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Agenda

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Taking stock of the OFT's approach in supermarket mergers

In 2008 the UK Office of Fair Trading (OFT) accepted undertakings from the Co-op for it to sell more than 120 supermarket stores rather than have its acquisition of Somerfield referred to the Competition Commission for further investigation. Tim Geer, OFT Case Officer, explains how the OFT assessed this case and how its approach to supermarket mergers has been honed

In October 2008, the UK OFT announced its decision to seek divestment remedies following its investigation into the then proposed acquisition by Co-operative Group Limited (CGL) of Somerfield Limited (Somerfield).[1] CGL has since completed the large package of divestments.

The divestments were to remedy the OFT's competition concerns in a large number of local markets throughout Great Britain. By the time CGL had completed the divestments it had sold 124 supermarkets, making this the largest divestment package ever undertaken at the phase 1 stage of a UK merger investigation. Oxera advised CGL during the OFT's investigation.

This case followed several other inquiries into the groceries sector since 2000 by the UK's phase 2 investigative body, the Competition Commission (CC). Most notable among these are the groceries market investigation (2008)[2] and the merger investigation, *Somerfield/Morrisons* (2005).[3] The valuable know-how developed by the CC enabled the OFT to undertake the sophisticated local market analysis required for it to resolve competition concerns at the phase 1 stage of the UK merger investigation process.

However, the OFT's analytical approach in *CGL/Somerfield* does, in part, deviate from the analytical foundation laid down by the CC, and it has been honed in some subsequent OFT decisions. Notwithstanding the case-specific elements which are taken into account during any merger investigation, some have raised the question as to whether the OFT's role in preventing substantial lessenings of competition (SLCs) through merger activity has come at the price of legal certainty. This is an especially important consideration in the UK's voluntary notification regime, in which the OFT encourages parties to self-assess their transactions.

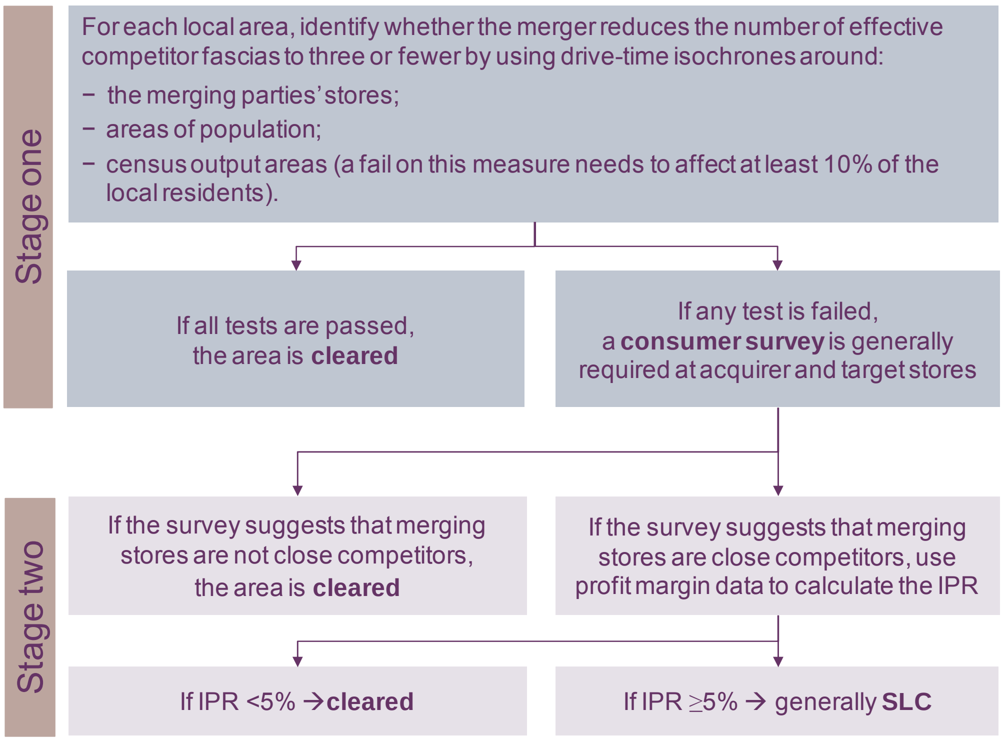
This article discusses this question, drawing on merger cases undertaken since *CGL/Somerfield*, and identifies possible areas for analytical development in future cases. It concentrates on the OFT's unilateral effects analysis at the local level since it is this which is likely to be at the centre of most future supermarket cases.

Local market analysis: background

In *CGL/Somerfield*, as with a number of other supermarket cases, the OFT adopted a method of local market filtering based on fascia counting (called the stage one filter in that case).[4] The purpose of filtering local markets is not to identify competition problems, but rather to dismiss (or filter out) those local areas in which competition problems are unlikely to arise as a result of the merger, thereby freeing up the OFT's investigation time for it to properly examine the competition effects of the merger in the remaining local areas. It therefore offers a pragmatic and efficient way to proceed in those cases that involve a large number of local overlaps.[5] Figure 1 below shows how this analysis was performed in the *CGL/Somerfield* case.

After the stage one filter was completed, the OFT subjected the remaining local areas to a stage two analysis in order to assess the closeness of competition between the merger parties' stores. This involved examining diversion ratios derived from a survey of consumers, calculating an 'illustrative price rise', or IPR (which uses diversion ratio and profit margin data), and examining other area-specific information (eg, barriers to entry, imminent entry, expiry of leases and the like). The OFT (after market testing) adopted the CC's findings from the groceries market investigation in its product and geographic market definitions.[6] The method for determining local areas by drive time (ie, where the isochrones should be centred)

Figure 1 Local area assessment used in *CGL/Somerfield*



and the fascia counting and IPR threshold levels (to distinguish passes from fails) were taken from the CC's *Somerfield/Morrisons* report.

Filtering based on fascia

The OFT, in *CGL/Somerfield*, required CGL to undertake isochrone centring on both its own (acquirer) stores and the Somerfield (target) stores in order to take account of the asymmetric constraint that exists in those areas where one store is of a different size category to the other.[7]

The stage one filtering approach used in *CGL/Somerfield* has most notably been refined in:

- *Morrisons/30 CGL stores*, where the OFT did not require Morrisons to undertake analysis where the drive times would be based on local competitors since 'this would not have been probative of additional competition concerns given that re-centring on census output areas was conducted';[8] and

- *Tesco/six former Somerfield stores*, where the OFT did not require Tesco to undertake re-analysis where the drive times would be based on population areas[9] since 'census output data re-centring applies the same concept but at a finer level of detail.'[10]

These two examples indicate the importance that the OFT attaches to fascia-based isochrone analysis with isochrones based on census output areas. There is a sound logic to this: consumers will view their choices of local supermarkets from the perspective of the starting point of their shopping trip, which is often their home (and not usually a competing supermarket). Furthermore, the census output area centrings offer a more demanding stage one filter, examining the possible loss of choice for local communities arising from a merger at a finer level of detail than do isochrones based on population centres.

Regardless of where the isochrones are centred, the original purpose of fascia-based filtering was to whittle down the number of local areas for analysis to manageable levels. But the OFT has sometimes applied the filtering tests to cases in which the number of overlaps is already manageable (that is, when between one and three stores were being acquired).[11]

While it is worth remembering that the OFT stated in *Tesco/Brian Ford* that 'the 'Safeway criteria' were designed to deal with mergers involving a large number of overlapping stores rather than the acquisition of a single store',[12] there are sound reasons as to why the OFT should continue using the fascia-based filtering employed in *CGL/Somerfield* (or something similar).

First, it is often to the mutual advantage of both the merger parties and the OFT for the stage one filter to be employed in those cases which there are no local overlaps between the parties or when the count of competing fascia is high. Therefore, the stage one filter can be a valuable tool for clearing single/few store acquisitions in a timely and comparatively cost-effective way even though the filter was not initially devised for these types of case. An alternative approach, of the type used by the CC in *Tesco/CWS* (Slough)[13]—in which the CC relied on case-specific evidence to define the local market and to carry out its assessment—would be a time-consuming and expensive way of clearing unproblematic mergers at the phase 1 stage. (Such an approach for potentially problematic mergers is better suited to a phase 2 investigation.[14])

Second, any analytical methodology replicated across cases helps parties to self-assess their own mergers and to feel that they have been treated on a par with their competitors. In this way legal certainty has been strengthened by the OFT's use of fascia analysis over recent years.

Use of the 'illustrative price rise'

One of the more remarked upon aspects of the methodology employed by the OFT in *CGL/Somerfield* has been the OFT's use of diversion ratios and the IPR,[15] especially in setting the diversion ratio threshold at 14.3%. In the view of some, a 14.3% threshold increases the risk of a type I error (ie, finding an SLC where none exists) in the OFT's analysis. Diversion ratios are usually derived from a survey of shoppers (which may considerably add to the time and expense of the phase 1 merger review).

Before discussing this it is worth making some preliminary points. The first is that customer surveys (or some other robust method of generating diversion ratios) give the OFT a considerably better view of how closely merger parties were competing in an overlapping area before the merger than a less sophisticated method would (eg, fascia counts or market share estimates).

Second, despite the richness of information that the approach provides, the OFT appreciates the time and expense that it takes for the input data to be generated and therefore it tries to limit (through stage one filtering) the number of local areas which are subjected to IPR analysis.

Third, the IPR combines both profit margins and diversion ratios and therefore offers the OFT some insight into a merged entity's incentive and ability to raise prices post-merger. However, the application of the method is still in its early days and therefore the OFT continues to hone and improve its application of the IPR through experience. Indeed, the OFT has listened and made improvements to its approach in a range of mergers when merger parties and others offer it a constructive way forward, some examples of which are mentioned in this article.

Finally, by way of preliminary comments, although the 14.3% threshold itself has received a lot of attention from practitioners, it should be borne in mind that in *CGL/Somerfield* the OFT required local area divestments if the expenditure-weighted diversion ratio was at least 14.3% *and* the IPR calculation was at least 5%.[16]

In *Somerfield/Morrisons*, the CC selected a threshold of 14.3% since it was equivalent to a merger in a market with eight equal-sized firms with diversions allocated equally among the suppliers. The CC considered an eight equal-sized firm market to be an appropriate hypothetical starting point since a two-firm merger would result in the merged entity holding a 25% share (ie, 12.5% each). Moreover, its *Merger Guidelines* stated that mergers resulting in a share of less than 25% are unlikely to raise competition concerns.[17]

This starting point has quite often been the basis of criticism of the approach.[18] Is there, therefore, a case for the OFT to re-calibrate the threshold it uses in passing and failing local areas based on IPR calculations, or to reconsider its use of IPR in other ways? To consider this question, a good place to start is with the OFT's *Morrisons/30 CGL stores* decision; the largest supermarket deal that the OFT has examined since *CGL/Somerfield*.

In this case the OFT found that a strict application of the IPR formula used in *CGL/Somerfield* would result in a finding of a realistic prospect of SLC (albeit marginally). However, in light of evidence submitted by the parties the OFT adjusted the IPR calculation to take account of the low diversion ratio from the Morrisons store to the CGL store (despite it being around 25–30% in the other direction). It also altered the assumption on the shape of the demand curve.[19] The OFT concluded that there was not a realistic prospect of an SLC in the relevant local area.

The OFT showed in *Morrisons/30 CGL stores* that it could take account of asymmetry of competitive constraints between the merger parties within the existing IPR framework. (The OFT's use of the IPR is flexible in this regard when one acquiring firm store overlaps with one target firm store, but becomes extremely complex and difficult when there are multiple store local overlaps.[20]) However, IPR still requires an assumption about the shape of the demand curve which can in some instances materially determine whether the OFT will come to an SLC finding.

Further, the number of local market SLCs may in some instances be determined by how key input data (especially profit margins) is calculated (even if the threshold itself remains at 14.3%). In *Tesco/Brian Ford* the OFT carefully considered submissions from Tesco on profit margin calculation and applied a sensitivity analysis to its IPR calculations based on different methods of calculating gross profits.

There exist some possible alternatives to the IPR which use diversion ratio and profit margin evidence and so are no more information-demanding of merger parties than the existing IPR method. Some do not require an assumption to be made about the shape of the demand curve.[21] However, adopting an alternative method would still require the OFT to determine some threshold point below which a merger can be cleared at the phase 1 investigation stage.

Further methodological developments

Finally, there may be scope for the OFT to undertake additional analyses, perhaps as sensitivity checks, in its assessment of supermarket cases without placing substantially more of a burden on the parties. For example, the current product market definition used by the OFT has strict boundaries (by floor space) between store size categories. Although the OFT's assumption is that stores of a smaller size category do not effectively constrain stores of a larger size category, for two stores close to, but on either side of, the boundaries this may not always be the case. For example, a large mid-range store may act as a strong constraint on a small one-stop store (or a convenience store may constrain a small mid-range store). In order to better assess the relative strengths of different stores, the OFT could receive information from the parties about how many grocery product types—or stock-keeping units (SKUs)—are typically stocked in each store. This might allow the OFT to better assess how stores of different size categories may interact (in the stage one filtering) since grocery SKUs offer a richer insight into a supermarket's offering than does floor space, especially for stores of similar sizes but of different size categories.[22]

In terms of getting evidence directly from customers, since *CGL/Somerfield* the OFT has further improved its approach in contacting customers (which is not always easy in local retail markets), including using local media to generate customer views. Customer experiences may suggest to the OFT why various assumptions underlying the stage one filter may not hold in a particular area. For example, people living in particularly remote areas may have different shopping habits than those in less remote areas (perhaps viewing convenience-sized stores as being a more important source of groceries).

Conclusion

The *CGL/Somerfield* merger showed that the OFT is both willing and capable of resolving local market competition concerns at the phase 1 stage of the merger review process, even if the number of SLC markets is large. This development is set against the backdrop of the OFT also resolving competition concerns during its phase 1 investigation in smaller deals, which is now commonplace. Indeed, the OFT has not referred a supermarket merger to the CC since *Somerfield/Morrisons* in 2005.[23] It is therefore important for the OFT to make clear its analytical approach to supermarket and grocery mergers. This approach is now well established and recently has differed between cases only in relatively small ways and therefore has helped enhance legal certainty. However, improvements can be made to the OFT's approach.

As has been demonstrated in some supermarket cases since *CGL/Somerfield*, there is scope for the OFT to reduce the number of isochrone centrings required for local market analysis. However, the OFT clearly requires isochrones to be centred on both the acquirer's and the target's stores and on census output areas.

Whether the filtering methodology is continued for those cases which involve a small number of target stores will depend on the facts of the individual case. It may continue to be advantageous to both the OFT and merger parties for small deals to be cleared using the stage one filtering method (which has proven to be conservative). However, in cases that are not clear cut, the OFT is likely to continue to draw in case-specific evidence to use in conjunction with the stage one and stage two analyses, as it did in *Tesco/Brian Ford*.

The OFT has also shown a willingness to be flexible in its use of the prescribed methodologies when the evidence justifies such flexibility (eg, in introducing sensitivity analysis for profit margins or the assumptions on the shape of the demand curve). This is also likely to continue in future cases and may indeed include other sensitivity analysis, although this is yet to be seen. In order for a potentially problematic deal to be resolved at the phase 1 stage, it will remain likely that the OFT will expect parties to undertake surveys of customers in order for diversion ratios to be calculated.

The biggest challenge facing the OFT is whether it continues to employ the IPR and, if so, where the 'SLC/no SLC' thresholds should lie. This is a difficult issue for the OFT which, as the phase 1 authority, is deliberately cautious in its approach to merger analysis. So far the OFT has not shown any indication of its thinking on this issue, although it continues to debate internally the merits of the IPR.

Finally, it should be borne in mind that this is a personal article and does not prejudice OFT handling of future supermarket cases. The OFT Mergers Group, as always, welcomes parties to engage in pre-notification discussions on methodological issues for their supermarket cases and to do so sooner rather than later.

Tim Geer

[1] OFT (2008), 'Anticipated Acquisition by Co-operative Group Limited of Somerfield Limited', Case ME/3777/08, October 20th.
[2] Competition Commission (2008), 'The Supply of Groceries in the UK Market Investigation', April 30th.
[3] Competition Commission (2005), 'Somerfield plc and Wm Morrison Supermarkets plc: A Report on the Acquisition by Somerfield plc of 115 Stores from Wm Morrison Supermarkets plc', September. Some key parts of the CC's analytical approach can be traced back to its reports on supermarkets in 2000 and on Safeway in 2003. See Competition Commission (2003), 'Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets plc; J Sainsbury plc; and Tesco plc: A Report on the Mergers in Contemplation', September, and Competition Commission (2000), 'Supermarkets: A Report on the Supply of Groceries from Multiple Stores in the United Kingdom', October.
[4] The methodology is explained in some detail in annex A of the OFT's *CGL/Somerfield* report.
[5] In *CGL/Somerfield*, for example, at the time of the OFT's investigation CGL had around 2,200 stores and Somerfield had around 880, resulting in over 800 local overlaps by fascia.
[6] Local markets were defined according to drive times and store sizes.
[7] The asymmetric constraint concept is simply that larger stores typically impart a strong competitive constraint on smaller stores, but smaller stores typically impose only a weak constraint on larger stores (so that from the perspective of shoppers at one of the stores a merger looks benign, whereas from the perspective of shoppers at the other store it looks potentially concerning). In *Somerfield/Morrisons* it is not clear how the CC dealt with this in its stage one filtering exercise. From the report it seems that the CC did not require this analysis from the merger parties. However, paragraphs 6.68 and 6.87 of that report suggest that GeoBusiness, acting as a consultant to the CC in order to verify the CC's findings, did undertake a similar analysis but the exercise did not make any difference to the number of problematic local areas identified in that case.
[8] OFT (2009), 'Completed Acquisition by WM Morrison Supermarkets plc of 30 Stores from Co-operative Group Limited', Case ME/4132/09, July 10th.
[9] Population areas were calculated using data from the 2001 census and are the population-weighted midpoint of an area which houses at least 5,000 people.
[10] OFT (2009), 'Anticipated Acquisition by Tesco plc of Six Former Somerfield Stores from Co-operative Group Limited', Case ME/4056/09, March 18th.
[11] OFT (2009), 'Anticipated Acquisition by Tesco plc of Three Former Somerfield Stores from Co-operative Group Limited', Case ME/4174/09, August 3rd; OFT (2009), 'Anticipated Acquisition by J Sainsbury plc of Two Stores from Co-operative Group Limited', Case ME/4270/09, November 9th; OFT (2009), 'Anticipated Acquisition by Asda Stores Limited of Two Grocery Stores from Co-operative Group Limited', Case ME/4357/09, December 23rd; and OFT (2009), 'Anticipated Acquisition by Tesco plc of a Spar Grocery Store in Wroughton from Capper & Co Limited', Case ME/4162/09, July 14th.
[12] OFT (2008), 'Completed Acquisition by Tesco Stores Limited of Brian Ford's Discount Store Limited', Case ME/3827/08, December 22nd.
[13] Competition Commission (2007), 'Tesco plc and the Co-operative Group (CWS) Limited: A Report on the Acquisition of the Co-operative Group (CWS) Limited's Store at Uxbridge Road, Slough by Tesco plc', November 28th.
[14] It is worth noting that the OFT will still consider locality-specific evidence in these instances, especially if there are sound reasons to consider that the underlying assumptions in the filtering method are not met in a specific area.
[15] The IPR is an indicative calculation which takes into account not just the diversion ratio (which indicates the extent to which the merged entity can internalise customer switching) but profit margins as well (high margins may indicate little local-level competition and a larger incentive to increase post-merger prices or equivalently worsen non-price factors). To undertake the calculation one has to make an assumption about the shape of the demand curve. Because of its relative simplicity it should not be interpreted as being predictive of what the post-merger prices will be.
[16] The OFT also undertook sensitivity analysis using an IPR threshold of 1% and 2% and found it did not affect the findings in the *CGL/Somerfield* case.
[17] Competition Commission (2003), 'Merger References: Competition Commission Guidelines', June, para 3.4.
[18] See, for example, Oxera (2009), 'Diversion Ratios: Why Does it Matter Where Customers Go if a Shop is Closed?', *Agenda*, February.
[19] Paragraph 27 of OFT (2009), 'Completed Acquisition by WM Morrison Supermarkets plc of 30 Stores from Co-operative Group Limited', Case ME/4132/09, July 10th.
[20] The simple application of IPR assumes that margins and diversion ratios are symmetric between the two overlapping stores. These assumptions can be relaxed by using a slightly more complex version of the IPR.
[21] For one example, see Farrell, J. and Shapiro, C. (2008), 'Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition', UC Berkeley: Competition Policy Center, November 25th.
[22] In its *groceries market investigation* the CC found that there were significant differences in the way retailers measure the number of SKUs available throughout the course of the year, which can make comparisons difficult. However, these difficulties are likely to be less in a merger investigation (involving typically two firms) than a market-wide investigation and, in any case, could be used in the OFT's stage one filtering (and therefore would not be determinative of the final SLC decision since stage one 'fails' would be subjected to closer examination involving further evidence). SKU data would need to be relevant to the product market in question (typically focused on groceries).
[23] Disregarding *Tesco/CWS* (Slough) which had an unusual set of factors that led to its reference to the CC.

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