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Agenda

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Supermarket mergers: holding on to market share under competition scrutiny

In July 2008 the Co-operative Group Limited entered into a merger agreement with Somerfield Limited, worth £1.5 billion. Surveys undertaken as part of the merger review (carried out by the Office of Fair Trading) involved more than 400 stores and over 40,000 customers throughout the UK. As a result of the investigation, the merged entity had to divest 133 of 210 outlets at risk. What lessons can be learned from this case, and how can it help other merger parties hold on to their market share?

The Co-operative Group Limited (CGL) is the UK's largest cooperative, with activities ranging from banking and pharmacies to retailing and funeral services. While the merger review related only to CGL's food retailing business, this nonetheless involved 2,228 outlets, comprising 1,717 convenience stores, 452 mid-size stores and 59 one-stop stores. Somerfield's 877 retail outlets comprised 221 convenience stores, 616 mid-size stores and 40 one-stop stores.

Market definition

Market definition is the first step in any competition investigation. Before the potential impacts of a merger can be assessed, it is necessary to establish whether the merging parties are, in fact, in competition—ie, whether they operate within the same relevant market. In this case, the Office of Fair Trading (OFT) adopted the market definition applied by the Competition Commission (CC) in the 2008 groceries market inquiry.[1]

Product market definitions

In past cases the CC and the OFT have considered grocery retailing to comprise three broad product markets, illustrated in Figure 1.

In this inquiry, the OFT deemed net sales area to be a good proxy for the range of products stocked in a store: a larger net sales area indicating a wider range of products stocked, and vice versa. This could then be used to determine to what extent neighbouring stores were in direct competition with one another. A much smaller store, for example, would not be 'substitutable' to a customer used to buying a range of goods at a larger store, pre-merger. However, there is a degree of asymmetry in the substitutability—a larger store may be a substitute for a smaller one, but not vice versa. This is important in determining the starting (focal) point for the market definition exercise (as shown in Figure 1). This focal point will, in turn, depend on where the competition concerns are deemed to arise.

The store 'fascias' thus included in the 'effective competitor set' in the relevant market were therefore the larger grocery retailers (Asda, CGL, Marks & Spencer, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose), together with regional grocers and symbol groups (independent outlets supplied from a single supplier, including Londis, Costcutter and Nisa-Todays). Limited-assortment discounters (LADs), frozen-food retailers and specialist retailers (such as Iceland, Aldi and Lidl) were excluded.

LADs were not considered to be in the same product market as large retailers since these typically stock fewer than 1,000 products, compared with the typical 5,000–10,000 product range of the large grocery retailers. However, in some local areas LADs and frozen-food retailers are considered to provide effective competition to CGL or Somerfield given the diversion ratio (the percentage of consumer spending that would potentially be diverted from one merging party to the other)[2] between them in these specific local areas.

Figure 1 Product market definitions

One-stop stores	Mid-size stores	Convenience stores
– net sales area > 1,400m^2 – form their own product market	– net sales area 280–1,400m^2 – one-stop stores must be included in any market definition with mid-size stores as its focus	– net sales area <280m^2 – product market focused on convenience stores must also include mid-size and one-stop stores

Source: OFT (2008), 'Anticipated Acquisition by Co-operative Group Limited of Somerfield Limited', p. 3, and Oxera.

Figure 2 Geographic market definitions

	One-stop stores	Mid-size stores	Convenience stores
Urban areas	– ten minutes' drive time	– five minutes' drive time – but stores constrained by one-stop stores within ten minutes' drive time	– five minutes' drive time – but stores constrained by one-stop stores within a ten-minute drive and mid-size stores five minutes away
Rural areas	– 15 minutes' drive time	– ten minutes' drive time – but stores constrained by one-stop stores within 15 minutes' drive time	– five minutes' drive time – but stores constrained by one-stop stores within 15 minutes' drive time and mid-size stores ten minutes away

Source: OFT (2008), op. cit., pp. 6–7, and Oxera.

Geographic market definition

Previous CC and OFT reports on supermarkets have found both national and local aspects to competition. The local market definition reflects the asymmetry in competition between different sizes of stores (see Figure 2).

Theories of harm

The OFT needed to establish whether the proposed merger would lead to a substantial lessening of competition, both locally and nationally. It did not consider that any competition concerns would arise at the national level as a result of the merger for the following reasons.

- After the merger CGL would account for less than 8% of total UK grocery sales, while continuing to face strong competition from Asda, Morrisons, Sainsbury's and Tesco—all of which have larger market shares than CGL and Somerfield combined.

- The merger would not change the structure of the market significantly, so incentives and opportunities for coordination should not change. If anything, prospects for coordination among the leading supermarkets might be reduced, since the number of larger supermarket chains would be increased from four to five.

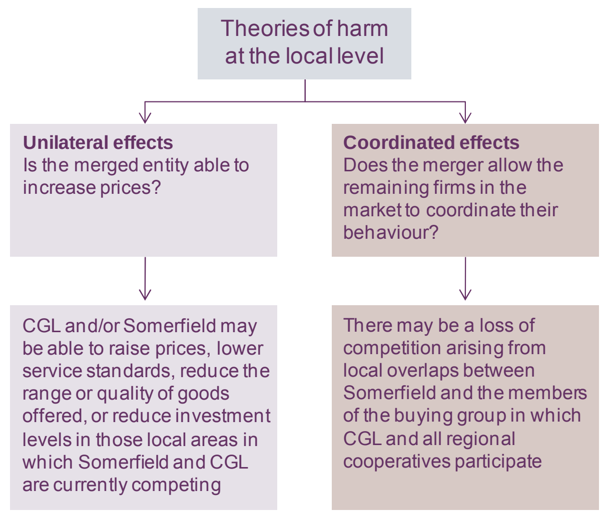
- While the merger would significantly increase CGL's purchasing requirements, its post-merger share of purchases of groceries for resale would still be below 10%. The OFT did not, therefore, consider that the merger would be likely to create or strengthen buyer power.

At the local level, the OFT examined two theories of harm that might affect consumers as a result of the proposed merger: unilateral effects and coordinated effects (see Figure 3).

The merging parties argued the case for efficiencies arising from the merger, specifically that:

- a supplier previously servicing both CGL and Somerfield would be required to supply the combined entity at the lower of comparative prices in force pre-merger;
- economies of scale would enable the merged entity to secure larger discounts;
- economies of scale would result in efficiencies for CGL in the production of own-brand goods.

Figure 3 Theories of harm at the local level



Source: OFT (2008), op. cit., and Oxera.

These arguments were rejected by the OFT, however, which stated that there was not 'sufficiently compelling evidence' that these efficiencies would a) occur and b) occur to a degree sufficient to offset competition concerns arising from the merger.

Unilateral effects

CGL argued that its existing pricing policies reduced the relevance of any ability to increase prices post-merger.

CGL stores are allocated to one of a number of pricing bands, determined by several factors but predominantly the store format, which is strongly correlated to the store size. Local pricing, it argued, is therefore not driven by local competition.

The OFT did not consider this pricing policy to negate any potential unilateral effects, for two reasons:

- CGL accepted that local conditions might be influential in determining price. The OFT stated that there was no conclusive evidence to suggest the elimination of the risk of local price flexing in any form;
- pricing is only one of a number of ways in which competitive harm might occur: the merger might also result in a deterioration of quality, range or service.

In order to make analysis of local areas more manageable, the OFT applied a 'filtering process' (see Figure 4) to reduce the number of local areas to be investigated.

The remaining 146 Somerfield stores were then assessed through customer surveys (of 100 respondents at each store) at both Somerfield and CGL stores. Respondents were asked what they would do if they found their 'usual' Somerfield or CGL store to be closed. The survey results were then used to calculate diversion ratios and illustrative potential price rises, which together were deemed to indicate the competitiveness (or otherwise) of local stores, and how far the merger might be expected to affect this. The particular circumstances of individual areas (eg, recent openings or closures, lease expiry dates and the availability of suitable sites) were examined in each case.

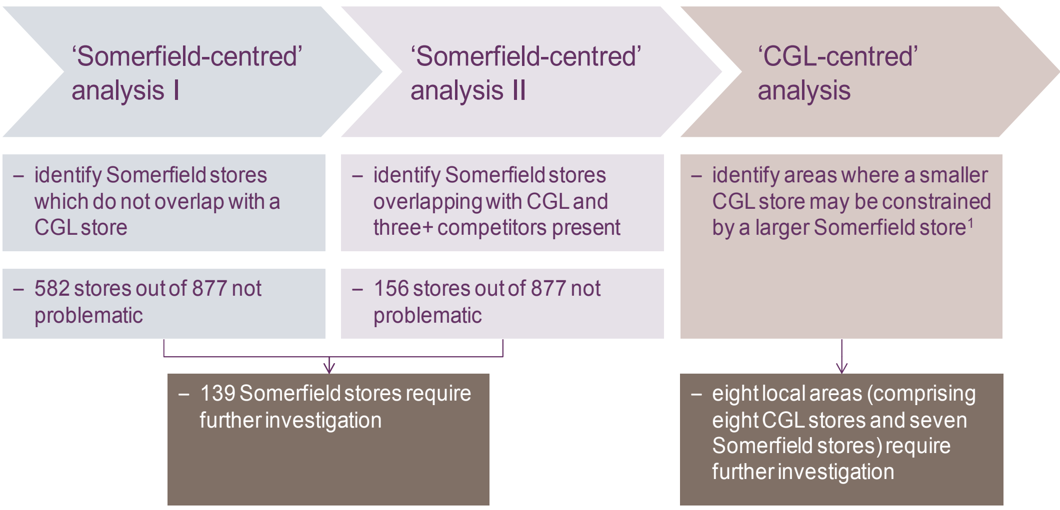
Customer surveys were undertaken at 115 Somerfield and 120 CGL stores; 37 Somerfield stores discarded under the initial filtering exercise were not surveyed, since it was apparent that the local areas in which they were located would be unlikely to pass any further tests and would therefore be deemed to reduce competition.

In total, over 40,000 consumers were surveyed, at more than 400 stores (including surveys undertaken to assess the potential impact of coordinated effects). Surveys were conducted in six phases throughout the country which, due to tight timescales, were limited to one to two weeks each.

Using the diversion ratio threshold of 14.3% and an illustrative price rise threshold of 5% (as used by the CC in the Somerfield/Morrisons merger[3]), 58 Somerfield stores were identified, which did not pass further tests.

This analysis identified eight potentially problematic areas where CGL stores were seen to overlap with seven Somerfield stores. Further analysis of these

Figure 4 Reduction of local areas under analysis



Note: [1] In some local areas, overlaps may arise from the presence of a one-stop Somerfield store and a mid-size CGL store. This would not have been identified in earlier Somerfield-centred analysis, since the Somerfield one-stop store would have been deemed unconstrained by the CGL store, and therefore excluded from the analysis. However, the CGL store might be constrained by the Somerfield store, and this possible 'asymmetric' constraint would be lost after the merger.
Source: OFT (2008), op. cit., and Oxera.

areas showed further test failures in local areas containing three Somerfield stores. When combined with the 37 previously eliminated from the analysis, 98 local areas were identified in which competition issues were deemed to be of concern. This was later reduced to 94 following the OFT's acceptance of further evidence on specific local areas.

Coordinated effects

The OFT needed to determine whether the merger would reduce competition in areas where a Somerfield store—competing pre-merger against a local regional cooperative—would be replaced with a CGL store (which might be viewed as competing with the local regional cooperative to a lesser extent than the Somerfield store, given existing links between CGL and regional cooperatives).

Approximately 25 cooperatives (including CGL) are part of the Co-operative Retail Trading Group (CRTG), CGL's central entity responsible for buying for all cooperatives. CGL Food Retail (a business unit within CGL) manages this operation and is a representative member of CRTG, while the CRTG Category Management Team (employed by CGL Food Retail) conducts and concludes all negotiations with suppliers regarding cost prices, terms of trade, product ranges and promotions for the food operations of all CRTG members.

The OFT found a significant degree of explicit cooperation and similarity in retail offers between CRTG members. The merger was therefore deemed likely to substantially lessen such local competition (in terms of price, range, diversity and/or quality) as had existed between CRTG members and neighbouring Somerfield stores before the merger.

Further filtering work was undertaken to identify relevant overlaps between Somerfield stores and regional cooperative stores, as if these regional cooperatives were CGL stores. This exercise identified 64 Somerfield stores not identified in earlier filtering work that might potentially be harmed by the merger as a result of coordinated effects. Further consumer surveys (at 53 Somerfield stores, 14 CGL stores and 129 regional cooperative stores) identified 32 local areas (including three which were not surveyed) centred around Somerfield stores, which the OFT claimed might suffer a substantial lessening of competition as a result of the merger.

Remedies and conclusions

The OFT considered whether the parties might make undertakings in lieu of reference to address the competition concerns discussed above. Following the OFT's acceptance of CGL's offer to divest individual stores in local overlap areas, 94 stores were divested in areas identified as giving rise to unilateral effects as a result of the merger, and a further 39 stores divested in areas where the OFT had highlighted concerns regarding post-merger interaction between CGL and regional cooperatives.

The OFT considered this 'sufficient to act as a clear-cut and comprehensive remedy to the competition concerns identified by the OFT'.[4] As a result, the merged entity was able to retain a total of 77 stores previously identified as potentially giving rise to merger concerns in earlier analysis.

The use of surveys in supermarket mergers, and more generally in merger analysis, is not a new phenomenon. Surveys have also proved crucial in the recent Sony/BMG and Ryanair/Aer Lingus mergers reviewed by the European Commission.[5] This survey, however, is possibly the largest antitrust survey in Europe. Yet its sheer scale was not ultimately the overriding factor in this case. Robustly designed, and with questions pre-agreed with the competition authority, it demonstrates how survey evidence can mean the difference between clearance at phase 1 and a drawn-out second-phase merger process. It also resulted in reduced divestment requirements once the competition authority had been assured that all competition concerns had been addressed.

[1] Competition Commission (2008), 'Market Investigation into the Supply of Groceries in the UK', April 30th. The market definition applied here was used in OFT (2008), 'Anticipated Acquisition by Co-operative Group Limited of Somerfield Limited', November. All data shown in this article is sourced from this OFT decision. Oxera advised the acquiring party in the merger review.
[2] For a more detailed examination of diversion ratios, see Oxera (2009), 'Diversion Ratios: Why Does it Matter Where Customers Go if a Shop is Closed?, *Agenda*, February. Available at www.oxera.com.
[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.
[4] OFT (2008), op. cit., p. 48, para 181.
[5] European Commission (2007), 'Commission Decision of 03/X/2007 Declaring a Concentration to be Compatible with the Common Market and the Functioning of the EEA Agreement (Case No COMP/M. 3333 - Sony/BMG)', October, and European Commission (2007), 'Commission Decision of 27/06/2007 Declaring a Concentration to be Incompatible with the Common Market and the EEA Agreement (Case No COMP/ M.4439 - Ryanair/Aer Lingus)', June 27th.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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