Anticipated acquisition by Co-operative Group Ltd of Nisa Retail Ltd

Decision on relevant merger situation and substantial lessening of competition

ME/6716-17

The CMA's decision on reference under section 33(1) of the Enterprise Act 2002 given on 23 April 2018. Full text of the decision published on 21 May 2018.

Please note that [✂] indicates figures or text which have been deleted or replaced in ranges at the request of the parties for reasons of commercial confidentiality.

SUMMARY

1. Co-operative Group Ltd (**CGL**) has agreed to acquire Nisa Retail Ltd (**Nisa**) (the **Merger**). CGL and Nisa are together referred to as the **Parties**.

2. The Competition and Markets Authority (**CMA**) believes that it is or may be the case that the Parties will cease to be distinct as a result of the Merger, that the turnover test is met and that accordingly arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

3. The Parties' activities are vertically related as they are active at different levels of the groceries supply chain. CGL is active in the retail supply of groceries and Nisa is active in the wholesale supply of groceries. Nisa also offers symbol group services to retailers under the fascias Nisa Extra, Nisa Local and Loco. Retailers operating under these fascias (symbol group stores) are independently owned but pay a membership fee in return for certain benefits, including upfront investment in store fascia/imagery, and business support services.

4. The CMA has adopted a frame of reference in line with previous decisional practice, including most recently in *Tesco/Booker.*[1] In the retail supply of groceries, the CMA has categorised grocery stores according to their size: one-stop stores (more than 1,400 square metres) (**OSS**), mid-size stores (280 square metres – 1,400 square metres), and convenience stores (smaller than 280 square metres). OSS constrain each other and stores from the smaller categories, but stores in the smaller categories do not constrain stores in the larger categories. The geographic frame of reference is local, with larger stores, such as OSS, competing and acting as a constraint over a larger area, and smaller stores, such as convenience stores, competing over shorter distances. In the wholesale supply of groceries, the CMA has distinguished between delivered wholesale services, symbol group services and cash and carry services, all of which were found to have a regional scope.

5. The CMA investigated whether the merged entity would, as a result of the Merger, be able to:

   (a) increase its wholesale prices or cut costs (that affect its quality of wholesale service) to Nisa-supplied stores in local areas where those stores overlap with CGL stores, in the expectation that it would be able to offset any resulting loss of wholesale sales through increased retail sales at CGL stores, to the advantage of the merged entity as a whole (**ToH1, or Wholesale to Retail Strategy**);

   (b) increase its retail prices or cut costs (that affect its quality of retail service) at CGL stores in local areas where those stores overlap with Nisa-supplied stores, in the expectation that it would be able to offset any resulting loss of retail sales through increased wholesale sales to Nisa retailer, to the advantage of the merged entity as a whole (**ToH2 or Retail to Wholesale Strategy**).

6. The CMA had particular regard to the evidence and assessment of wholesale and retail competition undertaken in the recent *Tesco/Booker* investigation. The CMA also conducted further detailed evidence gathering for the purposes of this investigation, including conducting market testing of a range of third parties including retail competitors, wholesale competitors and Nisa members.

7. With regard to ToH1, the CMA believes that the merged entity would have no material incentive to worsen its wholesale offer to specific Nisa-supplied stores. The CMA used a vertical gross upward pricing pressure index (**vGUPPI**) to identify areas where the merged entity could have some incentive to pursue the Wholesale to Retail Strategy. This assessment

[1] See CMA report on the anticipated acquisition by Tesco PLC of Booker Group plc, 20 December 2017.

indicated that limited incentives might exist in relation to a limited number of stores (23). However, any such incentives identified would be reduced in this case by retailers purchasing less from the merged entity and more from other wholesalers, and by retailers not passing the full wholesale price rise through to shoppers at the retail level. Further, pursuing a targeted strategy in these areas would require coordination across the merged entity's retail and wholesale arms. The costs relating to implementing such a strategy would be disproportionately high compared to the limited number of areas identified by the vGUPPI. In addition, there are a sufficient number of wholesale alternatives in each of these areas, such that Nisa supplied retailers could switch away in the event of a price increase (or equivalent degradation).

8. With regard to ToH2, the CMA believes that the merged entity would have no material incentive to worsen its retail offer at its own stores. The vGUPPI identified a limited number of stores (9) in which the merged entity would have some incentive to implement a Retail to Wholesale Strategy. The vGUPPI does not fully capture the retail competitive environment in each of these local areas, as it understates out-of-market constraints specific to those areas. Pursuing a local strategy in these areas would require coordination across the merged entity's retail and wholesale arms. Moreover, the recaptured revenue would come via customers of the merged entity's wholesale business whose continued purchases from the merged entity are not guaranteed. Accordingly, the CMA believes that the costs and risks of implementing such a strategy would be disproportionately high relative to the very small number of areas involved.

9. The CMA therefore believes that the Merger does not give rise to a realistic prospect of a substantial lessening of competition (**SLC**) as a result of vertical effects.

10. The Merger will therefore **not be referred** under section 33(1) of the Enterprise Act 2002 (the **Act**).

ASSESSMENT

Parties

11. CGL is a mutual business owned by over eight million members and active in a range of activities including grocery retailing, insurance, funeral care and legal services. The turnover of CGL in 2016 was £ 9.5 billion in the UK. CGL operates 2,637 grocery retail stores across the UK.

12. Nisa is a wholesaler of grocery products and also provides symbol group services to its members.[2] Nisa does not own or operate grocery stores. Collectively, Nisa supplies approximately 4,200 stores throughout the UK. Around 900 stores are symbol stores operating under one of Nisa's three fasciae[3] and around 1,900 are independent stores, which are independently owned and operated and are not affiliated with a symbol group. An additional 1,400 stores that are currently supplied by Nisa are operated by large multi-site retailers (such as McColl's and [✂]).[4]

Transaction

13. CGL intends to acquire all shares in Nisa by way of a court-sanctioned scheme of arrangement.

14. CGL submitted that the rationale for the Merger is to grow scale through wholesale and franchise channels. The acquisition of Nisa would give CGL that scale and a credible wholesale capability, as well as an existing and flexible logistics network to pursue other wholesale opportunities.

Procedure

15. The Merger was considered at a Case Review Meeting.[5]

Jurisdiction

16. As a result of the Merger, CGL will acquire a controlling interest in Nisa and, therefore, the Parties will cease to be distinct.

17. Nisa had a turnover of £1.2 billion in the financial year ending in April 2017. The CMA therefore considers that the turnover test in section 23(1) of the Enterprise Act 2002 (**EA**) is met.

18. The CMA therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.[6]

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[2] Nisa has three symbols/fascia: Nisa Local, Loco and Nisa Extra
[3] A symbol store is operated by a retailer which is independent from the wholesaler, but generally commits to minimum purchase requirements (and other conditions), in return for use of the symbol brand and other benefits such as improved promotions
[4] The CMA notes that Nisa's contract with McColl's is an interim solution before it is transferred to Morrison's later this year and [✂].
[5] See *Mergers: Guidance on the CMA's jurisdiction and procedure* (CMA2), January 2014, from paragraph 7.34.
[6] *Mergers: Guidance on the CMA's Jurisdiction and Procedures*, paragraph 4.3.

19. The initial period for consideration of the Merger under section 34ZA(3) of the Act started on 23 February 2018 and the statutory 40 working day deadline for a decision is therefore 23 April 2018.

Counterfactual

20. The counterfactual is an analytical tool used in answering the question of whether the merger gives rise to a realistic prospect of a substantial lessening of competition (**SLC**).[7] Since the counterfactual may be either more or less competitive than the prevailing conditions of competition, the selection of the appropriate counterfactual may increase or reduce the prospects of an SLC finding by the CMA. At Phase 1, the CMA will assess the merger against the most competitive counterfactual of which there is a realistic prospect.[8] The 'most competitive counterfactual' in any given case, is the one that represents the most conservative framework for assessment.[9]

Costcutter Wholesale Agreement

21. In November 2017, CGL and Costcutter Supermarkets Group (**Costcutter**) agreed that CGL will become the exclusive wholesale supplier to Costcutter from Spring 2018 (the **Wholesale Agreement**). Costcutter was previously supplied by Palmer & Harvey, prior to Palmer & Harvey entering administration. In the interim, Costcutter is being supplied by Nisa. Should the Merger go ahead, CGL has indicated that it intends to service the Costcutter contract using the Nisa business and distribution arrangements.

22. In theory, the supply of Costcutter by an independent third party could have been a more competitive counterfactual (if CGL were only able to service the Costcutter contract as a result of the Merger). This is because CGL would not have had any ability to exert any influence over the Costcutter retail offering in this circumstance.

23. The Parties submitted that CGL will supply Costcutter in any event (ie that the Merger is not necessary for CGL to be able to supply Costcutter). CGL submitted evidence that [✂]. The Parties also submitted evidence that prior to and since Merger discussions were finalised, [✂].

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[7] See Merger Assessment Guidelines, paragraphs 4.3.1.

[8] *Merger Assessment Guidelines* (OFT1254/CC2), September 2010, from paragraph 4.3.5.

[9] Merger Assessment Guidelines (OFT1254/CC2), September 2010, from paragraph 4.3.5. The *Merger Assessment Guidelines* have been adopted by the CMA (see *Mergers: Guidance on the CMA's jurisdiction and procedure* (CMA2), January 2014, Annex D).

24. The CMA notes that: (i) CGL has provided documentary evidence showing it was considering viable alternative logistics solutions; (ii) [✂] told the CMA that [✂] (iii) the discussions on contingency plans [✂] and (iv) CGL provided details of [✂].

25. Therefore, the CMA considers that Costcutter would have been supplied by CGL absent the Merger (and therefore that the alternative supply of Costcutter by a third party should not be considered as an alternative counterfactual). The CMA has therefore taken the prevailing conditionsof competition, taking into account the supply of Costcutter, as the relevant counterfactual for the purposes of its assessment.[10]

Frame of reference

26. Market definition provides a framework for assessing the competitive effects of a merger and involves an element of judgement. The boundaries of the market do not determine the outcome of the analysis of the competitive effects of the merger, as it is recognised that there can be constraints on merging parties from outside the relevant market, segmentation within the relevant market, or other ways in which some constraints are more important than others. The CMA will take these factors into account in its competitive assessment.[11]

27. This case concerns the supply of groceries and related non-groceries products (**groceries**) at the retail and wholesale levels. CGL owns and supplies a large number of grocery stores and is therefore active at the retail level of supply.[12] Nisa supplies a large number of grocery stores but does not own or operate any stores. It is therefore only active at the wholesale level of supply. The CMA has very recently conducted an in-depth investigation into a transaction involving the retail and wholesale supply of groceries – the Tesco/Booker phase 2 investigation (hereafter **Tesco/Booker**)[13] – in which it considered in detail product and market definitions for the retail and wholesale supply of groceries.[14] As described in further detail below, the CMA has had

[10] In its incentives analysis the CMA treated Costcutter stores as a potential source of recapture only when centring on a Nisa focal store. When centring on a CGL focal store, the CMA does not consider there to be a Merger-specific effect. The CMA has also treated Costcutter as competitor stores, consistent with its approach to own-brand diversion within the vGUPPI mode (see discussion of own-brand diversion below).
[11] *Merger Assessment Guidelines*, paragraph 5.2.2.
[12] CGL owns and supplies [✂] OSS, [✂] MSS, and [✂] Convenience stores (Source: CMA Analysis of CGL's store data base submitted in response to RFI1). In addition, CGL will be the sole supplier to Costcutter Supermarkets Group, commencing in Spring 2018. Nisa supplies [✂] OSS, [✂] MSS, and [✂] Convenience stores (Source: CMA Analysis of Nisa's store data base submitted in response to RFI1).
[13] See CMA report on the anticipated acquisition by Tesco PLC of Booker Group plc, 20 December 2017.
[14] See CMA report on the anticipated acquisition by Tesco PLC of Booker Group plc, 20 December 2017.

particular regard to the findings in *Tesco/Booker* in determining the appropriate frames of reference.

Product scope

Retail supply of groceries

28. The CMA (and its predecessor bodies) have conducted a number of investigations into mergers involving grocery retailing in recent years, most recently in *Tesco/Booker*. In these cases, the definition of the relevant market has been used primarily to determine the framework (typically described as a filtering methodology) which is used to identify relevant local overlaps and to exclude from further analysis local areas where competition concerns are unlikely to arise. The approach to product frame of reference in past decisional practice reflects a cautious starting point for the CMA's assessment and the CMA has had regard to constraints from outside these segments, where evidence of such a constraint was available.

29. The CMA has adopted a similar approach in this case.

Product scope

30. In *Tesco/Booker*, the CMA, consistent with previous cases, assessed the market for grocery retailing by reference to the size of grocery store net sales area:[15]

   (a) One-stop stores (**OSS**) (1,400 square metres (sqm) and larger);

   (b) Mid-size stores (**MSS**) (280-1,400 sqm); and

   (c) Convenience stores (less than 280 sqm).

31. The CMA has found that the competitive constraint faced by such stores is asymmetric, in that a large store will constrain a smaller store (eg a MSS constrains a convenience store), but not *vice versa*.

[15] The CC's Report, *'The supply of groceries in the UK'* dated 30 April 2008; and for example, *Anticipated acquisition by Asda Stores Limited of five grocery stores and three petrol filling stations from Co-operative Group Limited (ME/6466/14)*, paragraph 20; *Anticipated acquisition by Cooperative Group Limited of David Sands CGL/David Sands (ME/5317/12)*, paragraph 21*; Completed Acquisition by Co-operative Group Limited of Somerfield Limited (ME/3777/08)*, paragraph 10; *Anticipated acquisition by Martin McColl Ltd of 298 groceries sotres from Co-Operative Group Ltd (ME/6632/16),* paragraphs 22 to 27. The CMA also noted that there is no clear threshold between smaller and larger convenience stores (*Anticipated acquisition by Martin McColl Ltd of 298 groceries stores from Co-Operative Group Ltd (ME/6632/16),* footnote 12).

32. The Parties submitted that, for the purposes of the Phase 1 review, the approach adopted in *Tesco/Booker* is an appropriate product market definition in this case.

33. The CMA has received no evidence to indicate that it should depart from this approach and has accordingly assessed the impact of the Merger on the retail supply of groceries from convenience stores, MSS and OSS, as set out in paragraph 30 above.

Geographic scope

34. In *Tesco/Booker*, the CMA considered the local geographic scope to be:

   (a) for OSS, a 10/15-minute drive-time in urban/ rural areas. These stores are considered to be constrained by other OSS within this catchment area.

   (b) for MSS, a 5/10-minute drive-time in urban/rural areas to other MSS stores. These stores are also considered to be constrained by other OSS located within a drive-time of 10/15 minutes in urban/rural areas; and

   (c) for convenience stores, a 1-mile catchment in both urban and rural areas, noting that the constraint is likely to be stronger the closer another retailer is to the store in question. [16] These stores are constrained by other convenience stores, MSS and OSS within 1 mile.

35. In other cases, the CMA has also used 5-minute drive time catchment areas for convenience stores and acknowledged that they may be constrained by MSS and OSS stores located further away.[17] The CMA has received no evidence to indicate that it should depart from the approach in *Tesco/Booker* and in this case has adopted the geographic frame of reference set out in paragraph 34. However, as noted above, this approach is intended to represent an appropriately cautious starting point for the purpose of excluding areas unlikely to raise concerns from further assessment and is likely to underestimate the constraint from larger grocery offerings outside the 1-mile area. Therefore, consistent with previous case practice, the CMA has taken into account the constraint from grocery stores located outside the frame of reference in its competitive assessment, where there was evidence to do so.

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[16] See Tesco/Booker, para. 6.24 and 6.25.
[17] Anticipated acquisition by Booker Group plc of Musgrave Retail Partners GB Limited Booker/Musgrave, paragraph 40; Anticipated acquisition by Co-operative Foodstores Limited of 15 Budgens grocery stores from Booker Retail Partners (GB) Limited, paragraph 33(c); Completed acquisition by Co-operative Foodstores Limited of eight My Local grocery stores from ML Convenience Limited and MLCG Limited, paragraph 43(b)(iii); Anticipated acquisition by Martin McColl Ltd of 298 groceries stores from Co-operative Group Ltd, paragraph 29(1)(iii);

Wholesale supply of groceries

Product scope

36. In *Tesco/Booker*, the CMA found it appropriate, as a starting point, to consider symbol group, cash-and-carry, and delivered grocery wholesale services separately, whilst acknowledging that each of these services provides an important constraint on the others.[18]

37. The Parties suggested that, for the purposes of the Phase 1 review, the effects of the Merger should be assessed against the same framework as in *Tesco/Booker*.

38. The CMA has received no evidence to indicate it should depart from this approach and has therefore adopted the approach set out in paragraph 36 above.

Geographic scope

39. In *Tesco/Booker*, the CMA considered both national and regional/local frames of reference. It did not find it necessary to conclude on the geographic scope of the markets for delivered and cash and carry grocery wholesale services (including those offered to symbol group and independent retailers). However, the CMA did conclude that the appropriate starting point for its local/regional analysis of wholesale competition was the 80% catchment areas around each wholesaler's cash and carry or delivery depot, with 100% catchment areas also being relevant to its competitive assessment.[19]

40. The Parties submitted that, for the purposes of the Phase 1 review, the geographic market definition adopted for the wholesale supply of groceries in *Tesco/Booker* is appropriate in considering the geographic frame of reference in this case.

41. The CMA has received no evidence to indicate that it should depart from this approach and has therefore adopted the approach set out in paragraph 39 in this case.

[18] See Tesco/Booker, para.6.58
[19] See Tesco/Booker, para. 6.74.

Conclusion on frame of reference

42. For the reasons set out above, the CMA has considered the impact of the Merger in the following frames of reference:

(a) The retail supply of groceries (differentiating between OSS, MSS and convenience store) on a local basis, within each of the geographic frames of reference identified in paragraph 46 above;

(b) The supply of delivered wholesale services on a regional basis;

(c) The supply of cash-and-carry wholesale on a regional basis.

Competitive assessment

Theories of harm

43. As noted above, CGL is active in the retail supply of groceries and Nisa in the wholesale supply of groceries. Therefore, the Parties do not compete head to head but are instead active at different levels of the supply chain. The Merger is therefore vertical in nature.

44. Vertical mergers may be competitively benign or even efficiency-enhancing, but in certain circumstances can weaken rivalry, for example when they result in foreclosure of the merged firm's downstream competitors. The CMA only regards such foreclosure to be anticompetitive where it results in an SLC in the foreclosed market(s), not merely where it disadvantages one or more competitors.[20]

45. In the present case, consistent with *Tesco/Booker*, the CMA has considered the following vertical theories of harm:

(a) Wholesale to retail (**ToH1**): The CMA has considered whether the Merger could make it profitable for the merged entity to increase wholesale prices (or cut costs that affects the quality of wholesale service) to Nisa-supplied stores due to the possibility of recapturing sales at CGL-owned (and supplied) retail stores that overlap with Nisa-supplied stores. That is, the Merger may make it profitable for the merged entity to pursue a foreclosure strategy in areas where a CGL-owned store and a Nisa-supplied store overlap.

[20] In relation to this theory of harm 'foreclosure' means either foreclosure of a rival or to substantially competitively weaken a rival.

(b) Retail to wholesale (**ToH2**): The CMA has considered whether the Merger could make it profitable to increase retail prices, or cut costs affecting the quality of retail service, at CGL stores due to the possibility of recapturing sales at Nisa-supplied retail stores.

46. The CMA's approach to assessing vertical theories of harm is to analyse:

(a) whether the merged entity would have the **ability** to carry out the strategy;

(b) whether it would find it profitable to do so (ie the **incentive**); and

(c) whether the **effect** of any action by the merged firm would be sufficient to reduce competition in the affected market to the extent that it may give rise to an SLC.[21]

47. These conditions are cumulative: if one condition is not met, it may not be necessary to assess the other conditions. They may also overlap. For example, at the extreme end, with sufficient resources a firm is likely to be able to pursue almost any strategy, but if it is exceedingly costly to do, the firm is very unlikely to have the incentive to do so.

48. As discussed in further detail below, the CMA has used the same analytical framework for assessing ability and incentive as in *Tesco/Booker*. However, the CMA has also considered whether there are any facts or circumstances in this case that would warrant a different approach in reaching conclusions about the impact of the Merger. For example, the Merger involves suppliers that may have different competitive strengths and weaknesses to the merging parties in *Tesco/Booker*.

National assessment

49. The CMA has assessed whether the Merger could result in vertical effects at the national level.

50. Nationally, Nisa accounts for around 17% of delivered wholesale to independent and convenience retailers, and CGL accounts for around 6% of grocery retailing.

51. Therefore, the CMA does not believe that the Parties could carry out a national foreclosure strategy at these levels of supply. If the merged entity were to increase its wholesale prices and/or cut wholesale costs that affect its

[21] Merger Assessment Guidelines, paragraph 5.6.6.

quality of service nationally, its customers would be likely to switch to the other wholesalers who make up around 80% of UK wholesale supply.

52. The CMA also notes that if the merged entity had a sufficiently strong incentive to pursue a local strategy in respect of a very large number of local areas, this could lead it to make national changes, such as increasing prices to all of its customers, or to large subsets of them. However, as set out further below, the CMA has found this not to be the case.

Local assessment

53. This assessment focused on the possibility that the merged entity may have the ability and incentive to increase the wholesale price or reduce the quality of the wholesale service it offers to specific individual retail stores that overlap with a CGL store – that is, to follow a local foreclosure strategy.

Wholesale to Retail assessment

Ability

54. The merged entity's ability to pursue a local foreclosure strategy through its wholesale offer will depend on the merged entity being able to target any wholesale price increases, or cutting of wholesale costs, to specific retailers according to local competitive conditions. This is because the merged entity must be able to target these actions to symbol group or independent retailers in local areas where:

    (a) those retailers would accept a worsening of their supply terms without switching away, because of their limited wholesale alternatives;

    (b) those retailers would pass on the worsening of their supply terms into their retail offer. This pass through is likely to be higher in areas with less retail competition; and

    (c) the local conditions of retail competition mean that sufficient customers leaving the Nisa-supplied retailer's store would shop at a CGL store instead.

55. Therefore, as part of its assessment of ability, the CMA has considered the extent to which retailers could avoid a significant deterioration of their own retail offering through switching to an alternative wholesaler and the extent to which the merged entity can flex its wholesale offer at a local and/or individual retailer level and.

Wholesale competition

56. Whether individual customers will switch, either partially[22] or fully[23], to another wholesaler in the face of any deterioration depends on the alternatives available to them in their local area and their propensity or willingness to switch.

57. In *Tesco/Booker*, the CMA found that wholesale competition – both in delivered wholesale and symbol group services – is generally strong and that retailers typically have several options at their disposal.[24] More specifically, the CMA's investigation in *Tesco/Booker* found that there are a number of strong delivered wholesale alternatives for retailers (in addition to Nisa) that are active on a national basis, including Bestway, Blakemore (part of SPAR), Conviviality,[25] Filshil, United Wholesale Scotland and Musgrave and C&C. The CMA also found that a long tail of other, smaller, wholesalers, that are only in certain regions or local areas or offer specialist products, are also an important wholesale alternative for retailers. Finally, the CMA found that retailers tend to multi-source from more than one wholesaler and were able and willing to switch between wholesalers.

58. The CMA has assessed whether the evidence in this case supports the conclusions in *Tesco/Booker* set out above.

59. The Parties submitted that Nisa-supplied stores face no significant hurdles in multi-sourcing their supply from several wholesalers and that multi-sourcing occurs frequently in practice. In addition, the Parties said that Nisa-supplied stores can switch fascia easily and that wholesale competitors compete fiercely to supply retailers, as shown by the recent entry of Morrison's and its successful bid to supply McColl's retail stores.

60. The CMA received evidence from the Parties that indicated that partial switching and full switching of Nisa-supplied stores has occurred in the past. The CMA's analysis of this evidence suggested that:

    (a) Between [✂] and [✂] of all Nisa-supplied retailers (depending on the product category in question) partially switched volumes in the most recent financial year.[26] Purchases of tobacco varied most frequently and

[22] Ie multi-sourcing from more than one wholesaler and switching some volumes to a different wholesaler
[23] Ie a complete change of wholesaler or fascia switch (for symbol group stores).
[24] See Tesco/Booker, paragraphs 7.109-7.114
[25] The CMA notes the recent sale of the Conviviality wholesale and retail arms to C&C and Bestway respectively and has reflected this in its assessment.
[26] A store was considered to have partially switched if its volumes fell below 25% of its monthly average for at least two or three months in a year.

the extent of partial switching is lower if tobacco purchases are excluded – at between [✂] and [✂] of all Nisa-supplied retailers.[27] Partial switching by independent retailers was slightly higher than for symbol stores.

(b) Around [✂] of Nisa-supplied retailers fully switched to competing wholesalers in 2017. The Parties submitted that this is likely to underestimate retailers' propensity to switch because retailers may not tell Nisa the true reason for choosing to leave when switching to a competing wholesaler.

61. The CMA notes that the rate of partial switching estimated for Nisa members is [✂] than estimated for Booker's customers in *Tesco/Booker*. By contrast, full switching appears to be [✂] among Nisa members compared to Booker-supplied retailers.

62. Observation of past rates of switching are not necessarily determinative of retailers' propensity to switch in the face of any deterioration in the wholesale offer post-Merger. Therefore, the CMA has also considered the wholesale alternatives available to retailers and their ability and incentive in exploring alternatives.

63. The market testing evidence from in this case is consistent with the findings relating to wholesale competition in *Tesco/Booker*. In addition, most of the third-party retailers that responded to the CMA's merger investigation said that switching wholesale fascias is easy and that there are sufficient fascias and delivered wholesale service providers available to them.

64. The CMA further considered whether there are any specific circumstances in this case which would result in Nisa retailers having less incentive to switch post-Merger, which would mitigate the risk of retailers switching away from CGL. In particular, the CMA considered the effect of two types of payments from CGL to Nisa members which were included as part of the consideration for the Transaction:[28]

(a) an annual payment of around £550 per share for three years post-Merger if the Nisa member continues to purchase from CGL in that period and maintains its spending with Nisa at the 2017 level (the **deferred consideration**). If the member purchases less than its 2017 level, the

[27] While the CMA has tried to control for seasonality in purchasing patterns (by removing certain product categories from the analysis), the CMA notes that these results are still subject to a number of caveats. Importantly, volume switching is not observed directly and a fall in purchases may be explained by other factors.
[28] See Recommended Cash Offer for Nisa Retail Ltd by Co-operative Group Holdings (2011) Ltd.

payment is decreased proportionally (eg if spending in 2018 is 10% below the 2017 spending, the deferred consideration is decreased by 10%).

(b) a 1% rebate on a quarterly basis for four years post-Merger on the Nisa member's rebateable annual turnover.[29] In order to receive the full amount of this rebate, a member must maintain its spending with Nisa at the 2017 level (the **rebate consideration**). As with the deferred consideration, if the member purchases less than its 2017 level, the rebate consideration is decreased proportionally.

65. The CMA considers, however, that these post-Merger payments would not materially impact on Nisa members' propensity to switch.

66. First, if the merged entity increased wholesale prices by *more* than the overall consideration (ie the sum of the deferred consideration and the rebate consideration), the payments would not dis-incentivise a Nisa-supplied store from switching to another wholesaler, as the overall input costs for that retailer have increased and it may be better off by switching.

67. Second, if the merged entity increased wholesale prices by *less* than the overall consideration, the Nisa-supplied store would face the choice of whether or not to increase its retail prices (ie whether to use the overall consideration to offset price increases to end-customers). In this scenario the incentive for the Nisa-supplied store to increase retail prices is very low. The overall (net) average wholesale price would fall for the targeted store and the Nisa-supplied retailer has no incentive to sacrifice downstream volumes (by raising prices or otherwise degrading its offer), as it does not benefit from any sales that may be recaptured at a CGL store in its catchment area.

68. Accordingly, based on the available evidence, the CMA considers that the description of the competitive dynamics in grocery wholesaling in *Tesco/Booker* is still accurate and provides the appropriate background for assessing the Merger.[30] Overall, the evidence available indicates that Nisa-supplied retailers multi-source, regularly monitor their competitive alternatives, and would have the incentive to switch in the face of a price rise (even if actual rates of fascia switching are generally low).

69. However, as noted above, the ability of individual customers to switch will depend on the alternatives available to them in their local area. Therefore, the CMA also considered the wholesale options available to Nisa-supplied stores in specific areas in which the merged entity – provided it had the ability to do

[29] 'Rebateable turnover' is the total value of goods purchased from Nisa excluding [✂] net of VAT.
[30] See paras 7.54-7.114 Tesco/Booker Final Report.

so – might have the incentive to raise wholesale prices or deteriorate quality. As considered below (see paragraphs 111-113), the vast majority of those specific Nisa-supplied stores have sufficient alternative wholesale options available to them.

Ability to flex wholesale offer at a local and/or individual-retailer level

70. Consistent with the approach adopted in *Tesco/Booker*, the CMA's assessment of the ability to flex an offering at a local and/or individual-retailer level involves a consideration of:

(a) The extent of retailer variation in the current offering;

(b) The potential for retailer level flexing; and

(c) The cost or barriers to flexing in response to competitive conditions.

71. The greater the variation in the current offering, then the less cost associated with flexing the offering in response to competitive conditions post-Merger and therefore the greater the likelihood that the merged entity would have the ability to target deterioration at an individual store.

72. For this purpose, customers supplied by Nisa can be grouped into two categories: single-store retailers (ie symbol and independent members operating a single store) and multi-site retailers (ie individual Nisa members that operate a number of retail stores pursuant to a single supply agreement).[31] The CMA has assessed Nisa's ability to flex its offering on an individual level in relation to each type of customer.

- *Single store retailers*

73. The Parties submitted that they do not tailor their wholesale offering to reflect local conditions of competition in relation to any one particular store and that to change their approach to flex their offering at a local level would be costly.

74. The CMA notes that the evidence submitted by Nisa indicates that although some aspects of its offering may be specific to a particular retailer (eg delivery times) most key aspects of its offering are not varied locally to differentiate between retailers at this time. The CMA also notes, however, that the evidence provided on this point is limited and that other evidence available to the CMA indicates that it would be possible for Nisa to introduce local, retailer-

specific terms (if it had the incentive to do so). Importantly, Nisa's agreements with retailers are agreed individually with every retailer (even if they are generally standard) and enable it to adjust prices, range and certain promotions (eg Nisa's standard price list and terms and conditions explicitly stipulate that it can amend the price list from time to time).[32]

75. Nonetheless, the CMA notes that, as recognised in *Tesco/Booker*, in the context of the vertical nature of the Merger, for the merged entity to flex its wholesale offering to respond to local competitive conditions at both the wholesale and retail level is likely to involve greater operational complexity, and central oversight, than in the context of a horizontal merger. This is because it would require the merged entity to monitor (and respond to) both the local conditions of wholesale competition, and also the local conditions of retail competition faced by its retailer customers and by CGL stores. The CMA notes that this is likely to involve greater complexity (and cost) than in a horizontal merger situation, where the CMA assesses whether a firm may flex its offering in response to conditions of competition in its own market, rather than in a market which is upstream or downstream to it.

- *Multi-site retailers*

76. The Parties submitted that Nisa is unable to flex its offering to single stores owned by multi-site operators since the contract is held at the operator rather than store level. The merged entity would therefore have to flex its offering across all the stores of a given multi-site retailer, including in areas where the local conditions of competition would make it unfavourable to do so, which would limit any profit the merged entity could recoup from such a strategy and therefore its incentive to do so.

77. In this context, the Parties noted that Nisa publishes a price list order form (setting out prices and range) which is uniformly available to all members via its website. Further, Nisa's delivery service is currently contracted out to DHL, which the Parties submit would, in practice, limit the ability of the merged entity to target a degradation of delivery terms at individual stores. The Parties also recognised, however, that although the overall contract may be held by a multi-site retailer, there are some operational decisions made at a local level, where individual stores make day-to-day purchasing and stocking decisions.[33]

78. Based on the available evidence, the CMA believes that Nisa's arrangements with multi-site operators leave very little scope for flex on parameters at

[32] See clause 10 and Section 3 of the Terms and Conditions (Annex 4.1, RFI1 submission).
[33] Para 4.3 of RFI 4 Response of 14 March: [✂].

individual stores within a multi-site retailer's estate.[34] Therefore, any changes to the key elements of Nisa's offering would likely have to be replicated across the member's estate. However, based on the available evidence, the costs of changing prices across a multi-site retailer's estate would outweigh any incentive to increase prices in a single store (or limited number of stores).[35]

- *Conclusion on local flexing*

79. On the basis of the above, the CMA believes that the merged entity may have the ability to target specific Nisa-supplied single stores, although the limited evidence submitted by the Parties indicated that Nisa does not generally flex its offering currently. With regard to multi-site retailers, the CMA has found that there is very limited scope for the merged entity to target specific stores within a multi-site retailer's portfolio.

80. However, as discussed further below, given the CMA's conclusions with regard to wholesale competition and its findings in relation to incentive below, the CMA does not believe that the merged entity would have the ability or incentive to increase wholesale prices and/or cut costs affecting its quality of wholesale service, in any local areas (given the combination of local conditions of retail and wholesale competition). Given this, the CMA has not found it necessary to conclude on whether the merged entity would have the ability to flex its wholesale offering at a local/retailer level.

Incentive

81. For there to be an incentive for the merged entity to increase wholesale prices and/or cut costs that affect its quality of wholesale service to its symbol group and independent retailer customers, the strategy must be profitable to the merged entity overall. There are several factors that affect whether this is likely to be the case. These are:

    (a) First, the degree of competition between CGL stores and Nisa-supplied retailers at a local level. This will determine the extent to which end-customers may switch from Nisa-supplied retailers to CGL stores, rather than to other retailers' stores. This will depend on which other retailers are

[34] The main exception the CMA is aware of is 'delivery', since Nisa delivers to individual stores. However, any degradation to this aspect of service would likely introduce inefficiencies into the delivery service itself, and so would incur higher levels of cost for Nisa than other methods of degradation (eg price increases) and so would be less likely to be relied on in this strategy.
[35] The CMA has calculated average vGUPPIs for the estates of each multi-site retailer and the CMA's findings are described below in paragraphs 107-110.

present in the local area and where they are situated relative to the CGL and Nisa-supplied stores.

(b) Second, the degree of competition at the wholesale level (see paragraphs 56-63 above).

(c) Third, the profits that the merged entity stands to gain from any consumers who switch to the locally-competing CGL store, compared to the profits that the merged entity stands to lose on lost wholesale sales (net of the higher profits its earns on higher-profit wholesale sales it retains).

(d) Fourth, the extent to which a worsening of the wholesale offer (particularly in the form of a wholesale price rise) is likely to feed through to a similar worsening at the retail level (particularly in the form of a retail price rise). The extent to which wholesale price rises feed through to the retailer's average retail prices depends on:

(i) Nisa's share of the retailer's total wholesale purchases (its 'share of wallet'), as only those goods that are purchased from the merged entity will be affected by the merged entity's actions; and

(ii) the extent to which the retailer passes on the wholesale price increase (or deteriorates quality), in the form of a retail price increase (or deterioration in quality).

82. The first two factors – the conditions of local retail competition and local wholesale competition – are likely to be highly determinative. A local foreclosure strategy will only be profitable for the merged entity if the amount of business gained by a CGL store through consumers diverting away from Nisa-supplied retailers is large. The volume of diverted business would need to be sufficient to compensate for any loss of wholesale business through retailers switching purchases to other wholesalers in response to a price rise/quality degradation. Given that the wholesale market is generally competitive, diversion to the CGL store will need to be high for the strategy to be profitable in any local market. The CMA's findings in *Tesco/Booker* (which are consistent with feedback from the market testing in this case) also indicate that the market for convenience retail is highly fragmented. This suggests that, in many areas, the merged entity would not find it profitable (and would therefore not have the incentive) to engage in a local foreclosure strategy, as shoppers may be more likely to switch to any number of competing retailers rather than to a CGL store. This means that a local foreclosure strategy would only be plausible in 'marginal cases' where the local retail conditions of

competition mean that CGL stores and Nisa-supplied stores are close competitors, and face little competition from other retailers.

83. The incentives in any given local area will vary. Given the large number of overlaps between CGL's stores and the retail stores which Nisa supplies, the CMA has sought to apply a systematic method for combining the factors outlined above to assess the incentives within individual local areas. This allowed the CMA to identify those marginal cases where the retail conditions of competition may make the overall strategy profitable.

Framework for assessment - vGUPPI

84. As regards such a systematic framework, the CMA, consistent with *Tesco/Booker*, has assessed the above factors using a 'vertical gross upward pricing pressure index' (vGUPPI) tool. The vGUPPI is an extension of the GUPPI tool frequently used in horizontal merger cases which aims to express the magnitude of post-merger incentives to increase prices.

85. The general method of calculation used for the vGUPPI framework, and in particular the inputs used in reflecting each of the factors discussed above, is explained in detail in Appendix C of the CMA's final report in *Tesco/Booker*.[36]

86. However, as this Merger relates to different entities, the CMA has considered in the sections below whether there are any case-specific elements that could influence the vGUPPI framework including any which may differ from those in Tesco/Booker.

Effective retail competitor set

87. The Parties' post-Merger incentives to raise prices depend in large part on whether the shoppers that are lost because of a price increase would switch to stores owned or supplied by the other Party in sufficient numbers to make this increase profitable. The extent to which customers will switch to a certain store can be expressed in a diversion ratio (ie the percentage of customers captured by a certain store after a price increase).

88. The CMA systematically estimated diversion ratios for the purposes of the vGUPPI using a weighted share of shops (WSS), intended to capture both

[36] See Appendix C Tesco/Booker.

distance[37] and differentiation[38], based on that used recently in *Tesco/Booker*.[39]

89. The Parties submitted that Nisa-supplied stores and CGL stores compete with a wide range of grocery retailers including those considered to fall within the effective competitor set in *Tesco/Booker*. The Parties submitted that the discounters (Aldi and Lidl) and Iceland are strong and effective competitive constraint on the Parties. On this basis, the Parties considered that the weightings given to Aldi and Lidl in the CMA's WSS should be increased (compared to that weightings used in *Tesco/Booker*) and that Iceland should be included as an effective competitor (having been excluded from the effective competitor set in *Tesco/Booker*).

90. The evidence available to the CMA in this case that the effective competitor set and weightings used in *Tesco/Booker* remain the appropriate basis for assessment in this case.[40]

91. In particular, the evidence available does not support the Parties' position that the weighting given to the discounters should be increased or that Iceland should be included in the competitor set. In particular, while the internal documents provided by the Parties indicate that they monitor the discounters [✂]. The Parties have not provided sufficient evidence that Iceland should be included the effective competitor set. The CMA notes, in addition, that CGL and Nisa-supplied stores typically sell tobacco and that sales of tobacco account for a significant proportion of the Parties' overall revenues (and a similar proportion to those of the merging parties in *Tesco/Booker*). The CMA therefore considers, consistent with its findings in *Tesco/Booker*, that the discounters and Marks & Spencer should not be treated as fully effective competitors because they do not sell tobacco.[41]

Own-brand diversion

92. In *Tesco/Booker*, the CMA recognised that, in calculating diversion ratios and pricing pressure indices, it is necessary to account for possible 'feedback

[37] The closer stores are located the closer they compete and the higher the diversion ratio. In its WSS assessment, where the relevant focal store is a convenience store, the CMA has taken into account the distance of any relevant competing convenience retail offering from the given focal store into account. It has done this by giving any relevant competing store a weighting that changes depending on its proximity to the focal store.
[38] Differentiation between the competing stores: the more comparable the product offering between the stores, the higher the diversion ratio.
[39] Following the approach taken in Tesco/Booker, symbol stores are downweighted relative to an owned (CGL) focal store since they are considered to exert less of a competitive constraint on CGL than the stores of other retail multiples.
[40] See Tesco/Booker, Appendix C, para. 50.
[41] See Tesco/Booker, para. 7.50(c).

effects' in areas where the Parties own or supply more than one store in a local area (ie own-brand diversion).[42] The CMA has accounted for this possibility in the same way in this case, by running a 'second-round' vGUPPI which allows for diversion between stores owned or supplied by the same party where the vGUPPI in the 'first-round' (assuming zero own-brand diversion) is less than 5% for that store.[43] The results of the CMA's incentives analysis have taken into account any own-store diversion in the second-round.[44]

93. The CMA considered how it should treat regional cooperatives, eg the Midcounties Co-operative, which are supplied by CGL through the buying group FRTS (Federal Retail Trading Services). Given the nature of the supply agreement between CGL and regional cooperatives, the CMA believes that CGL would not have any incentive to worsen the offering to regional cooperatives, and as such has not calculated a vGUPPI for these stores. Therefore, for consistency of approach in light of treatment of own-brand diversion as set out above, the CMA has allowed for diversion between CGL and regional cooperatives in its analysis. However, the CMA undertook a fascia-based sensitivity to check the impact of this approach on its findings in this case. As part of this sensitivity, regional cooperative-owned stores and CGL-owned stores were counted as one fascia (and therefore no diversion is accounted for between the stores), and this did not substantially change the CMA's results.

Margins

94. The use of margins in the vGUPPI analysis is primarily to reflect the level of value which would be lost/recaptured by the merged entity if it were it to worsen its retail offering, or induce a worsening of rivals' retail offerings, as described in ToH1 and ToH2.

95. The correct margin figures to use should reflect the profit made/lost from the incremental gain/loss of associated volumes. This is referred to as the variable margin. Given the potential difficulties with accurately determining the variable margin, the CMA has typically adopted the conservative approach of using the gross margin (ie treating all cost lines other than COGs as being fixed over the volume and time changes) in Phase 1 proceedings.[45] By way of

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[42] See Tesco/Booker, Appendix C, para.52.
[43] See Tesco/Booker, Appendix C, para 57 for a detailed discussion on the 'first' and 'second' rounds of the vGUPPI.

[45] For example, all of the following cases specify that *'Diversion ratio estimates and gross margin data can be combined to estimate illustrative price rises [or IPRs]'*: Co-op/Budgens (2014), paragraph 34; Asda/Co-op (2014),

exception to this approach, the CMA (or OFT) has accepted certain other cost lines as being variable or semi-variable in a very small number of Phase 1 cases where this was supported by the available evidence.[46]

96. The Parties were able to provide compelling evidence to establish that a small number of cost lines should be treated as variable or semi-variable. More specifically:

   (a) Rebates, incentives and discounts paid by CGL wholesale suppliers (CGL retros), which are subsequently allocated to the CGL stores. A proportion of this income is not dependent on sales volume/value (as described in CGL's 2016 annual accounts).[47] The CMA considers that there is evidence in public, audited figures which pre-date the Merger plans, to support the position that these cost lines are 50% variable. The CMA has therefore treated these costs as being 50% variable in its vGUPPI analysis.

   (b) Nisa currently operates [✂] different rebate systems and provided evidence that some of those rebates varied with the volumes sold. The CMA notes that [✂] of these schemes are linear (ie apply a fixed percentage rebate on the relevant turnover)[48] and [✂] are stepped (ie they apply a different percentage rebate to the entire purchase depending on which volume thresholds are met).[49] The CMA considers that only linear rebates are clearly fully variable and, based on the Parties' submissions of the relative split of rebate spend, has estimated that the linear rebate schemes amounted to around [✂]% of the value of the total rebate costs. The CMA has therefore treated [✂]% of the rebates as being variable in its vGUPPI analysis.

   (c) Nisa submitted that distribution costs were regularly reviewed, and that its management accounts included an estimate that [✂] of these costs were variable. The Nisa distribution contract is outsourced to [✂], which provides a weekly breakdown of costs into their constituent elements (which are categorised as variable or fixed). The categorisation took place prior to contemplation of the Merger, and Nisa submitted that the contract is monitored and managed on this basis (as is reflected by the resulting

paragraph 57; One Stop/Alfred Jones, trading as Spar (2013), paragraph 35; and Midcounties Co-op/Tuffins (2012), paragraph 80.

[46] See 'Anticipated acquisition by Asda Stores Limited of Netto Foodstores Limited' (OFT 2010), Annexe A, paragraph A.15.

[47] See page 114 of the Co-op Annual Report 2016 which discusses accounting policies for supplier income.

[48] [✂].

[49] [✂]. The CMA considers that the associated change in cost associated with stepped rebates schemes is unclear. In particular when retailers' existing volumes are close to any of the relevant thresholds, there may be strong economic incentives for retailers to change their behaviour to maintain the relevant rebateable expenditure. Therefore, the cost of these schemes may not be treated as being variable.

variability estimates that appear in a number of historical annual accounts). This calculated estimate of the variability of distribution costs has consistently been around [✄](varying slightly between [✄] and [✄] over time). This available evidence therefore indicates that this estimate is robust (in particular because it is consistent with the basis upon which the business has been managed). Accordingly, the CMA has treated these costs as being [✄]% variable.

97. The Parties made additional submissions on various other costs, eg Nisa leaflet costs and CGL distribution costs as well as other rebates not mentioned above, which they considered should also be treated as being variable or semi-variable. However, the CMA considers that the evidence submitted did not support the Parties' position to the standard required within the context of a Phase 1 investigation and has therefore adopted a cautious approach of treating these costs as fixed.

Results of the incentives assessment

98. On the basis of the framework described above, the vGUPPI screen identified 23 Nisa-supplied stores with a vGUPPI of more than 5% out of a total 1,417 overlaps. Three of those 23 stores had a vGUPPI in excess of 10%.

Factors which may mean incentive as estimated by vGUPPI is overstated

99. In *Tesco/Booker*, the CMA noted that a 5% threshold for concern, in relation to a wholesale to retail theory of harm of this type, was conservative in that case. In that case, the CMA noted certain factors that would reduce the overall profitability of the strategy, and therefore the incentive for the merged entity to pursue it, particularly where the affected number of areas is extremely small relative to the Parties' overall estate.[50] As described below, these factors are also present (and therefore also affect the incentives of the merged entity) in the current case.

100. The vGUPPI results relate to upward pricing pressure experienced by Nisa as a result of the Merger, so that a 5% vGUPPI would be equivalent to an increase in Nisa's costs equal to 5% of wholesale prices. This will need to be passed through twice to have an effect at the retail level; first by Nisa to its wholesale price (*wholesale pass-through*), and then by retailers supplied by Nisa to retail prices (*retail pass-through*).

[50] See Tesco/Booker, paragraph 9.51

101. First, on wholesale pass-through, if a pass-through of a cost shock at the wholesale level is 100%, then a vGUPPI of 5% would equate to a 5% increase in Nisa's wholesale prices. No evidence on the precise level of pass through in the wholesale market (which could be higher or lower than 100%) is available to the CMA. In circumstances where competition in the wholesale sector is strong (which, as described above, appears to be the case), the CMA would expect that Nisa may not be able to pass through all of an asymmetric increase in wholesale costs into a price increase.

102. Second, on retail pass-through, the overall success of pursuing a strategy of degrading the wholesale offering relies on some level of pass-through by retailers to their customers (eg in the form of higher prices). However, retailers may not pass on any wholesale price increase in full in particular because:

(a) Retailers are independently owned and there is no mechanism in their contractual relationship for sharing any additional profits that would be derived from this strategy with CGL. Raising their prices, or otherwise degrading their offering, may result in lost revenues for the retailer (subject to there being some competitive constraint at the retail level).

(b) Some retailers – particularly those that hold multiple shares in Nisa – will receive significant incentive payments because of the Merger - as discussed in in paragraph 64 above. This means that a very large wholesale price increase would be required, at least in some cases, to put retailers in a worse position than they were in prior to the Merger. This could, in turn, further dilute the rate of pass-through in this case.

103. Consistent with the position in *Tesco/Booker*, any effect on overall retail prices brought about by the Parties worsening their wholesale offering may be further dampened by buying efficiencies brought about by the Merger, as a result of greater scale and purchasing power, that would place downwards pressure on the merged entity's costs and therefore prices.

104. Finally, the vGUPPI analysis assumes that there are no costs to the merged entity of implementing a targeted strategy of focusing any wholesale price increases, or cost-cutting that affected quality of wholesale service, in any local areas where the conditions of competition may favour it. As noted above and in *Tesco/Booker*,[51] the CMA believes that there are likely to be costs in implementing such a strategy. This is likely to reduce the overall profitability of the strategy, and therefore the incentive for the merged entity to pursue it, particularly where the affected number of areas is extremely small relative to

[51] See Tesco/Booker, para 9.35.

the Parties' overall estate – which the CMA's vGUPPI analysis indicates is likely to be the case.

105. For these reasons, the CMA believes that a 5% vGUPPI threshold for concern, in respect of the wholesale to retail theory of harm, is likely to be conservative. On that basis, the CMA believes that the vGUPPI results indicate that the merged entity will have limited incentive to increase prices or otherwise degrade quality post-Merger.

106. On a cautious basis, the CMA has, nevertheless, assessed the 23 local areas attracting a vGUPPI of more than 5%.

107. Fourteen of the 23 Nisa-supplied stores with a vGUPPI of more than 5% are stores owned by a multi-site retailer and therefore form part of a wider multi-site estate.

108. For the reasons described in paragraphs 76 to 78 above, the CMA believes that any increase in price or worsening in quality would likely have to implemented over the whole of that multi-site member's estate. Therefore, when assessing the relevant incentive on the Parties for multi-site retailers, the CMA has considered the vGUPPI across the member's estate rather than for the individual stores. Having calculated the average vGUPPI for each multi-site retailer's total store estate, the CMA has found that there is no multi-site retailer for which the Parties would have an incentive (at a 5% threshold) to worsen their offering to the whole estate. The CMA therefore does not believe the Parties would have the incentive to engage in any such strategy in relation to these multi-site stores.

109. Even if the merged entity did have the ability to target individual stores within a multi-site retailer's estate, the CMA understands that the multi-site retailer may be able to switch the targeted store to an alternative wholesaler. This is consistent with the CMA's findings in *Tesco/Booker*, which indicated that some multi-site retailers multi-source across wholesalers and even have stores operating under different symbol fascia.

110. Therefore, the CMA believes that there is no realistic prospect of an SLC in any of the local areas associated with these 14 individual stores as the Parties would not have the ability and incentive to implement the theory of harm in these local areas.

111. For single-store retailers, the CMA conducted a fascia count of large delivered grocery wholesalers, that would be able to supply these stores. The CMA included the large national delivered wholesalers in its analysis as well as some that have a large regional presence. Each of these wholesalers also offer a symbol offering and can therefore be considered as relatively close

competitors to Nisa. Based on the 80% catchment of each of the wholesalers, each of the remaining 9 stores identified by the vGUPPI have at least three alternative wholesale providers offering both delivered wholesale service and symbol group services.

112. The CMA notes that even on this relatively conservative basis (including only those delivered wholesalers with a national or significant regional presence and which offer a symbol fascia, and using 80% catchment areas) these Nisa-supplied retailers have several wholesale choices.

113. Therefore, given that the Nisa-supplied stores have other options for wholesale supply, the CMA believes that these retailers would have the ability to defeat any foreclosure strategy in these areas by switching to other wholesalers.

Conclusion on wholesale to retail theory of harm

114. On the basis of the Parties' national shares of supply in retail and wholesale services, the CMA believes that the merged entity would not have the ability or incentive to worsen wholesale price or service at a national level.

115. The CMA also believes that the merged entity would not have any material incentive to worsen wholesale price or service at a local level. This is because, overall, the CMA believes that competition in wholesaling services is generally strong, meaning that, in most areas, many retailers would switch purchases to other wholesalers rather than suffer (or pass on to shoppers) a worsened service – defeating the merged entity's ability to carry out this strategy. Further, in many areas, the presence of other nearby retail competitors means that CGL would not be able to recapture sufficient sales to make the strategy profitable, as competing retailers would capture some of the switching sales.

116. The CMA notes that there may be, at most, some limited incentives in relation to a very small number of local areas. However, any incentives that might arise at the wholesale level would be reduced by, for example, retailers purchasing only a fraction of their products from the merged entity and the rest from other wholesalers, and by retailers not passing the full wholesale price rise through to shoppers at the retail level. Further, pursuing a targeted strategy in these areas would require coordination across the merged entity's retail and wholesale arms. The CMA believes that the costs of implementing such a strategy would be disproportionately high relative to the very small number of areas involved. In addition, the CMA believes that wholesale competition was sufficiently strong in all of these local areas.

117. On this basis, the CMA believes that there is no realistic prospect of an SLC under this theory of harm on a national basis or in any local areas.

Retail to wholesale assessment

Ability

118. The CMA assessed whether the merged entity could vary some aspects of its retail offering by local area, to respond to local retail conditions of competition. If so, the merged entity could adjust its retail offering at CGL stores in local areas where conditions of retail competition meant that sufficient customers leaving the CGL store would shop at Nisa-supplied stores instead, thereby increasing the profits of the merged entity overall.

119. CGL made limited submissions on how it currently determines its retail offering. CGL submitted that it uses uniform prices across its CGL estate, [✂]. The only exception to this rule is [✂].

120. Notwithstanding CGL's submissions that it sets price and some other elements of its offering centrally, the CMA considers, consistent with its position in prevision decisions in relation to the CGL retail business,[52] that CGL could flex its retail offering at a local level.

Incentive

121. For there to be an incentive for the merged entity to increase its retail prices or cut costs that affects its quality of retail service, the strategy must be profitable to the merged entity overall. Whether this is the case will depend upon:

    (a) the degree of competition between CGL and Nisa-supplied stores. This determines the extent to which end customers might switch from CGL stores to Nisa-supplied stores, rather than diverting to other stores in or just outside of the catchment area; and

    (b) the profits that the merged entity stands to gain from any additional wholesale sales that results from consumers switching to Nisa-supplied retail stores which, is in turn, determined by:

        (i) Nisa-supplied retailers' share of total cost of goods that is with Nisa; and

[52] See Completed acquisition by Co-operative Foodstores Limited of eight My Local grocery stores from ML Convenience Limited and MLCG Limited, case ME6625/16, paragraphs 50-54.

(ii) The margins earned on each sale (ie the ratio between the lost retail margin and the gained wholesale margin).

122. The pass-through consideration discussed above in relation to the Wholesale to Retail theory of harm does not apply here since CGL owns and operates its stores and therefore has direct control over pricing decisions (albeit such changes might not come at zero cost, as described above).

123. Using cautious inputs to the model, as described in Appendix C of *Tesco/Booker* and paragraphs 84-97 above, a vGUPPI of 5% or greater is found in 9 local areas out of a total 668 overlaps. For 7 of these areas the vGUPPI is below 7.5% and all areas are below 10%. Therefore, there are a very small number of areas in which the CMA has found a possible, albeit small, incentive to increase prices to some extent.

124. However, there are a number of reasons why the CMA believes that none of these areas give rise to a realistic prospect of an SLC.

125. First, some of the assumptions used in the calculation relating to retail competition are likely to overstate the merged entity's incentives to raise prices. The vGUPPI screen used in this case only allowed for 10% out-of-market diversion. This includes the possibility of:

(a) Consumers switching to stores outside of the defined catchment areas set out in paragraph 34. This includes consumers choosing to shop at stores just outside of the catchment area, and/or stores which are close to their place of work rather than home. For convenience stores in both in rural or urban locations this also includes the possibility of customers travelling to a larger MSS or OSS offering outside the 1-mile catchment area;

(b) Consumers switching to shop online. The largest growth in UK grocery sales in recent years has been in online sales and discount retail.[53] However, it is not clear how strong a constraint online shopping provides for individual stores, particularly for convenience.

126. Allowing for greater out-of-market diversion significantly reduces the scope for any incentive to be significant.

127. The CMA believes, in particular, that convenience stores in rural locations are more likely to be asymmetrically constrained by MSS and OSS located further

[53] IGD data shows that online grocery sales had a cumulative annual growth rate of 7% between 2014 and 2016 (to £9.7 billion) and discounter sales had a cumulative annual growth rate of 14% in the same period (to £18.2 billion).

away because driving is a more common mode of transport than in densely populated urban areas.[54]

128. The CMA therefore considered, in each of the nine areas in which the vGUPPI was found to be greater than 5%, whether there were features of the market that would suggest that the vGUPPI overstates diversion between the Parties such that competition concerns are not likely to arise. To do this, the CMA looked to see if there may be an asymmetric constraint on convenience stores in rural areas by MSS within 10 minutes and OSS within 15 minutes. The CMA also considered whether the available evidence indicated, to the required standard within the context of a Phase 1 investigation, whether any other features of the retail competitive environment indicated that diversion between the Parties was likely to be overstated in these areas.

129. The inclusion of the asymmetric constraint on convenience stores from larger stores (in the CMA's effective competitor set) in rural areas, and the identification of additional constraints from effective competitors just outside of the catchment area for the remaining flagged stores, indicates that the incentive of the merged entity to worsen its offering in these nine areas would be lower than suggested by the vGUPPI.

Risks and costs associated with implementing a local strategy

130. In addition to the likely underestimation of out-of-market diversion, the vGUPPI analysis also only accounts for the expected gains to CGL of the strategy and does not take account of the inherent risk associated with this theory of harm.[55] Importantly, under a strategy of worsening its offering at owned retail stores, CGL would be seeking to recapture sales via a store that the merged entity does not own. The risk of failing to recapture in the future any lost sales at a store that is currently supplied by Nisa is likely to dampen the merged entity's incentive to pursue such a strategy.

131. The CMA notes that the latest full year of data indicates that Nisa member churn (which includes stores that fully switched away to a competitor, or left retailing altogether) is around 15% per year, which highlights the potential risk associated with the strategy. While the post-Merger consideration payments due to be paid to Nisa members could, in theory, reduce the propensity of Nisa retailers to leave,[56] it will still be possible for them to partially switch without losing all of these benefits. This would reduce the overall revenues

[54] Of the seven convenience stores identified by the CMA as having a vGUPPI of greater than 5%, five were classified by the ONS as being rural.
[55] See Tesco/Booker final report, paragraph 10.2.
[56] The CMA notes that the considerations for the Nisa retailer to switch as described above in paragraphs 64-68 do not apply in this scenario, as there is no worsening of the wholesale offer to the Nisa retailer.

recaptured by CGL. In addition, retailers may also still leave Nisa completely, even if the Merger payments reduce incentives to do so (at least to some extent). In addition, while any strategy by CGL to worsen its offering could be reversed in the event that a supplied store nearby switched some or all of its sales away, this would come at additional cost which would need to be factored into any decision upfront. This risk and associated costs are not reflected in the vGUPPI analysis. The CMA also notes that the evidenced rationale of the Merger – to grow scale – is also wholly inconsistent with the merged entity's incentive to engage in this kind of strategy.

132. Finally, there are also likely to be some costs of implementing a targeted strategy, in terms of coordinating retail and wholesale arms of the business, which will reduce its profitability, particularly when very few local areas are involved.

133. The CMA believes that, together, these factors mean that the merged entity could only be expected to engage in such a strategy if the expected gains were high, given the costs and risks associated with the strategy in this vertical setting. Given the very small number of areas, relatively low vGUPPI values found (none of which exceeded 10%), and the considerations regarding the extent to which these values are capturing actual retail competitive dynamic, the CMA believes that there is no realistic prospect that the merged entity would have the incentive to increase its retail prices or cut costs that affect its quality of retail service in any local areas.

Conclusion on retail to wholesale theory of harm

134. The CMA believes that there is no realistic prospect the merged entity would have any material incentive to worsen retail price or service. This is because, if the merged entity were to raise its retail prices or cut costs that affect its quality of retail service, it would incur losses through retailers supplied by other wholesalers capturing sales and Nisa-supplied retailers not purchasing all their stock from the merged entity.

135. The CMA notes that there may be, at most, some limited incentives in relation to a very small number of areas. However, pursuing these would require coordination across the merged entity's retail and wholesale arms. Moreover, the recaptured revenue would come via customers of the merged entity's wholesale business whose continued purchases from the merged entity are not guaranteed. The costs and risks of implementing such a strategy would be disproportionately high relative to the very small number of areas involved.

136. On this basis, the CMA believes that there is no realistic prospect of an SLC under the retail to wholesale theory of harm in any local areas.

Conclusion on vertical effects

137. For the reasons set out above, the CMA believes that the merged entity does not have the ability and incentive to pursue a Wholesale to Retail Strategy at a local level, as there is sufficient wholesale competition and the costs of implementing such a strategy would outweigh the benefits. As regards the Retail to Wholesale Strategy, the CMA believes that there is no incentive to implement such a strategy, as the risks and costs associated with it would outweigh the benefits of the strategy. Accordingly, the CMA found that the Merger does not give rise to a realistic prospect of an SLC as a result of vertical effects in relation to the wholesale and retail supply of groceries.

Barriers to entry and expansion

138. Entry, or expansion of existing firms, can mitigate the initial effect of a merger on competition, and in some cases may mean that there is no SLC. In assessing whether entry or expansion might prevent an SLC, the CMA considers whether such entry or expansion would be timely, likely and sufficient.[57]

139. However, the CMA has not had to conclude on barriers to entry or expansion as the Merger does not give rise to competition concerns on any basis.

Decision

140. Consequently, the CMA does not believe that it is or may be the case that the Merger may be expected to result in an SLC within a market or markets in the United Kingdom.

141. The Merger will therefore **not be referred** under section 33(1) of the Act.

Sheldon Mills
Senior Director Mergers
Competition and Markets Authority
23 April 2018

[57] *Merger Assessment Guidelines*, from paragraph 5.8.1.

ANNEX 1 – EFFECTIVE GROCERY RETAIL COMPETITOR SET

Retailers	Symbol groups/Fascia operated by wholesalers
Aldi	Bargain Booze
Asda	Best-One
Booths	Budgens
Co-operative societies (including Co-operative Group)	Centra*
Dunnes	Costcutter
Iceland	Key Store/Key Shop
Lidl	Lifestye Express
Marks & Spencer	Londis
Martins	Mace
McColl's	Nisa
mLocal	P&H Retail
Morrison	Premier
Sainsbury's	Spar
Tesco	Supervalu*
Waitrose	Todays
Whole Foods*	VG/Vivo

Source: CMA analysis; information on store locations is based on store data provided by the parties updated with information from Landmark, Filshill and Conviviality, the stores of which the parties indicated that their data did not fully reflect