9. In order to assess whether the proposed merger gives rise to a realistic prospect of a substantial lessening of competition (SLC),

[2] The turnovers of the merger parties are such that the merger would have a European Union dimension but since both parties earn more than two-thirds of their European Union turnover in the UK the case falls within the jurisdiction of the UK (Article 1(2) of the EC Merger Regulation, Council Regulation (EC) No 139/2004).

the OFT needs to make an assessment of what would be the case without the merger (the counterfactual). In most instances this is simply the pre-merger situation.[3]

10. In this case, at the national level the OFT has not received any evidence that the pre-merger situation is not the appropriate counterfactual. As such, the OFT has used the pre-merger situation as the counterfactual in this case.

11. At the local level, the parties have submitted some evidence that the pre-merger situation is not the appropriate counterfactual in some areas (for example, because of the imminent entry of rivals). These have been incorporated in the OFT's analysis where relevant to the outcome of the OFT's decision (and all such areas are discussed below).

MARKET DEFINITION

Product market

12. Based on the Competition Commission's (CC's) groceries market report the parties submitted that Asda operates mostly in a market of large supermarket stores, or one-stop stores (greater than 1,000 to 2,000 sq m) constrained by other national grocery multiples (Tesco, Sainsbury's, Morrisons, Co-operative Group (CGL), Marks & Spencer and Waitrose) operating one-stop stores.[4]

13. Netto, on the other hand, operates in the LADs segment. All of its stores are greater than 280 sq m (below which a store is classified as a convenience store) but below 1,400 sq m.[5] The parties

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[3] 'Merger Assessment Guidelines', A joint publication of the Competition Commission and Office of Fair Trading, September 2010, paragraph 4.3.5.

[4] Competition Commission, 'The supply of groceries in the UK market investigation', 30 April 2008, paragraphs 4.135 ('CC groceries report').

[5] The CC used the threshold of 1,400 sq m for much of its analysis (CC groceries report, paragraph 13). In Tesco plc and the Co-operative Group (CWS) Limited: a report on the acquisition of the Co-operative Group (CWS) Limited's store at Uxbridge Road, Slough by Tesco plc (November 2007) the CC also used 1,400 sq m as the threshold.

submitted that Netto is not in the same product market as Asda but nevertheless the OFT should be mindful that after the proposed merger the Netto stores will eventually trade under the Asda fascia.

14. In previous decisions the OFT has examined supermarkets according to their size.[6] One-stop stores were classified as those with a net sales area of 1,400 sq m or above. These stores were found to form their own product market. Mid-size stores were classified as those with a net sales area of less than 1,400 sq m but above 280 sq m. These stores were found to be constrained by one-stop stores and other mid-size stores.

15. Moreover, an aspect of product market definition in previous grocery investigations has been which store fascia to include within the relevant product market. From the perspective of the large grocery retailers (defined by the CC as comprising Asda, CGL, Marks & Spencer, Morrison, Sainsbury's, Tesco and Waitrose) the effective competitor store fascia, has included the large grocery retailers, regional grocers and symbol groups. Importantly for this case, LADs, frozen food retailers and specialist retailers have not previously been included in the product market from the perspective of large grocery multiples (even where their stores are above 1,400 sq m).

16. The OFT has not investigated any case involving the acquisition of a LAD and therefore has no case precedent on the extent to which there would be a loss of competition between a larger grocery retailer and a LAD.

17. Third party competitors were mixed in their responses on this point. Some considered that LADs should be included in the same relevant product as the large grocery multiples, especially in the mid-size sector.

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[6] See, for example, Completed acquisition by Wm Morrison Supermarkets plc of 30 stores from Co-operative Group Limited, Case ME/4132/09, OFT decision of 10 July 2009 ('Morrisons/30 CGL stores'); and Anticipated acquisition by Co-operative Group Limited of Somerfield Limited, Case ME/3777/08, OFT decision of 20 October 2008 ('CGL/Somerfield').

18. Others pointed out that the competitive constraint between Asda and Netto may be asymmetric in that Asda may place a strong constraint on Netto but in turn Netto only places a weak constraint on Asda.

19. There is some evidence to support this proposition. For example, the CC found in its groceries report that:

- with the exception of the impact of Lidl's entry on the revenues of Sainsbury's stores, the entry of a LAD does not impact on the revenues of the large grocery retailers,[7] and
- the limited number of products offered by the LADs means that they are not close substitutes for similarly sized stores operated by the large multiples.[8]

20. Evidence submitted by the parties in this case show that the simple average of the (expenditure weighted) diversion ratio from surveyed Netto shoppers to Asda was around [ ] per cent whereas from Asda to Netto it was around [ ] per cent.[9] This is suggestive that Netto does not constrain Asda to any material extent but Asda does constrain Netto. On this basis, the OFT has included Asda, and the other large grocery multiples, as competitors to Netto for the purpose of assessing this merger.

21. Evidence indicating that the OFT should include the other LADs in the same product market as Netto comes from the CC's groceries report, which concluded that LADs stores are competitively constrained by other LADs stores. A key rationale for this finding was their similar product offering by number of Stock Keeping Units (SKUs, a measure of the number of products).[10]

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[7] CC groceries report, paragraph 4.71.

[8] CC groceries report, paragraph 4.80.

[9] These figures are based on stores which failed the stage 1 fascia counting filtering test. The OFT is not aware of any reason why including the stores which passed the stage 1 test would not suggest an asymmetric constraint from Asda to Netto.

[10] CC groceries report, paragraph 4.85.

22. In its groceries report the CC did not conclude that the LADs were constrained by frozen food retailers such as Iceland. The OFT has, however, reviewed other evidence indicating that Iceland should be included in the same product market as Netto. This includes:

- analysis based on Kantor Worldpanel data show that around 55 per cent of Netto shoppers also shop at Iceland (making it with Aldi the most popular alternate destination for Netto shoppers) and relative to UK shoppers as a whole are significantly more likely to choose Iceland as their alternate shopping destination[11]

- the OFT finding in 2008[12] that Iceland had a comparable number of SKUs to Somerfield (across various product lines) which suggests that Iceland can compete with Netto, at least to some degree, on product range, and

- internal Netto customer research finding that [ ].[13]

23. On this basis, the OFT has taken a broad view of the relevant competitor set in this case, and has included Aldi, Lidl, Iceland, the large grocery multiples, regional multiples and symbol groups in the counting of the relevant fascia during the stage 1 tests (described below and in annexe A) when examining the proposed merger from the point of view of Netto shoppers. It should be noted that evidence on diversion ratios, from customer survey results, are used later in this decision for the purpose of competitive assessment. These provide a clearer indication of the extent of competitive constraint between individual fascia in specific local areas.

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[11] Based on data from Kantar Worldpanel for the year to 18 May 2010. When all UK shoppers are indexed to 100, the data show that Netto shoppers choosing Iceland as an alternate destination are indexed to 141 which makes Iceland second only to Aldi (index = 155) in the ranking of Netto shoppers' alternative destination.

[12] CGL/Somerfield, paragraph 17.

[13] [ ].

Geographic market

24. Previous CC and OFT reports into supermarkets have found that there are both national and local aspects to competition.[14] The parties did not disagree with this.

25. Based on previous CC and OFT reports, the OFT's proposed candidate geographic market in this case for local level competition is a 10-minute drive time isochrone for one-stop stores in urban areas and a 15-minute drive time isochrone in rural areas.[15] For mid-size stores the candidate geographic market is a five-minute drive time isochrone for urban locations and a 10-minute drive time isochrone for rural locations.

26. For Netto, the parties submitted that [ ].

27. In some past cases the OFT has used the catchment area capturing 80 per cent of a firm's customers or sales as a good rule of thumb in determining a candidate geographic market.[16] However, the current case involves a multi-step analytical process which uses a conservative fascia-based filtering exercise within local areas before another exercise is employed which uses customer survey responses. Therefore, the OFT has adopted a cautious approach in the first step of the filtering exercise and allowed the customer survey responses to dismiss competition concerns in some or all of the remaining areas.[17]

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[14] For example, Morrisons/30 CGL stores; CGL/Somerfield; Anticipated acquisition by Tesco plc of 45 outlets from Adminstore Ltd, OFT decision of 5 March 2004 (paragraph 11); Competition Commission, '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', September 2003 (paragraph 2.65).

[15] For example, the CC groceries report, CGL/Somerfield and Morrisons/30 CGL stores.

[16] For example, Completed acquisition by Aggregate Industries Limited of Atlantic Aggregates Limited and Stone Haul Limited, Case ME/3978/08 (aggregates); and Anticipated merger between Co-operative Group (CWS) Limited and United Co-operatives Limited, OFT decision of 23 July 2007 (funeral services).

[17] This is a conservative approach because of the asymmetric constraint. [ ].

28. [ ], the OFT has used a five minute drive time isochrone in the first stage of the filtering exercise with respect to the Netto stores (apart from the one Netto store in a rural area in which the relevant drive time used is 10 minutes). This mirrors the approach taken for mid-size grocery multiple stores.

HORIZONTAL ISSUES

Competition at the national level

29. The OFT does not consider that competition concerns arise as a result of the proposed merger at the national level. Netto's share of grocery retailing at the national level is less than one per cent and other competitors, such as Tesco, Sainsbury's, Morrisons and Co-operative Group, will remain after the proposed merger to constrain the merged entity at the national level. This reasoning – that the proposed merger does not remove an important constraint at the national level – applies for both unilateral effects concerns and coordinated effects concerns. (Nor does the OFT consider that the proposed merger will create or strengthen coordination at the local level. The OFT has no evidence of pre-existing coordination at the local level nor does the OFT believe that the removal of Netto will make local level coordination more likely.)

30. Vertical effects concerns do not arise in this case.

31. The OFT does not believe that the proposed merger will lead to issues of anti-competitive buyer power in respect of the merged firm's suppliers since the increment to national share of supply arising from the proposed merger is very small.

32. Finally, following evidence submitted by the parties on their holdings of land banks, and taking into account the recent Order on controlled land,[18] the OFT does not consider that the proposed merger would result in competition concerns arising through land banking.

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[18] The Groceries Market Investigation (Controlled Land) Order 2010.

33. Therefore, any competition concerns which arise in this case will do so solely through possible unilateral effects at the local level.

Unilateral effects at the local level

34. The proposed merger removes Netto as a supermarket operator independent from Asda. As discussed above, the available evidence suggests that Asda is a stronger constraint on Netto than vice versa. As such, the primary theory of harm in this case is that the merger removes, at a local level, the competitive constraint from Asda on Netto, which will in turn enable the merged firm to raise prices at the Netto site or worsen some non-price factor of competition (such as by reducing quality of service, reducing the quality or range of goods offered, or reducing investment levels).

35. In carrying out its investigation, the OFT did not rule out the possibility that there may be some local areas in which an important constraint imposed by Netto on Asda is lost. The CC, in its groceries report, found that LAD stores did not, in general, constrain stores operated by large grocery retailers (but that mid-size and one-stop stores operated by large grocery retailers did constrain the LADs stores).[19] However, notwithstanding the generic value of this evidence, the OFT adopted a cautious approach and examined whether there were, at a local level, any areas in which Netto imposes a material constraint on the Asda store, such that its removal through merger would result in a realistic prospect of the Asda store worsening its competitive offering. In practice, however, the diversion ratios from Asda to Netto in every surveyed local area were sufficiently low to dismiss this theory of harm.

36. In order to identify possible competition concerns at the local level the parties adopted a variant of the two-stage methodology that has been employed in other recent supermarket cases. The methodology for this case is detailed in annexe A. However, the key components of the exercise were as follows:

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[19] CC groceries report, paragraphs 4.81 and 4.84.

- Stage 1 filter: A desktop fascia counting exercise was carried out in order to remove from the analysis any local area where, despite both Asda and Netto being present, concerns are highly unlikely to arise. Specifically, areas were removed if there were at least three other relevant competitors present within the relevant isochrones. Isochrones were also re-centred on census output areas in order to ensure that this stage 1 filtering exercise led to a cautious and over-inclusive identification of all possible problem areas.

- Stage 2a: Customer surveys were conducted at the Netto stores and used to calculate expenditure-weighted diversion ratios from Netto to Asda. These were then combined with variable profit margins to estimate an illustrative price rise (IPR) for each area, based on a symmetric version of the IPR formula (stage 2a).[20] Given the expectation that diversion ratios from Asda to Netto would be lower than those from Netto to Asda, this approach was expected to generate over-estimates of the IPR in each local area. A number of areas were ruled out from further analysis at this stage, on the basis that the (over-stated) estimate of IPR was below the threshold value of five per cent.[21]

- Stage 2b: For the remaining local areas, customer surveys were then conducted at the Asda stores. The diversion ratios from Asda to Netto, resulting from this survey, were combined with

[20] The illustrative price rise is a measure which the CC used in Somerfield/Morrison and which the OFT has subsequently used in some of its supermarket cases (for example, CGL/Somerfield and Morrisons/30 CGL stores). It incorporates the diversion ratio from a store (which provides some indication of the closeness of competition between the merger parties and so whether a store has the ability to raise its prices) and the variable profit margin of a store (which provides some indication of price sensitivity of demand of the store's customers and whether a store therefore has the incentive to raise its prices). Therefore, the illustrative price increase is probative of unilateral effects theory of harm. Importantly, the IPR is not the same thing as merger simulation and therefore it does not try to predict post merger prices nor does it suggest that the OFT is willing to tolerate post merger price increases of up to five per cent.

[21] The threshold of five per cent is based on recent grocery merger cases adopting the IPR methodology (for example, Somerfield/Morrisons; CGL/Somerfield).

those from Netto to Asda to calculate a revised IPR for each local area, based on the asymmetric version of the IPR formula.

37. The rationale for taking a two step approach to stage 2 was that it provided a pragmatic way for the parties to reduce the number of local areas in which they needed to conduct costly customer surveys, while minimising the risk to the OFT of allowing local areas to be filtered out of the analysis when they should not be.[22]

38. A final step in stage 2 was to review evidence on mitigating circumstances for some local areas as to why the merger may not lead to a SLC in those areas, even though the IPR methodology might suggest a likely SLC.

39. Following the stage 1 filter and stage 2 analysis, the parties submitted evidence of a general type as to why the OFT should be less concerned about the proposed merger than suggested by the stage 2 results. This is because the standard stage 2 analysis does not allow for the rationale for the merger, which is that the Netto stores will be re-branded as mid-size Asda stores containing a significantly larger number of SKUs and a different mix of grocery products than offered by Netto. As a result, the parties submitted, consumers will enjoy the benefit of the expansion of supply in the mid-range grocery sector and Asda will enjoy purchasing synergies, which it will also pass through into lower prices.

40. Instead, the stage 2 analysis used Netto's current variable profit margins and customer surveys reflective of Netto's current customer offering. The parties called this stage – when the OFT considered the parties' views on the Netto stores being

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[22] Given the asymmetries between the Asda and Netto stores – that Asda provides significantly stronger competition to Netto than Netto does to Asda (see paragraph 44) – the symmetric form of the IPR calculation will always give a higher illustrative prise rise than the asymmetric form. Consequently, a store 'passing' the stage 2a IPR test could not fail the stage 2b one, reducing the number of stores to which the parties needed to apply the stage 2b. As a check, the OFT calculated the diversion ratios from Asda to Netto that those stores passing the symmetric IPR would need to have in order for the asymmetric IPR to be five per cent. In all cases the critical diversion ratio would need to be at least six times the average measured Asda to Netto diversion ratio.

repositioned as Asda stores – the stage 3 analysis. The stage 3 analysis is discussed later in this decision.

Stage 1 & 2 analyses: Issues and results

41. In line with previous cases the OFT employed the IPR in this case.[23] As detailed in annexe A, the parties put a considerable amount of work into determining the input variables for the IPR formula.

42. The IPR can be estimated using a symmetric form. That is, one that assumes symmetry of both profit margins and diversion ratios (the proportion of customers who would switch to the other merger party in the event that the first one puts up its prices). Such an assumption may work well for two similarly positioned firms.

43. In this case, however, the parties argued that it was appropriate to employ the asymmetric form of the IPR calculation.[24] Although this is more complicated and information demanding than the symmetric form, the evidence available in this case, discussed above, does indicate that the competitive constraints between Asda and Netto are asymmetric.

44. The OFT noted that customer survey evidence collected in the case supported the parties' view that the constraints between Asda and Netto are asymmetric. Indeed, in no local area was the calculated expenditure-weighted diversion ratio from Asda to Netto more than [ ] per cent (whereas the average Netto to Asda expenditure-weighted diversion ratio was [ ] per cent). As such, the OFT agreed

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[23] For examples of previous cases see Morrisons/30 CGL stores; CGL/Somerfield; and Completed merger between Co-operative Group Limited and Lothian Borders & Angus Co-operative Society Limited, Case ME/3933/08, OFT decision of 6 March 2009 ('CGL/Lothian').

[24] This is not the first time that the OFT has considered asymmetry in supermarket mergers. For example, in Completed acquisition by Wm Morrison Supermarkets plc of 30 stores from Co-operative Group Limited, Case ME/4132/09, OFT decision of 10 July 2009 the OFT considered evidence of asymmetry between the merger parties although in that case the OFT did not explicitly model that asymmetry in the IPR calculation.

with the parties' submission that it was appropriate to apply the asymmetric form of the IPR in this case.

45. The key parameters of the asymmetric formula are:

- expenditure-weighted diversion ratios from Netto to Asda and from Asda to Netto
- short-run variable profit margins for both Asda and Netto, and
- **either** the pre-merger relative prices of the merger parties *or* their relative short-run variable costs.

46. The OFT has had considerable interaction with the parties on the calculation of these input variables and accepts the parties' approach. The key points concerning the calculation of the input variables are discussed in annexe A.

Relative price levels

47. The IPR, using the asymmetric form, requires a measurement of the relative costs of the parties or their relative price levels.[25] The OFT considered very carefully which of these measures offered the more accurate data. Ultimately the OFT decided that the information available on relative costs was not as robust as it was on relative prices (for example, see the discussion in paragraphs B.11 to B.19 and B.28 to B.33). Prices, the OFT believes, are in general more transparent than costs, and price comparisons are in general less contentious than cost comparisons.

48. Nevertheless, determining relative prices is not a straightforward exercise and the evidence received by the OFT was mixed. For example, while Asda and Netto may offer similar products, they will not offer exactly the same products across their offerings. By way of example, packets of meat or vegetables may be of slightly

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[25] Since the parties can measure their own margins with some accuracy one cannot then vary both prices and costs (since this would lead to a different margin calculation). Therefore, the analyst must choose which of the more difficult relative components to use – relative prices or relative costs.

different weights, or the products may be of the same quantity but of a different quality which the price reflects. Another challenge in coming to a relative price measure is to allow for differences in the sales volume of the products being offered.

49. The parties argued that Asda's prices were lower than Netto's and provided a variety of evidence on relative prices, much of which supported this claim.

50. The OFT encouraged the parties to come to a relative price measure using a typical basket of products sold in Netto, and the parties undertook such a comparison. Netto's average sale amounts to £[ ]. The parties therefore [ ] to compile a basket of around £[ ] in value, [ ] whilst being careful to avoid duplication of products (for example, two types of milk). These products were then matched to equivalent Asda products. In doing this, branded products were matched with branded products and [ ]. All prices used were valid on 14 May 2010. For this exercise the parties used [ ] matching products of which [ ] did not match by size and so the parties pro rated the Asda price to the Netto size category.

51. This matching exercise found that Asda was [ ] per cent cheaper than Netto. However, this price relationship appeared to be influenced by significant price differences on a small number of products. When the parties extended the exercise to include [ ] matched products (of which [ ] products did not match the size and the pro rating exercise needed to take place) and extended it again to include [ ] matched products (of which [ ] did not match size). The results for these were that Asda was [ ] per cent and [ ] per cent cheaper respectively. Thus, this evidence indicates that any price relationship is not consistent across products.

52. The parties also highlighted that 'The Grocer' magazine (August 2009) had found that Asda was 25 per cent cheaper than Netto for a basket of 50 commonly purchased products. This followed another 'The Grocer' report from December 2008 showing that Asda was 26 per cent cheaper than Netto (for a selection of 33 commonly purchased products).

53. Notwithstanding the evidence submitted by the parties, a document internal to Asda showed that [ ].

54. Moreover, evidence from other sources did not support the parties' claim that Asda's prices were lower than Netto's. An individual shopper submitted to the OFT her own price comparison across 64 products (undertaken in May 2010). While this comparison suffered from the difficulties already discussed of making a robust comparison (for example, different pack sizes were used in some instances and it is not clear how branded and own label products were dealt with) the comparison nevertheless highlighted the fact that shoppers ultimately require a basket of groceries regardless of whether exact matches can be found for the retailer being removed by the merger (which is the reason for her submitting the evidence). This comparison found that Asda was 22 per cent more expensive than Netto.

55. Finally, the OFT is aware of one local newspaper undertaking a price comparison in its area, finding Netto to be 17 per cent cheaper than Asda.[26]

56. Of these pieces of evidence, the OFT finds the Asda price comparisons and the Asda internal document the most persuasive. The Grocer price comparisons and those of the individual shopper analysis do not appear to be strict like-for-like comparisons, and the OFT has not been able to authenticate them as it has with the parties' analysis.

57. Nevertheless, the OFT finds that all of the price comparison evidence presented is highly sensitive to which products are being compared and how many products are being compared. The Asda exercise [ ].

58. The Asda internal document, [ ].

59. Overall therefore, the OFT concludes that evidence on relative prices was mixed. On the basis of the parties' submissions, the OFT is persuaded that [ ]. On a cautious basis, therefore, the OFT

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[26] The Grimsby Telegraph, 'Petrol prices look set to plummet but residents fear loss of budget store', 14 September 2010. The article found a basket of products cost £12.63 at Netto but a similar basket cost £15.30 at Asda.

has assumed [ ] between Asda and Netto for the purpose of calculating the IPRs in this case.

Demand function assumption

60. Both the symmetric and asymmetric approaches to assessing IPRs require an assumption to be made about the shape of the demand curve faced by the merging parties. In line with previous cases[27] and the absence of evidence to the contrary, and on a cautious basis, the OFT worked on the basis of 'isoelastic' demand for the purpose of calculating the IPRs in this case.[28]

Thresholds used

61. In terms of the thresholds applied to identify local competition concerns, the OFT notes that in some past cases local competition concerns were found to arise if the calculated IPR was five per cent or above **and** the expenditure-weighted diversion ratio was 14.3 per cent or above.

62. However, the OFT does not consider these necessarily to be immoveable thresholds. For example, in *CGL/Somerfield* the OFT applied an IPR threshold of one and two per cent by way of sensitivity checks in addition to the five per cent threshold and found that these potentially alternate thresholds did not make any difference in that case.[29] In *Morrisons/30 CGL* stores one local area was found to have a diversion ratio significantly above 14.3 per cent (from one of the merger parties to the other but not vice versa) and a calculated IPR of above five per cent. But the OFT concluded on the basis of evidence submitted that applying plausible yet less restrictive assumptions the 'true' IPR would be less than five per cent.

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[27] For example, Somerfield/Morrison; CGL/Lothian; CGL/Somerfield.

[28] Isoelastic demand curves assume that demand is equally sensitive to changes in price regardless of the price level.

[29] CGL/Somerfield, paragraph A.14.

63. In the current case, the OFT has applied an IPR threshold of five per cent in this case as it did in *CGL/Somerfield*, which in turn was based on the CC's methodology in *Somerfield/Morrison*.[30]

64. The OFT has not found it necessary to conclude on the exact expenditure-weighted diversion ratio threshold to be applied in this case, given that all of the local areas which had a calculated IPR of at least five per cent had an expenditure-weighted diversion ratio (from Netto to Asda) of above [ ] per cent.

Purchasing efficiencies

65. The OFT gave significant consideration to the parties' submissions that the proposed merger would result in significant efficiency gains due to higher purchasing volumes. More specifically, the parties argued that Asda will be able to [ ] and it will be in a position to share in cost savings with some suppliers due to the fact that the distribution chain will be consolidated into one delivery destination instead of the pre-merger situation of two (Asda and Netto) destinations.

66. Verified efficiency gains can be incorporated into the IPR calculation by adjusting the post merger variable cost terms used in the IPR formula by the amount of the efficiency gain.[31] This exercise involves determining an efficiency value for Netto as well as for Asda, even though after the merger the Netto stores will trade as Asda stores with Asda products acquired on Asda supply contracts and sold at Asda prices. This is because the IPR takes account of post-merger margins at both sets of stores.

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[30] In that case an illustrative price increase of five per cent was chosen as a suitable threshold since this level of price change is considered small but significant when deciding on market definition which the CC thought provided a useful benchmark for the purpose of considering illustrative price rises (paragraph 7.11 of Somerfield/Morrison).

[31] The types of efficiencies in this case are rivalry enhancing (see following paragraphs) and directly lower the marginal costs of the merged entity. Therefore, it is relatively straightforward to incorporate them into the IPR formula.

67. However, first the type of expected efficiencies are discussed within the context of how the OFT assesses efficiency claims.

68. OFT/CC guidance says that the OFT is more likely to take into account cost savings which reduce marginal (or short-run variable) costs as these tend to stimulate competition and are more likely to be passed on to customers in the form of lower prices.[32]

69. In assessing efficiencies, the guidance says that the key question is whether the claimed efficiency will impact on rivalry among the remaining players in the market or act as a relevant customer benefit. The key difference between the two is how they are handled in the merger assessment.

70. Efficiencies affecting rivalry are taken into account at the stage in which the OFT is assessing whether there is a realistic prospect that the proposed merger would result in a SLC. Such efficiencies may be sufficient to prevent any SLC from arising in the market being assessed, or the claimed efficiency may mitigate the severity of the SLC.

71. Relevant customer benefits, on the other hand, may be taken into account once the OFT has found that the proposed merger raises a realistic prospect of a SLC and are potentially evaluated as an exception to the OFT's duty to refer a merger.

72. In the current case the OFT considers that the claimed efficiencies (discussed below) are likely to be rivalry-enhancing, at least to the extent that they reduce short run variable costs, since, if they eventuate, would be expected to reduce prices to customers and thereby to intensify competition between Asda and its rivals. In this regard, the OFT notes the parties' evidence that savings in short run variable costs tend to be passed on to customers.

73. Our guidance also specifies that the OFT will consider whether such efficiency benefits are: likely to arise in a timely manner;

[32] 'Merger Assessment Guidelines', A joint publication of the Competition Commission and Office of Fair Trading, September 2010, paragraph 5.7.9.

merger-specific; and are of sufficient scale to prevent an SLC from arising.[33]

74. The OFT does accept that any efficiencies are likely to be merger-specific. It is unlikely that Asda would be able to grow on a scale comparable to its post-merger size without the merger (in a timely manner), especially given, for example, the barriers to entry that exist in mid-size store grocery retailing.

75. Annexe B evaluates the evidence on the likelihood, timeliness and scale of the parties' claimed efficiencies. The OFT finds compelling the evidence that [ ]. It does not, however, accept as compelling the evidence provided by the parties on [ ].

76. Having concluded on the cognisable cost savings in this case, the OFT incorporated these efficiency adjustments into the IPR calculation. In practice, this adjustment did not alter the overall number of SLCs found in this case.

Area-specific countervailing factors

77. The parties submitted area-specific evidence for three areas:

- the imminent entry of [ ] in the [ ] area, which is likely to greatly reduce the diversion from Netto to Asda, and thereby the estimated IPR in this area
- the possible entry of a Netto store in [ ], which the parties argue was too speculative to give rise to an SLC
- the intended acquisition by [ ] of a store at [ ] which overlaps with a [ ] store at [ ] but which nevertheless does not create competition concerns.

Imminent entry: [ ]

78. The OFT considers that, based on current conditions of competition, the merger would give rise to a realistic prospect of an

[33] CC and OFT Merger Assessment Guidelines, paragraph 5.7.4.

SLC in [ ] on the basis of the stage 1 filtering and stage 2 analysis. However, the parties submitted that in [ ] town centre, [ ] is building a one-stop store (of around [ ] sq ft or [ ] sq m) which is due to open around the end of next year and that [ ] has signed a conditional agreement to [ ] sq ft ([ ] sq m) site at [ ]. The parties submitted that as a result of such entry a realistic prospect of a substantial lessening of competition will not arise in the [ ] local area.

79. In addition to Asda and Netto in [ ] is [ ].

80. [ ] confirmed to the OFT that its store will be ready within the next two years. The proposed [ ] store has planning consent (issued on [ ]) but the company told the OFT that it is not certain when building work will commence. Therefore, there is some uncertainty as to the timeliness of the [ ] entry. However, both parties confirmed that they are likely to enter although the likelihood of [ ] entering is tempered by the fact that the period to lodge an appeal against the planning approval is still current.

81. The entry of [ ] would prevent a SLC arising in the [ ] area if (on an expenditure-weighted basis) the diversion ratio from Netto to Asda was reduced from [ ] to [ ] per cent.

82. The OFT believes that entry of a supermarket on the scale of the proposed [ ] sites in [ ] could reduce the diversion ratios to this level, depending on the local circumstances. In this regard the OFT notes that the location of the [ ] development site is reasonably close to the Netto store (about the same distance away as the Asda store is from Netto).

83. The parties submitted that:

- internal Netto research shows that in general [ ]
- the entry of [ ] in [ ] and [ ] in [ ] provide very similar circumstances to [ ] (in terms of the store fascia, the relative proximity of the stores and the store sizes). Here, sales at the [ ] stores fell by around [ ] per cent and [ ] per cent respectively as a result of the entry by these rivals. As

such it is reasonable to expect that Netto will lose a similar proportion of customers in [ ], and

- the local conditions of competition in [ ] also have close similarities to local conditions in the area surrounding the Netto store in [ ]. In this area the Netto to Asda diversion ratio is below [ ] per cent because of the presence of a one-stop [ ] store in the area.

84. Further evidence submitted to the OFT included a map of the local area showing the location of the [ ] development sites. This showed that the [ ] is likely to compete for customers who in the centre of [ ], near to where the Netto is located. For customers living south of the Netto stores [ ] will provide a shopping alternative (although given the more uncertain timing of the opening of the [ ] store, and the slightly longer drive to get to the [ ] site (over five minutes) relative to the [ ] site (four minutes), the OFT has placed less weight on the opening of [ ] than it has on the opening of the [ ].

85. The OFT has taken this evidence together, especially the strong likelihood, scale and relative proximity of the [ ] entry, and on this basis has decided that a realistic prospect of a SLC does not arise in [ ].

Development site at [ ]

86. The parties identified a [ ].

87. [ ]. Given these factors the OFT accepts the parties' arguments that it is speculative as to if and when Netto will operate from this site, and on this basis a realistic prospect of a SLC does not arise in the [ ] local area.

88. For completeness, the OFT notes that there are no Asda development sites which overlap with an existing Netto store and where there are three or fewer fascias in the local area.

Imminent entry of [ ] and [ ] in [ ]

89. The parties submitted that [ ] intends to acquire the [ ] store at [ ] which overlaps with a [ ] store at [ ].

90. Based on the [ ].

91. Nevertheless, [ ] is due to open a store (of around [ ] sq ft / [ ] sq m) in the local area [ ]. Planning approval details are available [ ].[34]

92. The imminent opening of the [ ] (scheduled for [ ]) is confirmed by [ ].

93. On this basis the OFT's accepts the parties' arguments that there is no realistic prospect of a SLC arising in [ ].

Conclusions on the stage 2 analysis

94. Overall, on the basis of the extensive stage 2 analysis described above, the OFT has found that a realistic prospect of a substantial lessening of competition arises in 47 local areas. Efficiencies, though accepted by the OFT where they have been demonstrated to the requisite high standard, were not in practice determinative in the OFT's decision in any local area.

Stage 3 Analysis

95. Once the local area analysis comprising the estimation of IPRs and expenditure weighted diversion ratios was completed the parties submitted a package of information which they called the 'stage 3' analysis. The stage 3 analysis attempts to draw together various arguments as to why the removal of Netto from some local markets should not be as concerning to the OFT as the IPR calculations indicate (since after the merger the Netto stores will be significantly re-positioned in the spectrum of supermarket offerings). The parties' view is that these mitigating factors should be applied to stores with IPRs of between five and 10 per cent.

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[34] [ ].

96. Asda's stage 3 analyses comes under four categories:

- capacity expansion in the market for mid-size stores
- an increase in the number of fascia in the market for mid-size stores
- competitor responses, and
- [ ].

Capacity expansion

97. The parties' argument with respect to capacity expansion is that after the proposed merger the Netto stores will stock significantly more products (of around 5,000–6,000 SKUs in some stores and over 10,000 SKUs in others compared to around 1,650 today), have more staff (and therefore improved quality of service levels) and have longer opening hours. An important element to the parties' argument is that the Netto stores will no longer be LADs but mid-size supermarkets which will strengthen competition emanating from this segment while not losing any competitive constraint on any remaining LADs. This, the parties argued, is a shift outwards of the supply curve (of mid-size supermarkets) which would provide a downward pressure on prices.

98. Further, the parties argue that there is some evidence indicating that mid-size supermarkets are substitutable, at least to some extent, with one-stop stores for top-up shopping missions. Therefore, removing a LAD and introducing a mid-size supermarket will benefit shoppers by increasing competition to supply those top-up shopping missions currently carried out in one-stop stores.

99. One possible way to indicate the size of this effect, or at least to identify the number of people affected, is (as the parties have done) to identify those local areas in which the supply of retail services provided by mid-sized supermarkets (as measured by floor space) increases by at least 10 per cent and/or to identify those local areas which had three or fewer mid-size and one-stop supermarkets.

Increase in fascia

100. Related to the capacity expansion argument, the parties argue that after the merger there will be an increase in the number of mid-size supermarket fascia in some local areas, at least for some proportion of people living in those areas. Clearly local areas do not qualify for stage 3 consideration unless there is an overlap between the Asda and Netto stores and so for some people there will be no beneficial change in fascia (since they had access to an Asda before the merger). However, for a proportion of people it may be the case that, despite being within the relevant isochrone, they live within the catchment area of the Netto store but fall outside of the catchment area of the overlapping Asda store.

101. For these people, one of two possibilities arises as a result of the merger. The first is that the Netto becoming an Asda will give these people access to a mid-size supermarket and all of the increased product range that this entails.

102. The second possibility is that a third party mid-size supermarket may fall within the catchment area of the Netto store but outside of the catchment area of the overlapping Asda store. Re-positioning the Netto to an Asda will strengthen the competitive constraint on the third party mid-size supermarket to the benefit of its customers. Netto was unable to do this before the merger.

103. Using census output area data the parties have been able to identify the proportion of local residents affected by either of these two effects.

Competitor responses

104. The parties argue that the IPR approach adopted in the stage 2 analyses does not take into account reactions by competitors at the local level which may undermine any behaviour by the merged entity that would disadvantage consumers. For example, Asda has argued that, if a grocery retailer were to decrease staffing levels a competitor's best response would be to increase staffing levels, rather than to accommodate the lessening of competition.

[ ]

105. The parties note that the transaction may [ ].

OFT view of the stage 3 arguments

106. As discussed at paragraphs 68 and 69 above, OFT/CC Guidance emphasises that the OFT can consider arguments of the sort described here under the SLC element of the reference test only if they enhance rivalry.

107. To the extent that these changes do not impact on rivalry, but do generate relevant customer benefits that might be balanced against the adverse effects of a reduction in rivalry, they must be assessed under the 'relevant customer benefits' exception to the duty to refer. The OFT is not able to accept customer benefits in some local areas affected by a merger while accepting undertakings in lieu of reference in other areas affected by the merger. As such, to the extent that the benefits described above are properly characterised as relevant customer benefits, the OFT is not able to take account of them unless they fully outweigh the adverse effects of the SLC in every affected local area.

108. In the current case, some of the benefits described above (in particular [ ]) are arguably better characterised as relevant customer benefits than rivalry-enhancement.

109. Nevertheless, the OFT recognises that the re-positioning of Asda stores as Netto stores may have some rivalry-enhancing effects, in particular in terms of increasing the number of fascia competing in the mid-size segment of the market. To be weighted against this, however, is the fact that there will equally be a reduction in the number of fascia competing in the LADs segment of the market. To carry out a full assessment of the competitive impact of this re-positioning in terms of fascia counts would involve detailed analysis on a local area basis.

110. Likewise, on competitor responses, the parties would need to show that competitors not only have the incentive to counteract the merged entity's actions but also the ability to do so, and that that this would have a competitive effect sufficient to prevent a SLC. In

any case, it is not clear to the OFT that decreases in service levels by one fascia would necessarily prompt a competing fascia to increase service levels. The reverse could also occur.

111. Overall, the OFT finds plausible the parties' arguments that there will be some competitive benefits from re-positioning. However, the asymmetry of the OFT's reference test[35] necessarily means that the OFT requires compelling evidence in relation to these stage 3 arguments to enable the OFT to find on the basis of them that there is no realistic prospect of an SLC.

112. It is clear from the discussion above that the net impact of these stage 3 arguments on local competition is an empirical question, which would involve detailed analysis on a local area basis. Given the limited empirical evidence supporting the parties' claims in respect of the benefits of re-positioning, the OFT is not persuaded that the stage 3 arguments alter its views on SLC in any local area. In general, the OFT considers that these stage 3 type arguments are better suited to a phase II investigation by the CC than a phase I investigation by the OFT, not least because it is so difficult to quantify the implications of these factors on a local area basis.

BARRIERS TO ENTRY AND EXPANSION

113. In it groceries report, the CC found that for larger grocery stores the planning system represents a significant barrier to entry, more so than for other grocery retailers.[36]

114. Previous OFT decisions, including *CGL/United* and *CGL/Somerfield*, have concluded that new entry could not be relied on to resolve SLC concerns identified with respect to mid-size and one-stop stores. Most grocery retailers responding to the OFT's questionnaire agreed that, the bigger the size of store that a retailer

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[35] The OFT is under a duty to refer when it is 'or may be the case' that the merger may be expected to result in a substantial lessening of competition, meaning that the parties need to provide compelling evidence that a merger will not raise competition concerns.

[36] CC groceries report, paragraph 7.122.

wishes to develop, the fewer the number of appropriate sites available and the more difficult it is to obtain planning permission.

115. The OFT has concluded in this case that barriers to entry and expansion with respect to one-stop and mid-size supermarkets cannot be relied upon to resolve competition concerns. Indeed, [ ].

THIRD PARTY VIEWS

116. The OFT contacted a large number of local newspapers in this case in an attempt to solicit customer views about the proposed merger. A number of complaints were received from individual shoppers relating to local aspects of the transaction; some of these complaints related directly to competition concerns whereas others expressed disappointment that Netto was exiting.

117. Most grocery retail competitors who received the OFT's questionnaire about the proposed merger responded to it. Some expressed concerns about the merger but most were not concerned. One third party argued that Asda is the closest mainstream supermarket to the LADs and is therefore a close competitor to Netto.

118. The OFT also received several responses from grocery suppliers. Some of Netto's suppliers were concerned that Asda would not purchase from them although the OFT does not view these as competition related concerns since the OFT has no evidence that such suppliers would be foreclosed to the detriment of competition and ultimately to consumers.

ASSESSMENT

119. Asda and Netto overlap in the supply of groceries to consumers. Asda is a large mainstream operator which has around 350 supermarket stores in the UK, almost all of which are one-stop stores. Netto, on the other hand, is not a mainstream operator but a limited assortment discounter. It has 194 stores, all of which are mid-size.

120. In this case the OFT has used, for the purpose of filtering by fascia, the candidate product market which it has used in some previous

cases. That is, mid-size stores are constrained by one-stop stores as well as by other mid-size stores. Further, the OFT has included in the candidate product market definition for the Netto stores all stores of the same size category or larger operated by large grocery multiples (including Asda), and Iceland stores. A list of stores included is in annexe A.

121. The candidate geographic market definition used in this case was a 10-minute drive time for one-stop stores in urban areas and a 15-minute drive time in rural areas. For mid-size stores and Netto stores the candidate geographic market is a five-minute drive time for urban locations and a 10-minute drive time for rural locations.

122. After a comprehensive investigation the only theory of harm that arose from the proposed merger was unilateral effects at the local level based on an asymmetric constraint imposed by Asda on Netto. In particular, the OFT found competition concerns arose at a local level as a result of the proposed merger's removal of the competitive constraint on Netto by Asda which, on a realistic prospect standard, could lead to Asda increasing prices or lowering non-price aspects of competition in some local areas.

123. In coming to this finding the OFT has applied a multi-stage filtering methodology, detailed in annexe A. After the parties had undertaken customer surveys and calculated the expenditure-weighted diversion ratio between the merger parties, the OFT applied the asymmetric IPR formula using a threshold of five per cent (which is consistent with previous cases).

124. The OFT considered area-specific evidence in relation to entry and possible entry in [ ]. On the basis of this evidence, no SLC finding was made in these areas.

125. The OFT gave careful considerations of the parties' submissions on efficiency gains arising from the proposed merger, due to improved purchasing power. The OFT found the evidence compelling on some level of efficiencies but did not accept all of the parties' claimed benefits. The OFT incorporated the level of efficiencies which it found compelling into the IPR formula. However, in this particular case, the accepted efficiencies were not sufficient to change the SLC finding in any local area.

126. Finally, the parties argued that its intended re-positioning of the acquired Netto stores as mid-size Asda stores would have significant benefits. While it is plausible that this will give rise to some benefits, the OFT was not persuaded on the basis of the evidence provided that these would have sufficient rivalry-enhancing effect to alter its SLC finding in any local area.

127. Overall, the OFT found that competition concerns arose in 47 local areas. 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 OF A REFERENCE

128. Where the duty to make a reference under section 33(1) of the Act applies, pursuant to section 73(2) of the Act, the OFT may, instead of making such a reference, and for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which may be expected to result from it, accept from such of the parties concerned undertakings as it considers appropriate.

129. The OFT has therefore considered whether there might be undertakings in lieu of reference (UILs) which would address the competition concerns outlined above. 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 those remedies are capable of ready implementation.[37]

130. As made clear from the OFT's guidance, the OFT must be confident that any proposed UILs will address the competition concerns. Consequently, in those cases in which there is doubt over the precise identification of the substantial lessening of

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[37] Mergers – substantive assessment guidance, OFT526, June 2003, paragraph 9.3 and Mergers: jurisdictional and procedural guidance, OFT527, June 2009, paragraph 8.5.

competition or over the effectiveness of the undertakings, the OFT is likely to consider that accepting UILs is not appropriate.

131. Asda offered UILs to divest the Netto stores in all of the local areas where the OFT identified competition concerns meeting its test for reference to the CC.

132. As a structural remedy that will, in each local area, remove the overlap between the parties, the OFT considers that Asda's proposed UILs are sufficient in principle to act as a clear-cut and comprehensive remedy to the competition concerns identified by the OFT.

133. The OFT was conscious in this case, however, that Asda's offer to remedy competition concerns was limited to sale of the Netto store in each locality, with no availability for Asda (or any divestment trustee, were one ever to be appointed) to sell the corresponding Asda store. This contrasts with a number of recent retail cases, in which the undertakings in lieu extended to sale of either of the overlapping store (or stores) in a given locality.

134. [ ]. On this basis, the OFT examined whether it would be appropriate to suspend its duty to refer notwithstanding the limitation of the divestment obligation to Netto stores only.

Up-front buyers

135. The OFT considered whether it is appropriate in the circumstances of this case to require that the relevant divestments be made in whole or in part to an up-front buyer or buyers.

136. An up-front buyer requirement means that the proposed divestment purchasers will have committed contractually, subject to formal OFT approval of the undertakings in lieu, to acquiring the relevant divestment store(s) before the OFT accepts undertakings in lieu. This means that the OFT will accept undertakings in lieu only where a provisional sale in the up-front buyer areas has been agreed, thereby demonstrating that a sale to a suitable purchaser is achievable. It also means that the OFT may consult publicly on the suitability of the proposed divestment purchasers, as well as any

other aspects of the draft undertakings, during the public consultation period.

137. The OFT will seek an up-front buyer where the risk profile of the remedy requires it, for example where the OFT has reasonable doubts with regard to the ongoing viability of the divestment package and/or there exists only a small number of candidate suitable purchasers.[38]

138. In this case, the question for the OFT was whether Asda, or a divestment trustee, should one need to be appointed, would be able to sell the Netto store in each of the divestment areas to a suitable purchaser approved by the OFT [ ].

139. The parties argued that an up-front buyer provision was not required given that: Netto stores will be attractive to a host of possible purchasers since relevant planning approval will be attached to the stores; the stores are of an attractive size; Asda is already receiving expressions of interest from competitors anticipating some divestment stores; and the fact that Asda is willing to acquire Netto indicates that other mainstream supermarkets will see the sites as being attractive.

140. In addition, Asda had already marketed a number of stores (which it thought the OFT might consider to pose competition concerns) to potential buyers and submitted the results of this marketing exercise to the OFT to assist in its consideration as to whether an upfront buyer was required for some or all of the stores. This exercise involved Asda selectively marketing stores to a number of potential buyers and, based on initial reactions, seeking indicative bids for the stores from the [ ] most interested possible buyers. Asda was then able to present evidence to the OFT confirming whether [ ] potential buyers had expressed an interest in each store and (in relation to the [ ] most interested possible buyers) and

[38] Mergers: jurisdictional and procedural guidance', OFT527, June 2009, paragraph 8.32. See in particular CGL/Somerfield; and Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd 15 April 2008 and Completed acquisition by Global Radio UK Limited of GCap Media plc 8 August 2008.

whether [ ] of them had decided or declined actually to make an indicative bid.

141. In *CG/Somerfield*, the OFT considered that there was no need to impose an up-front buyer requirement where the parties demonstrated that, based on a desktop analysis, there could reasonably be expected to be [ ] potential purchasers. [ ].

142. The OFT considers – based on its experience in relation to the subsequent divestment process – that the approach it adopted in *CGL/Somerfield* to determining the requirement for up-front buyer was both reasonable and proportionate in seeking to ensure that competition concerns were remedied in each of the local areas concerned (that is, having regard also to the obligation under section 73(3) of the Act for an undertaking in lieu to achieve 'as comprehensive a solution as is reasonable and practicable').

143. In seeking to strike an appropriate balance in the present case, the OFT is mindful that:

- on the one hand, it benefits from [ ] and the range of potential purchasers is wider here than in *CGL/Somerfield* given that it would include all the LADs as buyers but

- on the other hand, [ ].

144. The OFT considers in this case that no up-front buyer should be required for a store where [ ]:

- [ ][39] or more buyers have submitted an indicative bid for that store

- [ ] or

- [ ].

[39] The OFT is mindful of the comparative value of an actual bid, in comparison with mere predicted interest under a desktop analysis.

145. For the [ ] stores that do not satisfy [ ] the above criteria, the OFT considers that some purchaser divestment risk is present given [ ] such that it is appropriate and proportionate for it to require an up-front buyer in this area.

146. The OFT has therefore decided that, on a cautious basis, any undertakings in lieu that it accepts should include a partial up-front buyer provision in respect of [ ] identified stores.

DECISION

147. The OFT's duty to refer the anticipated acquisition by Asda of Netto to the Competition Commission pursuant to section 33 of the Act is suspended because the OFT is considering whether to accept undertakings in lieu of reference from Asda pursuant to section 73 of the Act.

ANNEXE A: FILTERING METHODOLOGY

A.1 In order to analyse the effects of the proposed merger at the local level the OFT employed a filter to identify those local areas which would be most unlikely to present competition concerns and therefore do not require further examination. The filtering methodology that the OFT applied in this case is based on previous work undertaken by the CC and OFT in the supermarkets sector but adjusted to account for the competitive asymmetry between Asda and Netto. Broadly speaking, the filtering separated out the OFT's investigation in two parts: stage one and stage two, although, as discussed in paragraph 36 above, stage 2 was a two step process.

A.2 The parties had considerable interaction with the OFT at the pre-notification stage, agreeing a methodological approach to the case and discussing with the case team various measurement issues.

The stage one filter

A.3 The stage one filter identified local areas in which the parties overlapped and which of those overlaps would be most unlikely to present competition concerns.

A.4 To identify overlaps, the filter used a 'maximum reach' isochrone. The 'maximum reach' isochrones, centred on the Netto stores, were based on that used in *CGL/Somerfield* and offered a conservative approach to capturing overlaps between the parties (and bearing in mind the asymmetric constraints imposed on each other by the merger parties). Definitions of urban and rural followed the *CGL/Somerfield* case.

A.5 The maximum reach isochrones used for Netto, other LADs, mid-size stores and Iceland were 10 minutes' drive time in urban areas and 20 minutes' drive time in rural areas. For one-stop stores they were 15 minutes and 25 minutes respectively.

A.6 Once local areas resulting in an overlap between the parties within the maximum reach isochrones had been identified, the filtering exercise identified those local areas in which competition concerns were most unlikely to arise. The parties did this by initially centring the isochrone analysis on the Netto stores being acquired in the overlap areas using the drive times specified in the geographic market definition in paragraph 25 above.[40]

A.7 A local area was deemed to be unlikely to present competition concerns if at least three other (non-merging) fascia were present in the primary isochrone.[41] What is more, an asymmetric constraints approach was adopted. This means that larger stores were deemed to impart some constraint on smaller stores but not vice versa. In terms of the filtering exercise, the market definition was adopted in the filtering rules (so, for example, mid-size stores in urban areas were deemed to be constrained by one-stop stores within 10 minutes drive time of the reference store and by other mid-size stores within a 5 minute drive time of the reference store).

A.8 In terms of the relevant fascia, the stage one filtering exercise followed the product market definition in determining which fascia would be counted (table A1).

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[40] The parties submitted that the road speed assumptions that they employed in the drive time software for this case are consistent with the OFT's *CGL/Somerfield* case and, moreover, are consistent with the CC's provisional recommendation of the software that the OFT should be using when enforcing the Controlled Land Order.

[41] This is consistent with pervious work undertaken by the CC and OFT including Somerfield/Morrison (paragraph 6.86) and CGL/Somerfield.

Table A1: Fascia used in stage one filtering for one-stop and mid-size stores

Supermarkets	Symbol groups	LADs and other
Booths	Nisa-Todays	Iceland
Budgens	P&H Retail	Lidl
CK Supermarkets	Select & Save	Aldi
Co-operative groups[42]	Centra	
Harry Tuffins	Best-One	
Longs	Spar	
Marks & Spencer	VG/Vivo	
Morrisons	Premier (Booker)	
Roys	Londis	
Sainsbury's	Costcutter	
Tesco	Key Store/Key Shop	
Waitrose		
Whole Foods		

A.9 In addition to the primary isochrone filtering (centred on the Netto stores), the stage one filtering exercise also replicated the primary isochrone filtering but re-centred on census output areas where Asda measured whether 10 per cent or more of the local population would see a reduction in fascias as a result of the proposed merger. Census output areas allow for the stage 1 analysis to be carried out at as fine a level of detail practicable.

A.10 Therefore, multiple differently centred isochrones were applied to each local overlap area, all using the same rules and approach. A local overlap area failed the stage one filtering exercise (meaning that it required further investigation) if the number of fascia within

[42] The non-CGL co-ops were treated collectively as a single fascia.

a local area was reduced three or fewer as a result of the proposed merger. However, a local area would only fail on the census output area re-centring if 10 per cent or more of the population in the primary isochrone would experience a reduction in fascia to three or fewer.

The stage two filter

A.11 Stage two of the OFT's investigation focused on the local areas which failed the stage one filter. The methodology employed at stage two followed that undertaken in *CGL/Somerfield* (and originally employed by the CC in *Somerfield/Morrison*[43]).

A.12 A consumer survey was undertaken at both Asda and Netto stores in order to gauge how close the rivalry is between the merger parties at the local level since results of the survey could be used to measure the likely level of switching between the parties (the diversion ratio which was weighted by the respondents' expenditure).[44] The survey was undertaken by [ ] who conducted an internal audit of the results via a telephone check-back process (no problems were found). The relevant questions in the customer surveyed were as follows:

IF YOU KNEW BEFORE YOU LEFT HOME TODAY THAT THIS NETTO STORE HAD PERMANENTLY CLOSED DOWN, WHICH, IF ANY, OF THESE TYPES OF STORE WOULD YOU HAVE USED INSTEAD?

A large supermarket

A same size supermarket

A smaller store

A corner shop

Petrol station forecourt shop

Specialist shops, for example, butcher, baker, greengrocer etc.

Used other (write in and ring)

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[43] Paragraphs 7.1–7.16 and appendix D of Somerfield/Morrison.

[44] The OFT case team and statisticians worked with the parties on the survey design.

Would not have done my grocery shopping

Don't know

IF WOULD HAVE SHOPPED AT ANOTHER SUPERMARKET OR SMALLER STORE WHICH STORE WOULD YOU HAVE USED INSTEAD?

Aldi

Asda

Booth

Budgen

Co-op

Costcutter

Iceland

Lidl

Londis

M&S

Morrison

Netto

Sainsburys

Somerfield

Spar

Tesco

Waitrose

Other (write in and ring)

HOW MUCH DID YOU SPEND IN THE NETTO STORE TODAY, TO THE NEAREST POUND?

(Round up or down to nearest £ with minimum value of £1)

A.13 However, in past cases the diversion ratio alone has been considered by the OFT to be insufficient in indicating whether the merger would result in a substantial lessening of competition.[45] As

[45] For example, Morrisons/30 CGL stores and CGL/Somerfield.

such the OFT and CC have both used the 'illustrative price rises' to estimate the post merger incentive that the merged entity will have to raise its prices or equivalently worsen its non-price offer. The illustrative price rise takes into account not just the diversion ratio (which indicates the extent to which the merged entity can internalise customer switching) but profit margins (high margins may indicate little local level competition and a larger incentive to increase post-merger prices or equivalently worsen non-price factors).

A.14 The parties' approach in calculating the relevant profit margin was to calculate the short run variable profit.[46] This offered a pragmatic proxy to using marginal costs in the calculation which are substantially more difficult to measure. The OFT used one month as a reasonable definition of short run.[47] Over the course of a month a supermarket can change its staffing levels (for particular shifts), stocking and pricing decisions.

A.15 The parties' variable cost calculation comprised cost of goods, staff costs other than managerial and supervisory staff (these costs were considered to be fixed) and the proportion of distribution costs which Asda considers to be variable for its own weekly management reporting purposes [ ].[48]

A.16 For each of the overlaps failing the stage one filter, the diversion ratio from Netto to Asda and Asda's short run variable profit margin were used to calculate a symmetric IPR. In the current case

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[46] The parties restricted Asda's revenue and cost data to food sales (that, is they have excluded items such as petrol, clothing and pharmacy services). The parties submitted that the definition of food closely resembles the definition of groceries which includes foods, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods.

[47] The OFT also used one month in Completed acquisition by Tesco Stores Limited of Brian Ford's Discount Store Limited, Case ME/3827/08, OFT decision of 22 December 2008.

[48] The parties submitted that the main costs of distribution which are variable are fuel and hourly wages.

the symmetric IPR provides a cautious filter (see footnote 23 above).

A.17 For those local overlaps which had symmetric IPRs greater than five per cent, Asda surveyed the Asda stores so that an asymmetric IPR could be calculated. Using the asymmetric IPR allowed the OFT to take account of the fact that Asda is a stronger constraint on Netto than Netto is on Asda. The asymmetric IPR also allows the OFT to incorporate additional information about either the relative prices or the relative costs of the merging firms.

A.18 The OFT decided, on the balance of the evidence available to it, to use relative prices (based on price equality) rather than relative costs for the reasons detailed in paragraph 47 above.

A.19 In line with previous cases, an isoelastic demand function was used in the analysis (paragraph 60).

A.20 In a further refinement of the methodology employed in previous cases, the OFT, based on compelling evidence from the parties, incorporated an efficiencies term into the IPR calculation (Annexe B). The efficiency terms used by the OFT in this case are [ ] per cent of variable costs for Asda and [ ] per cent of variable costs for Netto.

A.21 After applying the asymmetric IPR formula the parties failed a local overlap at the stage two testing if the IPR was five per cent or more. As discussed in paragraph 64 of the decision, the OFT did not find it necessary in this case to conclude on the diversion ratio threshold.

ANNEXE B: EVALUATION OF EFFICIENCIES

B.1 This annexe evaluates the evidence on the likelihood, timeliness and scale of the parties' claimed efficiencies.

Asda efficiencies

B.2 Asda has estimated the efficiencies gains directly resulting from the proposed merger amount to £[ ] per year. Almost all of these result from [ ]. They arrived at this range via two approaches: (i) a 'top down' approach conducted independently of the OFT's investigation, in which they estimated the [ ][49]; and (ii) a 'bottom up' approach conducted as part of the OFT's investigation whereby they [ ].

B.3 Under the first of these, the 'top down' approach, Asda estimated that as a result of the proposed merger, its sales would increase by around £[ ] per year.[50] Asda's experience has shown that [ ]. An internal paper from Asda shows that [ ]. After the merger Asda can do this in two ways. The first [ ].[51] The second [ ].

B.4 Internal [ ] papers corroborate Asda's submitted [ ]. Overall, the OFT considered the internal documents supplied by Asda [ ] to be of probative value.

B.5 The lower bound of Asda's estimated purchasing efficiency using the 'top down' method represents [ ] per cent of its cost of goods acquired or [ ] per cent of its estimated variable cost.[52]

B.6 In a separate 'bottom up' exercise undertaken as a part of the OFT's investigation into the proposed merger, Asda [ ].

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[49] Asda expects [ ].

[50] Based on [ ].

[51] [ ].

[52] How variable costs were calculated is detailed in annexe A.

B.7 This exercise involved [ ].

B.8 Asda submitted [ ].

Netto efficiencies

B.9 As discussed an estimate of purchasing synergies for Netto is required if such efficiencies are to be taken into account as a part of the IPR calculation. However, since the Netto stores would be moved to an Asda format after the merger, [ ]. Moreover, as the merger is not yet completed, Asda does not have access to [ ] and therefore must rely on using other sources of information to estimate likely efficiency gains arising from the proposed merger.

B.10 In determining what efficiencies can be attributed to Netto for the purpose of calculating the IPR the parties have undertaken three strands of work. They have:

- reviewed the evidence on buying from the CC's groceries report
- reviewed [ ], and
- [ ].

B.11 The first exercise, reviewing evidence from the CC's groceries report, found that the CC concluded that the UK's four largest grocery retailers (which includes Asda) pay, on average four to six per cent less for their supplies than the mean of the CC's sample of grocery retailers.[53] [ ].

B.12 The parties also submitted regression results (exploring the relationship between unit purchasing prices and volumes) used by the CC in its groceries report.[54] The CC used various regression specifications and the parties in this case submitted the most

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[53] CC groceries report, paragraph 5.22.

[54] CC groceries report, appendix 5.3, paragraphs 36–51.

conservative result (that is, the one producing the smallest purchasing price difference between Asda and Netto).[55] [ ][56] [ ].

B.13 The second exercise the parties [ ].[57]

B.14 [ ].[58]

B.15 In addition, [ ].

B.16 The parties submitted that [ ].

B.17 The final exercise [ ].

B.18 However, [ ].

B.19 Given all of the evidence discussed above, the parties submitted that the OFT should adopt the assumption that the merger would result in purchasing efficiencies for Netto of [ ] per cent of its cost of goods (or [ ] per cent of Netto's variable costs).

OFT's view of the scale and likelihood of efficiencies

B.20 The OFT recognises that the parties have made a serious attempt at quantifying efficiencies, supported wherever possible by available evidence. Notwithstanding this, efficiency claims are generally difficult to substantiate and the OFT has applied a cautious approach to such claims in this case.

B.21 Starting with the efficiencies estimated from Asda, the OFT notes that [ ]. [ ].

B.22 [ ].

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[55] This is the relative unit price for all brands regressed against relative volumes using a linear specification. The results for this regression are set out in table 4, appendix 5.3 of the CC groceries report.

[56] Total purchasing costs indicate that Asda is around [ ] times bigger than Netto.

[57] It is worth noting that [ ].

[58] The parties told the OFT that [ ].

B.23 However, the OFT notes that [ ][59] [ ]. [ ].[60] Notwithstanding this, the OFT notes that the parties submitted efficiencies gains using other calculation methods [ ].

B.24 [ ].

B.25 Overall the OFT is persuaded to the requisite high standard that some purchasing synergies will arise as a result of the proposed merger and that these are likely to be [ ]. The key to this reasoning is that the OFT considers that the underlying rationale for the buying synergies (discussed in paragraphs B.3 and B.4) is compelling and that the evidence submitted [ ] is of a high standard. [ ].

B.26 The OFT is therefore willing to accept [ ]. The OFT did not find the evidence of [ ] compelling.

B.27 [ ].

B.28 The OFT does not find use of evidence from the CC's groceries report compelling in this regard. The first strand of evidence from the report compares average price differences between supermarket groups (including the 'major four grocers' which includes Asda and 'other fascia' which includes Netto) not individual supermarket operators. For reasons of confidentiality therefore, the evidence does not specifically compare Asda with Netto.

B.29 Indeed, the CC itself noted this: 'these averages mask some underlying variations within these groups. In particular, we find that some fascias, wholesalers and symbol groups pay prices which are commensurate with those paid by the four largest grocery retailers'[61] and 'whilst on average the prices obtained by 'other fascia' and the two wholesaler/symbol groups are higher than

[59] [ ].

[60] [ ].

[61] CC groceries report, appendix 5.3, paragraph 6.

those obtained by the four largest grocery retailers, some individual companies [ ] extract unit and net prices that are commensurate with those paid by some of the four largest grocery retailers'.[62] Indeed, an Asda internal document [ ].

B.30 The second strand of this evidence, the regression analysis, suffers from similar problems to the average price levels between supermarket groups discussed above. That is, without access to the information relating to both Asda and Netto the parties have unavoidably had to make assumptions about the position of each relative to the average for all retailers. In particular, [ ]. Further, it is not clear to the OFT how the overall results found by the CC pertain to Asda and Netto specifically.[63]

B.31 [ ].

B.32 [ ]

B.33 The OFT was persuaded to the requisite high standard, however, by the evidence presented on [ ]. These amount to [ ] per cent of Netto's estimated variable costs.[64]

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[62] CC groceries report, appendix 5.3, paragraph 31.

[63] For example, from the CC groceries report it cannot be determined what the Asda and Netto starting positions are with respect to their terms of trade with the suppliers. In terms of the regression analysis undertaken by the CC, even if the slope of the regression line – or the tendency to receive a lower unit price for an increase in purchase volumes – is equal for Asda and Netto, the intercept for either or both Asda and Netto (represented by so-called 'fixed effects' in the analysis) may not be the same as the industry average thereby giving inaccurate results relative to each other.

[64] The parties submitted that Netto's cost of goods acquired is £[ ] and that [ ] per cent of this amount is equal to [ ] per cent of Netto's total variable costs. Therefore, an efficiency saving of £[ ] is [ ] per cent of total variable costs.