COMPETITION COMMISSION OFFICE OF FAIR TRADING

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Commentary on retail mergers

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This publication is also available from the OFT website at: www.oft.gov.uk and the CC website at: www.competition-commission.org.uk

Version 1a, issued on 8 April 2011, contains some minor revisions for accuracy.

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1 INTRODUCTION

1.1 Retail mergers account for a significant number of cases that come before the Office of Fair Trading (OFT) and the Competition Commission (CC) ('the Authorities'). Moreover, some of the questions that such mergers raise are largely specific to the sector.

1.2 This paper provides a commentary on three of the most frequently asked questions from retailers and their advisers regarding past merger cases.

1.3 As a commentary based on past merger cases in the retail sector, this paper does not constitute guidance under section 106(1) and (3) of the Enterprise Act 2002 (the Act). The OFT and CC published joint Merger Assessment Guidelines[1] in 2010, to which the Authorities will have regard when investigating merger cases.

1.4 Part 2 of those Guidelines describes the decisions that the OFT and CC must make when applying the 'Substantial Lessening of Competition' (SLC) test which forms the overall context for our casework. In assessing a merger both Authorities consider whether or not the merger situation will lead to an SLC. However, under the two-phase merger control regime in place in the UK, the OFT and the CC are required to apply different thresholds when answering the statutory questions they must determine in merger cases. The OFT applies a 'realistic prospect' threshold whereas the CC applies a 'balance of probabilities' threshold. This will inform the approach taken by the Authorities to their analysis. The difference in evidential threshold and reduced time available for review at the OFT stage will sometimes require a difference in the emphasis attached to certain aspects of the analysis - the extent of analysis on particular aspects and the evidence considered is likely to vary according to whether the merger is being considered by the OFT or the CC.

[1] OFT/CC Merger Assessment Guidelines, September 2010.

1.5 The commentary discusses certain aspects of methodology that have been applied in the past and may be applied to future cases. However, the methodologies of merger analysis cannot be applied mechanistically. The Authorities will therefore consider each merger with due regard to the particular circumstances of the case and will apply methodology flexibly.

1.6 We note that the focus of the commentary is on topics that relate to situations where a merger involves competing firms supplying competing products (so-called 'horizontal mergers') and may remove the rivalry between them, allowing the merged firm profitably to raise prices (so-called 'unilateral effects'). We also note that the paper relates solely to merger cases and not to non-merger investigations.

1.7 The three questions addressed in this commentary are:

- How do you use catchment areas, both to identify which of our stores overlap and to eliminate unproblematic areas from further analysis?

- What if we compete nationally - all our stores offer the same products at the same prices with the same service quality?

- How do you use simple quantitative techniques to assess how mergers might affect retail prices?

1.8 In recent years the Authorities have between them considered mergers involving many different retail sectors, including grocery stores, opticians, mobile phone shops, pubs, betting shops, bookshops, pharmacies and DIY retailers.

1.9 Retail businesses and markets have a number of common features which affect the Authorities' analysis:

- Retail businesses typically have fixed physical outlets, which consumers usually visit in order to acquire or consume goods or services. These businesses may also have an internet presence. In other cases retailers may operate exclusively on the internet. In many cases, retail businesses will have multiple outlets across a region or country.

- Retail businesses often supply a range of goods sourced from numerous (unrelated) suppliers, although other retailers may supply services or a mixture of goods and services.

- The decision to purchase from a retail business is made by the individual consumer.

1.10 The relevance of this commentary to a particular retail merger will therefore vary according to the characteristics of the businesses and market concerned. For example, the commentary on catchment areas (that is, the first question) will not be relevant to a business that is internet-based and does not have fixed retail outlets.

1.11 References to cases are designed to illustrate a particular point. It is not possible to comment in detail on each of the retail cases that the Authorities have examined in recent years. We hope nevertheless that the commentary will be useful and bring out some of the key themes from our experience in recent years.

2 CATCHMENT AREAS IN MERGER ASSESSMENT

Q: How do you use catchment areas, both to identify which of our stores overlap and to eliminate unproblematic areas from further analysis?

2.1 Many retail mergers involve physical ('bricks and mortar') stores. Where this is the case consumers generally have choices between a number of outlets that are local to where they live or work. When reviewing a merger between retail companies with such stores a key question to be considered, therefore, is whether the merger will lead to a loss of competition on the local level. As a starting point, the Authorities analyse the extent to which the stores of the merging parties overlap.

What is a catchment area?

2.2 A common approach has been to identify the geographic area within which stores derive a large percentage of their business (the so-called 'catchment area'). In practice, as we discuss further below, the Authorities have used distance or drive-times to identify catchment areas, applying varying distance and times according to different store types and whether a store is in an urban or rural area.

2.3 Different types of evidence have been used to shed light on the identification of the catchment area and we discuss this further below.

How are catchment areas used by the OFT and CC?

2.4 Catchment area analysis is used in several ways. This paper focuses on two related uses deployed by both Authorities:

- To identify in which local areas the parties' stores overlap in order to help inform the Authorities' approach to the evidence-gathering and review (for example, to help identify where to concentrate consumer research).

- In cases where there are a large number of local areas where the parties' stores overlap, as part of a filtering process intended to help the Authorities identify those local areas where the acquisition of stores would be unproblematic (for an unilateral effects theory of harm).

2.5 In both cases, the first step is to identify an appropriate measure to delineate the catchment area (for example, a specific distance or drive-time). The approach the Authorities have taken to identifying catchment areas is discussed further below.

2.6 Additionally the CC has used catchment areas in other ways, namely as a contributor to the CC's overall assessment of the impact of merger on competition. This is not addressed in this paper.

Use of catchment areas as part of a filtering process

2.7 When using catchment areas as part of a filtering process to identify unproblematic areas the Authorities have typically applied the following steps:

(i) Applied the catchment area measure (using drive-time/distance) to each of the stores of one of the merging parties.

(ii) Applied a criterion, usually a fascia[2] count, to identify those areas where the impact of the merger on concentration is unproblematic (that is, the number of remaining fascia in the local area post merger is sufficient).

(iii) Re-centred catchment areas or flexed the catchment area measure in order to confirm that only clearly unproblematic areas were filtered out from further analysis.

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[2] For the purposes of a fascia assessment stores under common ownership are treated as a single fascia (even if branded differently).

2.8 In relation to the third of these steps, the Authorities have re-run steps (i) and (ii) above, centring the catchment area this time around the stores of the other merging party or on stores of third party competitors. As shoppers often consider the alternatives from their homes, the Authorities have in certain cases re-centred on population centres where information has been available (for example, census output data). The Authorities may also flex the catchment area measure to see if it identifies further areas that may be problematic. For example, in Safeway the CC also adjusted the catchment area measure (that is, adjusted the drive-time) to test sensitivity to different measures.

2.9 In using catchment areas as part of a filtering process a key consideration for the Authorities has been to adopt a cautious approach to identifying unproblematic areas in order to ensure that all of the local areas in which competition problems might arise have been identified and assessed. Re-centring catchment areas is only one of the ways in which the Authorities' methodology reflects this cautious approach. They have also sought to be cautious in selecting (i) the catchment area measure, (ii) which stores are treated as competing fascia, and (iii) the number of competing fascia remaining in the local area post merger which is deemed sufficient to identify an area as unproblematic. More generally, the Authorities take an iterative approach within the filtering process, adjusting parameters as required to ensure the overall outcome is cautious.

2.10 Following a filtering exercise of the cautious nature described above, the Authorities conduct further analysis in relation to those overlap areas that are identified as potentially problematic. In cases where the Authorities have adopted the approach to filtering identified above the number of local areas where either the OFT's duty to refer the merger or the CC's finding of a SLC arose was less than the number of potentially problematic local areas left after the filtering exercise. For example, in the Somerfield/Morrisons case, around 50 stores were identified as potentially problematic after the filtering exercise but the CC ultimately decided that the merger would give rise to an SLC in respect of only 12 stores.

2.11 Particularly at the OFT stage, in some cases involving large numbers of overlaps an initial filter has been needed to help focus the data-gathering work on a manageable number of local areas. In some of these cases, however, there has been limited evidence available early on in the investigation to suggest how cautious or otherwise a given initial filter might be. In such cases the OFT has reserved the right, therefore, to re-examine local areas initially identified as unproblematic where evidence emerging later in the investigation suggests that the initial filter may not have been sufficiently cautious – for example, where evidence from third parties or consumer survey work suggests that the scope of the initial catchment area might have been too wide.

What techniques and evidence have the Authorities used to identify catchment areas?

2.12 The Authorities have used a number of techniques and types of evidence, often in combination, to establish an appropriate measure to identify a catchment area. Examples of these are outlined in this section.

Evidence on where a store's custom originates

2.13 The Authorities have typically established the average distance or drive-time for a catchment area based on the proportion of the store's[3] sales that originate within that drive-time or distance, that is, where customers representing those sales travel from to reach the store.

2.14 When applying this approach, the Authorities have often considered the distribution of sales over a range of drive-times or distances in order to identify an appropriate catchment area measure. In a number of cases, the catchment area measure identified has been based on capturing about 80 per cent of the store's sales.

[3] This is not typically assessed at an individual store level. Rather it is typically calculated as an average for a sample of stores of that profile.

2.15 The approach of identifying a measure that captures about 80 per cent of a store's sales was first used by the CC in a merger case in the 2003 Safeway merger. It was subsequently used in the CC's 2005 Somerfield/Morrisons decision. It was also used in a number of OFT cases, for instance Travis Perkins/BSS, Lodge Brothers in Hillingdon, Home Retail/Focus, Nationwide Building Society/Derbyshire Building Society.

2.16 The Authorities have used a variety of evidence to identify the origin of a store's sales, including (i) data from loyalty cards (for example, OFT's decision in Cineworld), (ii) home/site delivery records (for example, OFT's decision in Travis Perkins/BSS), (iii) customer contact details records (for example, OFT's decision in Nationwide Building Society/Derbyshire Building Society), (iv) customer surveys (for example, CC's decision in Sports Direct/JJB Sports), (v) company documents, such as business plans (for example, OFT's decision in Ladbrokes/Eastwood or internal company research[4] (for example, CC decision in Vue/A3 Cinema[5]).

Impact of entry

2.17 In a number of cases the CC has used econometric analysis of the impact of store openings on the merging parties' stores to help identify the appropriate catchment area measure, for example, in Holland & Barrett/Julian Graves and in Waterstone's/Ottakar's. The OFT used documentary evidence on the effect of store openings in, for example, the Boots/Dolland and Aitchison opticians case.

[4] Together with information from other industry sources.

[5] The catchment area was not used as part of a filtering exercise in that case.

Distance between stores

2.18 The OFT has also found it helpful when parties provide, for each party, a schedule of distances between each of their outlets and the nearest store of the other merging party. This has had four purposes:

- It has indicated how sensitive the identification of overlaps is to the distance used.
- It has enabled the OFT to identify those instances where the parties may not be within the initial catchment distance but are nevertheless still the closest outlets to one another. This can be the case, for example, particularly in sparsely populated parts of the country where there are generally fewer stores and where the actual catchment area for a store may be wider than the measure used.
- Where there has been little or conflicting information available to inform the distance for the starting catchment area, this information has helped inform the judgement on the best starting point to focus subsequent work.
- It has helped expedite the later analysis where subsequent evidence indicates that competitive pressure may be strongly related to physical distance between some or all of the local fascia - for example, Travis Perkins/BSS, Tesco/Brian Ford and Homebase/Focus.

Application of different drive-times and distance measures

2.19 In some cases the Authorities have used different drive-times and distance measures when identifying catchment areas according to criteria such as the type of store and its locality.

Store types

2.20 Different stores types may have different catchment areas.[6] For example, stores of different sizes may have different catchment areas if they have differentiated customer offerings (for example, the amount of choice or product categories available in different sized stores or differing prices between store types). A large supermarket may, for instance, have a larger catchment area than a convenience store. In Safeway the CC identified different catchment areas for different sizes of store (see below). Similarly in the carpet retailing sector (Carpetright/Allied Carpets), for example, the OFT noted that catchment areas for some independents were smaller than for the larger, often out-of-town, stores.

Rural v Urban

2.21 Retail stores located in rural or remote areas generally have different catchment areas to stores in urban areas. For instance, in Safeway the CC found that large supermarkets of 1,400 square metres and over had a catchment area of 10-minute drive-time in urban areas and 15-minute drive-time in rural areas. Smaller stores of under 1400 square metres had a catchment area of five-minute drive-time in urban areas and 10-minute drive-time in rural areas.

[6] Asymmetry of constraint between different store types and sizes was assessed extensively in the CC's Groceries Inquiries (final reports published in 2000 and 2008).

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3 LOCAL AND NATIONAL COMPETITION

Q: What if we compete nationally – all our stores offer the same products at the same prices with the same service quality?

Introduction

3.1 Mergers involving chains of retail outlets may have local or national effects (or both). The merging parties may, prior to the merger, apply a national retail or a local retail offer (the retail offer includes components such as price, quality, range and customer service (PQRS)) and the Authorities will consider both the local and the national effects.

3.2 Some retail chains have a national pricing policy. Other key aspects of the retail offer may also be set nationally. In this context, parties to a merger have sometimes argued that:

- the merger would not have an impact on prices and the service to customers at a local level because many of the important aspects of their offer to consumers are determined at a national level[7] and they would not change their national policy to a local one as a result of the merger, and
- where the merger involves a firm with a national policy acquiring a small number of stores, there would be no increases in national prices or deterioration of other aspects of their retail offer.

3.3 When considering a retail merger and these arguments, the Authorities have considered:

- whether the merging parties competed locally

[7] Sometimes parties have argued the opposite case: that local competition (including from strong locally- or regionally-based independent players) predominated, such that the Authorities should not be concerned about a merger removing one of a limited number of national operators. This argument is not addressed here.

- whether the merging parties competed nationally on some or all aspects of their retail offer

- whether how the merged firm competes would be changed as a result of the merger.

3.4 This chapter of the commentary covers each of these issues. It first sets out the starting position of the Authorities and then looks at evidence that the Authorities consider in assessing whether competition is national or local.

3.5 Before looking at the above issues, it is important to note that a centrally-set policy may not be the same as a national policy. In some cases the OFT has found a centrally-set strategy to lay down specific arrangements for local actions and responses such as targeted discounts, margin support, or order of store refurbishments. Hence even when centrally-set to apply across a full chain of retail outlets, important competitive variables do change locally as we found, for example, in the Travis Perkins/BSS case.

3.6 Even if, pre-merger, the merging parties have a national policy for all aspects of their retail offer, if a merger increases market power in some local areas, the Authorities would consider whether the merged firm would have an incentive to change its policy in order to be able to flex some local variables in areas where they gain market power. For instance a national chain could respond to changes to local conditions across multiple areas, resulting from a merger, by (a) moving from a policy of national pricing to one of local pricing or (b) changing its national prices.

The Authorities' starting position

3.7 The Authorities' starting point has been to recognise that consumers shop in local retail outlets, within a given travel time from their home or work. For example, in various investigations in the cinemas sector, starting with local analysis the OFT found that cinemas set ticket prices and other aspects of the retail offer locally to account for local competition. Against this background, the OFT's strong starting assumption on this has been that there will be material local competition on one or more aspects of price, quality, range and service. The OFT's thinking on this was set out at some length in its Home Retail Group/Focus[8] decision in 2008.

3.8 In Sports Direct/JJB Sports, the CC similarly first analysed whether Sports Direct was able to vary aspects of its retail offer locally. In each of these cases the Authorities also considered possible impacts on national competition (see below).

3.9 The OFT has found clear evidence of local aspects of competition in cases across a wide variety of sectors. Cases where both national and local elements of competitive strategy were identified related to pharmacies (Boots/Alliance UniChem), opticians (Alliance Boots/Dolland & Aitchison), and bookmakers (Ladbrokes/Eastwood). In Somerfield/ Morrison, the CC found that although prices were set nationally, Somerfield had tiered pricing, leading to variation in local prices.

Evidence considered by the Authorities

3.10 The cases illustrate that the Authorities gather and analyse a variety of evidence. The broad categories of evidence and analysis which have been considered relevant in the past when considering the parties' arguments include:

- Evidence as to whether the merging parties determine all or some of the retail offer by reference to national or local competitive conditions and the circumstances in which the retail offer may be flexed (at the national, regional and local level).

[8] OFT: Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd; Decision of 12 May 2008.

- Evidence on the extent to which the merger created an incentive to change the merging parties' existing national policy to respond to local competition.

- Evidence on the extent to which the merger created an incentive to change prices, or other aspects of service, on a national level, but reflecting local interaction.

3.11 In past retail merger inquiries, the evidence the Authorities have considered when looking at the pricing aspects of the offer has included:

- internal strategy documents setting out how prices were set

- internal documents setting out the responsibilities of local management

- internal documents setting out responses in relation to local entry

- evidence on how retailers responded to underperformance by one or more local stores.

3.12 Prices are not the only variable which has been considered by the Authorities. Even if the merging parties have had a national pricing policy, the Authorities have examined whether, for example, the following variables respond to local competition:

- promotions, vouchers, offers

- local advertising

- quality of management and staff training

- product range, availability and quality

- amount of pre and after sale service

- store aspect: layout, size, maintenance, decisions to refurbish and facilities at the store, and

- store opening hours.

3.13 In each of the cases mentioned at paragraph 3.9, the OFT found that there were elements of non-price competition at local level, including: staff expertise, customer in-store waiting times, and local promotions.

3.14 In looking at aspects of the retail offer other than price, such as those in paragraph 3.12, the Authorities have examined relevant evidence from the merging parties such as:

- business plans for refurbishments of local stores
- business plans for store openings and store closures, and
- internal strategy documents and business plans setting out how different characteristics of the local offering are decided
- the range of documents listed in paragraph 3.11.

3.15 Particularly at the CC stage of an investigation, empirical analysis has often been conducted to explore whether prices or other aspects of the retail offer are related to the degree of local competition, for example, price (or margin) concentration analysis or entry analysis. Less use has been made of these techniques at the OFT stage, having regard to the nature of, and the shorter timescale for, its review. In the following paragraphs we explain different techniques that have been used.

3.16 When considering the results of empirical analysis, the Authorities note that it may fail to find evidence of local effects even if they are present, for example because of limitations in the data.

Price (margin) concentration analysis

3.17 Using price (or margin) concentration analyses the CC has considered whether prices or margins are higher in areas which face less local competition. For instance, in catchment areas where the merging parties' stores face only one other competitor, the merging parties may offer a worse service (higher prices and/or lower service quality) than if they were facing a larger number of competitors. Even with uniform national pricing, a reduction in other aspects of the retail offer in response to a lack of local competitive constraint would tend to lower a given store's costs and therefore increase its profit margins at store level.

3.18 For instance, in Somerfield/Morrisons (supermarkets), the CC found that although both parties had national pricing policies, Somerfield's policy had tiered pricing, leading to variation in local prices. The CC's margin concentration analysis showed a statistically significant relationship between Somerfield's margins and the degree of market concentration in rural areas.

3.19 In Sports Direct/JJB Sports (sports retail), the CC carried out a local margin concentration analysis to examine whether Sports Direct varied any aspects of its retail offer on a local basis, and if so, whether these variations were related to the presence of a nearby JJB store. Since Sports Direct had a national pricing policy, the CC considered other aspects of the retail offer that might vary on a local basis, such as store staffing levels, stock deliveries, store opening hours, store maintenance and refurbishment, and stock shortages. The CC did not find a relationship between the degree of competition and local variation of the retail offer.

Entry analysis

3.20 When conducting entry analysis the CC has considered whether entry into a local market by a variety of competitors had an impact on the parties' revenues. This method relies on the fact that if a competing store opens near an incumbent store at least some of the incumbent's custom will be diverted to the new store for a sustained period.

3.21 The CC conducted entry analysis in a number of cases. For instance, in Waterstone's/Ottakar's (books), Holland & Barrett/Julian Graves (nuts, seeds and dried fruits (NSF)), and Sports Direct/JJB Sports (sports retail), the CC found that entry by one of the merging parties in an area where the other had been incumbent had a stronger impact on the incumbent store's revenues than entry by any other competitor.

Other econometric techniques

3.22 The CC has also used other econometric techniques based on regression analysis to assess the extent to which the different characteristics of a retailer's local offering was related to the extent of local competition pre-merger. For instance, in Waterstone's/Ottakar's, the CC found that prices and book quality were set nationally and did not vary by location. However, the CC found that many other variables did vary by location, such as the range of books offered, the number of staff and length of staff experience, the number of book signings, decisions to refurbish and opening hours. To examine if these local variables responded to the amount of local competition, the CC conducted a regression analysis which analysed whether these variables depended on whether the store was in an overlap area or not, taking into account store size and characteristics of local population. The CC found that range, staff size and length of staff experience did not depend on whether a store was in an overlap area, but it did find that book signings and general refurbishments responded to local competition.

Evidence that the merger did not lead the parties to change their policy

3.23 When considering whether the merged firm will have an incentive to move from a national policy to a local retail offer policy, the Authorities have considered the incentives for the merged firm and in doing so both the costs and the benefits to the merged firm. For example, when moving to a more local policy the merged firm may incur additional IT costs or reputation costs which exceed the benefits from flexing local variables. The Authorities therefore often seek from parties evidence as to why they will not have an incentive to change their policy.

3.24 In Holland & Barrett/Julian Graves the CC accepted that there would be costs for the merged parties associated with deviating from their national pricing policies. In Sports Direct/JJB Sports, the CC considered whether Sports Direct would have the incentives to move from its national pricing policy to a local pricing policy as a result of the store transfers. The CC recognised that moving to a policy of local pricing would represent a significant change in Sports Direct's business strategy. The CC considered the possible costs and benefits of such a change in strategy. The CC did not think it likely that the transfers would increase significantly Sports Direct's incentives to flex its PQRS in response to changes in local competition and, therefore, the costs of doing so were likely to continue to outweigh the benefits.

Evidence that the merger did not affect national prices

3.25 If all variables are set nationally the merger may create incentives for the parties to increase prices, or worsen other aspects of their retail offer, at a national level. The degree to which the merging parties have an incentive to worsen their retail offer nationally will be influenced by the degree to which they overlap pre-merger. The OFT noted this possibility in Boots/Alliance UniChem.[9]

3.26 In Sports Direct/JJB Sports, the CC established that 9.3 per cent of Sports Direct stores were within five miles of an acquired JJB Sports store.[10] Using quantitative techniques to assess post-merger upward price pressure (see the chapter on upward price pressure indices in merger assessment for more details on these techniques) and controlling for the 9.3 per cent exposure that Sports Direct had to the acquired JJB Sports stores, the CC analysed indications of potential national price effects based on five mile overlaps (see the chapter on upward pricing pressure indices for details on the use of indications of potential price effects). The CC also did the analysis based on two mile overlaps. On the basis of the evidence available the CC calculated indications of potential price effects of less than one per cent. The CC noted the uncertainty around the results of this analysis, and around the inputs into the calculations, and considered these results alongside many other pieces of evidence, including recognition that JJB Sports remained a

[9] Boots/Alliance UniChem (paragraph 14)

[10] This excluded stores the CC concluded would not have remained open under its counterfactual.

significant competitor with potential to expand further in the future. The CC concluded that the effect of this merger was likely to be too small to be significant. The merger was ultimately cleared.

3.27 In Holland & Barrett/Julian Graves, the CC found that the local markets where the CC considered that competition might be lessened as a result of the merger represented three per cent of the Holland & Barrett portfolio and five per cent of the Julian Graves portfolio. The CC found that this number of local areas would not be sufficient for the merged entity to increase its prices of NSF substantially, or to adjust any other feature of its NSF offering.

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4 UPWARD PRICE PRESSURE INDICES IN MERGER ASSESSMENT

Q: How do you use simple quantitative techniques to assess how mergers might affect retail prices?

Introduction

4.1 In many retail markets, retailers compete on a number of aspects, such as price, quality, range and service (PQRS). The Authorities refer to these aspects as the retail offer. When altering aspects of the retail offer, there are both costs and benefits to the retailers concerned. For example, if a retailer raised its prices, a cost of doing so would be the profit lost through customers switching to its competitors. However, the retailer may also benefit from increased profit from those customers who do not switch but who pay the higher prices.

4.2 When reviewing a merger, the Authorities consider whether some of the profits lost by one of the merging parties (resulting from an hypothetical change in the retail offer) would be recaptured by the other merging party. If so the merger may create an incentive to change the retail offer (for example, raise prices). The strength of this incentive will depend, amongst other things, on the profits from sales that the merging parties would recapture from the change to the retail offer. The Authorities have often considered this by reference to the incentive to raise prices, such reference serving as a proxy for other aspects of the retail offer. However, the Authorities have also considered separately and in more detail how other aspects of the retail offer may be altered by the merger.

4.3 Simple quantitative indicators such as 'illustrative price rises' consider the effects of the merger in terms of potential price rises. However rather than attempting to predict the exact extent of post merger price rises, they measure the extent of the upward price pressure or, if an assumption is made about the degree to which this pressure is passed through to consumers, a measure of upward price movement.[11]

4.4 These simple quantitative indicators are based on a static understanding of the market. They do not take into account the effects of entry (which the Authorities consider at a later stage). Entry may eliminate the merging parties' incentive to worsen the retail offer. They also do not take into account the responses of other competitors and as such may underestimate the impact of the merger on competition. In the absence of entry, a merger which leads to a worsening of the retail offer may lead to a softening of the competitive constraint that the merging parties impose on the remaining competitors which may create an incentive for the remaining competitors to worsen their retail offer.

4.5 The profits from recaptured sales, referred to in paragraph 4.2, are determined by two factors: diversion ratios and margins. The Authorities may use the diversion ratios and margins themselves, or use various simple quantitative indicators derived from them to examine the closeness of competition between the merging parties and their incentives to worsen the retail offer post-merger. These techniques are generally used as one input into the decision and are unlikely, on their own, to determine the outcome of a particular case.

4.6 In what follows we first discuss diversion ratios and margins. We then cover individual cases where we used these and the role they played in the Authorities' decision-making.

Key elements of the analysis

Diversion ratios

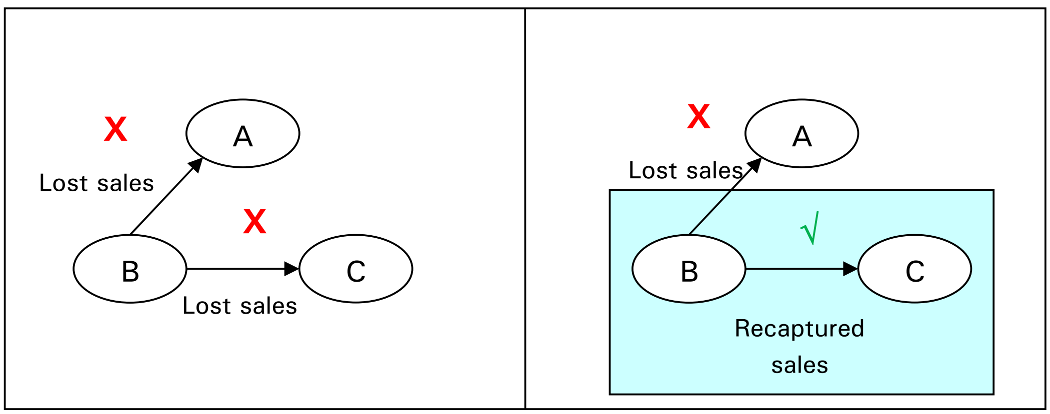
4.7 When a company increases its prices (or worsens other aspects of its retail offer), it loses a part of its sales to its competitors. The diversion

[11] Pass-through rates are rates at which firms pass on increases in costs to their customers in the form of higher prices.

ratio from company A to company B is the percentage of sales lost by company A that is captured by company B following a price increase by company A. The more closely A and B compete in terms of their retail offer and geographic location, the higher the diversion ratio is likely to be.

4.8 Panel 1 in the figure below shows the diversion of customers away from firm B to firms A and C when firm B raises its prices. Panel 2 shows that when firms B and C merge, the merged entity recaptures some of the sales that otherwise would have been lost if B's prices had increased pre-merger. The merged entity will take account of the recaptured profits from these sales when making decisions on price.

Panel 1: Effects of a price rise by B when A, B and C are independent | **Panel 2: Effects of a price rise by B following a merger with C**



4.9 In some cases, the diversion ratio from A to B may not be the same as the diversion ratio from B to A. If this is the case, we say that the constraint between companies A and B is asymmetric.

4.10 In the retail setting, asymmetric constraints have been found in a number of groceries mergers. For instance, in the Tesco/Brian Ford and Asda/Netto mergers, the OFT considered that the acquirers (Tesco and Asda respectively) exercised a stronger constraint on the acquired firm than the acquired firm exercised on them. Similarly, in the Somerfield/Morrisons merger, the CC decided that there was an asymmetry between different sizes of stores: larger stores exercising a stronger constraint on smaller stores than smaller stores exercised on large stores.

4.11 Diversion ratios used in past retail mergers have been derived from a variety of sources, particularly surveys or event studies. Diversion ratios can also be estimated using merger parties' records of past customer switching. Although this kind of evidence has not been used to form an explicit price indicator in past retail merger cases, it has been used to measure closeness of competition in non-retail merger cases.[12] Evidence on past customer switching has been used in a more qualitative way in a number of past OFT cases.

4.12 Surveys have been used in a large number of retail mergers, for example, Somerfield/Morrisons, CGL/Somerfield, Cineworld/Showcase Cinema, and Sports Direct/JJB Sports. In these cases shoppers have typically been asked which retailer they would use if, for example, stores of the acquired parties were unavailable.[13] Using event analyses, the Authorities have considered the effect of store closures or store openings on the sales of the merging and non-merging parties in order to examine the pattern of customer switching. Event studies were used for instance in the Tesco/Somerfield (Thurso) case and Waterstone's/ Ottakar's.

Profit margins

4.13 Variable margins are made up of the sales of the relevant products which both parties supply less their variable costs. The Authorities considered that cost variability depended on the period over which the merging parties could change prices or other key competitive variables in response to change in competition. The decisions on how to derive

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[12] See, for example, the OFT's decision in the completed acquisition by GXS of Inovis: www.oft.gov.uk/shared_oft/mergers_ea02/2010/GXS-Inovis.pdf

[13] The Authorities discuss best practice in surveys in a joint publication entitled 'Good practice in the design and presentation of consumer survey evidence in merger inquiries – consultation', www.oft.gov.uk/shared_oft/consultations/OFT1230con.pdf

variable margins were therefore made on a case-by-case basis. In general, if margins are high, unilateral effects are more likely to arise as a result of a merger.[14]

4.14 In Asda/Netto, for example, the OFT used one month as a reasonable period over which to assess variable margins. The OFT considered that over a month, a supermarket can change a number of variables including its staffing levels for particular shifts, levels of stock and pricing decisions. In Somerfield/Morrisons, the CC considered margins based on 'direct costs' including cost of sales, staff costs and distribution costs. In both cases, the Authorities used the merging parties' management and financial accounts to derive the margins and considered how much scope there was for the supermarkets to vary their costs in response to changes in the competitive landscape.

4.15 In some cases, a degree of judgement can be required to establish the right level of margins. This occurred in the Zipcar/Streetcar (car sharing) case as the market was growing at a fast rate. The CC therefore considered an array of margins based on different assumptions about the flexibility of the car fleet. In this case, it was particularly important to check the consistency of the estimate of elasticity with the estimate of margins: high margins typically indicate that customers are not price-sensitive and therefore that price elasticities are low.[15] It is therefore incorrect to use both high margins and high elasticities in the same analysis because one is generally not consistent with the other.

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[14] See paragraph 5.4.9(b) of the CC / OFT Merger Assessment Guidelines.

[15] See Appendix E, paragraph 8 of the Zipcar report, which stated that the main reason for such inconsistency is that the main parties' estimate of elasticity was not consistent with their estimate of margins.

Simple quantitative indicators used in past retail mergers

4.16 The following paragraphs set out a number of examples of cases in which diversion ratios, profit margins, or quantitative indicators based on these, have been used to help form a view on the incentive for merging parties to raise prices post merger. The particular methodology used in an individual case has often been determined by the nature of the data available and by developments in the literature underlying the quantitative indicators used. The Authorities have therefore taken a flexible approach to identifying the most suitable measure(s) for any particular case.

Direct inferences from diversion ratios and profit margins

Tesco/Somerfield (Thurso)

4.17 In Tesco's completed acquisition of five Somerfield groceries stores in north Scotland, the OFT considered closeness of competition between the merging parties' stores. The OFT used, amongst other evidence, diversion ratios derived from the estimates of sales diverted to alternative stores following the closure and opening of the merging parties' stores.

Home Retail Group/Focus

4.18 In the Home Retail Group/Focus (DIY sheds) merger, the OFT assessed closeness of competition between the merging parties by considering the level of the diversion ratios and margins in the areas where the parties overlapped. The OFT decided that, in Woking, high store margins and significant diversion ratios provided evidence of a realistic prospect of an SLC on the basis of unilateral effects arising from the merger.

Quantitative indicators of upward price pressure

Local effects

Zipcar/Streetcar

4.19 A simple method used by the Authorities consists of a multiplication of the diversion ratio from company A to B by company B's margins and is sometimes referred to as Gross Upward Price Pressure Index or 'GUPPI'. The CC used this method in the Zipcar/Streetcar merger to assess the closeness of competition between the two companies.[16]

Somerfield/Morrisons and CGL/Somerfield

4.20 In the Somerfield/Morrisons and CGL/Somerfield mergers, the Authorities used an illustrative price rise indicator as a filter to identify problematic areas.

4.21 In both cases, the CC (for the Somerfield/Morrisons merger) and the OFT (for the CGL/Somerfield merger) assumed that pass-through to consumers of any price rise was likely to be high. In Somerfield/Morrisons, the CC considered that an illustrative price rise of over five per cent might indicate an SLC. The CC considered that since a five per cent price rise is considered to be small but significant for the purposes of the market definition, it could also be a useful benchmark for assessing competitive effects.[17] In CGL/Somerfield, the OFT adopted the same 'Illustrative Price Rise' (IPR) approach as the CC in Somerfield/Morrisons. In the CC case, the CC imposed remedies on the merger parties whilst in the OFT case the parties offered divestment remedies which the OFT accepted.

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[16] See Zipcar/Streetcar, Final Report, Appendix H, paragraphs 1 to 16, CC, 22 December 2010.

[17] Somerfield/Morrisons, Final Report, Paragraph 7.9 to 7.12, CC, 2 September 2005.

Cineworld/Showcase Cinema

4.22 In the acquisition by Cineworld of the Showcase Cinema in Wood Green, the OFT carried out a profitability analysis using gross margins data, attendance figures and revenue data provided by Cineworld and the diversion ratio between Cineworld and Showcase Wood Green as indicated by a survey conducted by Cineworld. The OFT found that the high diversion ratio between the parties and Cineworld's high gross margins showed that the increase in revenue from raising prices by 10 per cent would be greater than the revenue lost by customers' switching to an alternative cinema. The OFT concluded that, from the evidence available to it, a 10 per cent price increase would be profitable.

Asda/Netto

4.23 In the Asda/Netto merger, the OFT recognised that the competitive constraint that Asda exercised on Netto was greater than the constraint that Netto exercised on Asda. The OFT used an asymmetric illustrative price rise formula to establish in which local markets the merger raised prima facie concerns. The merging parties ultimately offered, and the OFT accepted, divestments in those local areas in which the OFT had found a realistic prospect of an SLC.

4.24 Following the Somerfield/Morrisons and CGL/Somerfield cases, the OFT assumed a high level of pass-through of price rises to consumers and considered illustrative price rises in excess of five per cent as providing prima facie concerns. The OFT found that there was a realistic prospect of an SLC in a number of areas and the merger parties offered to divest stores in those local areas.

National effects

Sports Direct/JJB Sports

4.25 In the acquisition by Sports Direct of 31 JJB Sports stores (sports retail), the CC found that Sports Direct was generally charging uniform prices across all local markets. The CC examined other ways in which Sports Direct might vary its retail offer locally. However, the CC did not find a relationship between the degree of competition and local variation of the retail offer. The CC therefore used illustrative price rise indicators to examine the extent to which the merger effects at the local level might be expected to translate into national pricing.[18]

4.26 The CC surveyed customers at a representative range of Sports Direct and JJB stores, allowing it to estimate the diversion ratio from Sports Direct to JJB Sports (and other retailers) in these areas. Having estimated these diversion ratios, the CC used: estimates of the average diversion ratio across overlap areas (between Sports Direct stores and an acquired JJB Sports store); an estimate of variable margins; and the proportion of Sports Direct stores that were local within the overlap area of the acquired JJB Sports stores to provide an indication of the potential post-transfer price increase. This analysis gave indications of less than one per cent.

4.27 The illustrative price rise was considered with many other pieces of evidence, including recognition that JJB Sports remained a significant competitor with potential to expand further in the future, and the CC concluded that the effect of this merger was likely to be too small to be significant. The merger was ultimately cleared.

[18] Sports Direct/JJB Sports, Final Report, Appendix E, CC, 16 March 2010.

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