Oxera

Agenda

Advancing economics in business

The Thomas Cook/Co-op travel agency joint venture: cleared for take-off

In August 2011 a joint venture between travel agency, Thomas Cook, and the travel businesses of The Co-operative Group and Midlands Co-operative Society was cleared unconditionally by the UK Competition Commission. Six months earlier this high-profile case had been subject to the first 'fast-track' merger reference by the Office of Fair Trading, having started life at the European Commission

On November 9th 2010, Thomas Cook Group plc (Thomas Cook) notified the European Commission of its plan to create a joint venture (JV) with the travel agent branches of The Co-operative Group Limited (CGL) and Midlands Co-operative Society Limited (Midlands). In doing so, the companies began a journey lasting ten months, crossing the English Channel and involving both of the UK competition authorities, before ending up with an unconditional clearance and the reshaping of the UK overseas holiday market. Oxera advised the three JV partners and their lawyers throughout the process. We discuss the analysis undertaken by Oxera and by the Competition Commission (CC).

Background to the case

An international brand, Thomas Cook is one of the two major vertically integrated travel businesses in the UK (the other being TUI). It distributes its own and third-party travel products to consumers, mainly through its 780 UK high-street stores and numerous websites. In addition to its core product, overseas package holidays, Thomas Cook offers stand-alone services such as flights and insurance.

The JV's second-largest partner, CGL, has a network of more than 360 travel outlets in the UK as well as a website. CGL is the largest co-operative society in the UK, with approximately 5.8m members, and is active in a number of high-street businesses, such as retail food, insurance and banking.

Like CGL, Midlands has been formed from several retail society mergers in the UK. Owned by its members, it is associated with various businesses. Its travel division consists of a network of more than 100 high-street travel agencies and a few website operations.

On October 8th 2010 the three parties announced their plan to create a JV. Thomas Cook would hold 66.5% of the shares, CGL 30%, and Midlands 3.5%. By creating a retail network of more than 1,240 stores, the parties aimed to achieve cost synergies and to realise economies of scale through better management of the distribution of Thomas Cook's tour products.

Following the initial notification in Brussels, the UK Office of Fair Trading (OFT) requested the Commission to refer the proposed JV to review in the UK, under Article 9 of the EU Merger Regulation.[1] The Commission concluded that, since the JV parties' outlets overlap only in the UK retail market (only Thomas Cook has stores in mainland Europe), the potential for the lessening of competition was strongest in the UK. As a result, in early 2011 it granted the OFT's request for referral.

The standard two-phase approach of the UK merger review procedure involves two competition authorities: the OFT and the CC. If the merger is not cleared (unconditionally or subject to undertakings) by the OFT at the first stage (Phase I), a referral is made to the CC (Phase II) for an in-depth investigation. The jurisdictional framework allows firms to request a quick referral to the CC (known as a 'fast-track' reference) to speed up the review procedure in cases where the probability of a reference is high.

The anticipated JV was the first fast-track reference in the UK, following the parties' request on February 14th 2011. In reaching its conclusion on the case, the CC

drew on a wide range of quantitative analysis and qualitative evidence, as discussed below.

Market definition and the role of the Internet

How do competition authorities begin to assess whether a proposed merger is anti-competitive? Market definition is considered a basic step in evaluating the potential harm of a merger. Well-defined relevant markets allow for the measurement of market shares, which are subsequently used to analyse the competitive positions of the parties. If their combined market share is substantial then the merger is likely to require further scrutiny.

The role of market definition is not always limited to its use in the calculation of product market shares; it can also be used to assess whether the merger is likely to harm competition and consumers. In other words, the relevant market is the 'playing field' where the various theories of harm, such as horizontal effects and ability to foreclose, are analysed. The most common dimensions of the relevant market are the product type (eg, sports cars) and the geographic area (eg, central Rome). In many cases it is sufficient to define the relevant market on the basis of these two dimensions alone.[2]

The expansion of the Internet as a national (or even international) marketplace over the last decade has made the definition of the geographic dimension more challenging.[3] Consumers can use the Internet to compare prices and purchase almost anything, from electronic goods to clothes and package holidays, without leaving their home. Websites increasingly offer customisation and personalised services, such as live online advice via chat facilities or freephone numbers, simulating the more personal experience offered by bricks-and-mortar stores. Additionally, some companies have started to match offers available on their websites in store, and to charge the same prices nationally. As a result, it can be argued that in some cases the local geographic dimension is not particularly important for market definition due to the constraint from the Internet, and that the 'playing field' is now the national market.

To evaluate how strong the constraint from the Internet is in the market for package holidays, a pilot survey of 300 customers was designed and undertaken. Respondents were asked a question based on SSNIP analysis (small but significant non-transitory increase in prices):[4] how would you react following a price increase of 5% for all holidays sold on the high street? The assessment of the survey results indicated that the Internet provides an important constraint on high-street travel agencies.

The CC also conducted its own consumer survey in selected geographic areas. Although respondents were not asked a SSNIP-type question, the survey results indicated that, before buying their holiday, 50% of travel store customers used the Internet to research or compare prices.[5] The CC acknowledged more generally the constraint from the Internet, but also recognised that some important aspects of the travel store offering (such as personal face-to-face advice) are potentially only available in store, and that more travel store customers would switch to another branch than to the Internet if their preferred store were closed down.

The CC did not think it was necessary to conclude on the market definition in this case, and instead considered the assessment of competitive effects of the JV and market definition as an overlapping analysis. In other words, rather than first delineating the market and using it to evaluate the competitive effects, the CC chose to focus its analysis on the products and geographies where there was most overlap between the parties.[6] As a result, it concentrated on different packaged overseas holidays and considered local geographic markets. In the absence of clearly defined market(s) based on quantitative evidence, the assessment of local unilateral effects became the focus of the analysis.

Local unilateral effects

Horizontal mergers involving companies that operate high-street branches can potentially lead to a lessening of competition at the local level. In other words, the merged entity might unilaterally (ie, assuming normal competitive responses from remaining rivals) raise prices or reduce quality once the pre-merger rivalry between the merging firms is lost. These unfavourable effects, which can have an impact on consumers, are termed 'local unilateral effects'.

The JV parties provided evidence indicating that neither the range of products available, nor the prices, at high-street travel agencies are affected by local competitive constraints. Additionally, evidence supplied by the parties indicated that levels of store quality (for example, the frequency of store refurbishments) and service (for example, staff levels) are based on nationally set criteria.

Sales staff, on the other hand, have some discretion in offering discounts, and some store characteristics (eg, staff availability) are not uniform across shops. Several pieces of quantitative analysis were carried out to establish whether observed variations in discounts or customer perceptions of price, range, quality or service (PRQS) were linked to conditions affecting local

competition (ie, whether they were affected by the number and type of travel agencies in each local area). The main pieces of quantitative analysis presented to the CC are shown in the box below.

The CC used its survey results to model diversion ratios between the parties. It developed an econometric model to predict diversion ratios in areas where competition effects are expected to be the strongest (ie, local areas where there is overlap with rival JV stores, and where the constraint from third-party competitors is weak or absent). The model's predicted diversion ratios were relatively widespread, and not high enough to raise concerns, given the low store margins.

Overall, the CC analyses did not suggest that a substantial lessening of competition (SLC) was likely. The findings from its quantitative work were broadly in line with the findings of the Oxera analysis. The CC concluded that it did not expect that the parties' incentives to compete would change in the immediate future, and that any possible price increases would be small and eroded over time.

Additional issues considered by the CC

As well as their potential for local unilateral effects, mergers can lessen competition and weaken the offer to consumers in other ways. For example, Thomas Cook is a vertically integrated firm with a significant business as a tour operator. Its holidays are sold not just by Thomas Cook high-street travel agencies, but also by rival agencies. As a result, following the creation of the JV, Thomas Cook might choose to stop (or limit) the distribution of its packaged holidays to rival agencies (an action that is known as 'input foreclosure'). This could reduce the attractiveness of its rivals' offers (since they would have a smaller range of products available), leading to a decline in their revenues and potentially their exit from the market. Furthermore, the JV parties' stores could choose to favour Thomas Cook products, reducing the revenue of rival tour operators, weakening their position in the market or even leading to their exit (this is known as 'customer foreclosure').

The quantitative analysis presented by Oxera to the CC

***Price–concentration analysis*—an econometric analysis was performed of store-specific data supplied by the JV parties, to identify whether the level of discounts offered in stores varies with local competition.[1] The number of rival travel agencies within a five-mile radius of each store was used as a measure of concentration. Store-specific and geographic factors (such as staff costs and types of customer) were employed to control for the potential differences in discounts. The results of the analysis indicated that the effects of local competition on the size of discounts given to customers, or on the net margins of stores, were mostly insignificant.**

***Store opening/closure events*—further quantitative analysis was undertaken to assess whether the creation of the JV would soften competition between the JV parties at the local level. The variation in store financial indicators following a change in the number of rival businesses can be used to estimate whether local rivalry matters. In other words, past openings and closures of stores can help to capture the strength of local competition. A difference-in-difference[2] econometric analysis that was carried out showed no discernible impact on the discounts offered, or net margins, for stores affected by nearby openings or closures, compared with unaffected stores (the control group).**

***Perceptions of PQRS*—quantitative analysis was carried out to assess whether customer perceptions of PQRS at stores vary depending on the level of local concentration. A cross-sectional econometric analysis based on responses to a Thomas Cook customer survey indicated that the absence of a local competitive constraint from CGL or Midlands stores did not have a negative effect on the PQRS indicators of Thomas Cook stores.**

***Impact of the merger on prices*—additionally, in order to gauge the potential effect of the JV on prices charged to consumers, the indicative price rise formula[3] was applied using the diversion ratios obtained from a survey of six local areas, and profit margins from the parties' management accounts. The results were broadly consistent with similar analysis carried out by the CC, which used diversion ratios from its own survey.[4] The upward pressure on prices post-merger was expected to be limited. The CC also highlighted the importance of calculating the appropriate margin, noting that, even when diversion ratios between the parties involved are high, low margins limit the incentives to increase prices after a merger.[5]**

Note: [1] Ordinary least squares (OLS) and instrument variables (IV) methods were used. [2] Using a comparator to control for outside effects not due to the factor under investigation. [3] See Oxera (2010), 'Best of Both Worlds? Innovative Approaches to Modelling Merger Price Rises', *Agenda*, May. [4] Competition Commission (2011), op. cit., p. 47. [5] Diversion ratios are indicators of substitutability between products. They are the percentage quantity lost for a price-raising firm (usually of a SSNIP magnitude) and captured from another firm. For example, if a 10% price increase results in a loss of 100 units, and the demand for a competitor increases by 30 units, the diversion ratio between the two is 30%.
Source: Oxera.

A three-part test should be carried out to assess the risk of foreclosure following a merger:

1. would the merged entity have the ability to foreclose competitors?
2. would it have the incentive to do so?
3. if the merged entity had both the ability and the incentive to foreclose, would the effect of the foreclosure amount to an SLC?

The CC ascertained that it did not expect the JV to lead to an SLC on the grounds of vertical foreclosure. It concluded that the JV stores would favour Thomas Cook holidays to some extent, but found it unlikely that they would cease to sell other operators' products entirely. Moreover, it did not expect this to cause the exit of efficient competitors or a material change in the conditions of upstream competition. Oxera's own modelling also illustrated that full customer foreclosure would be unlikely, since the minimum customer retention levels following foreclosure would need to be very high.[7]

On a similar issue, a rival to the parties had concerns that the JV would enhance its own buying power with respect to certain types of holiday. It was argued that the JV would be able to negotiate far better terms than rival travel agencies, eventually driving them out of the market. The CC's qualitative assessment did not find much support for this argument. It concluded that, even in the unlikely event that the main parties enhance their buyer power as a result of the JV, it is doubtful that they would have the ability to damage rival travel agents.

Conclusions

The CC published its final report in August 2011, clearing the anticipated JV unconditionally. Active engagement with the CC at an early stage, including the provision of quantitative evidence on the main theories of harm, was a key element in the process of assisting the CC in its decision-making.

In this case, the CC's approach was to consider the assessment of market definition and the competitive effects of the JV as overlapping analyses. This is consistent with the approach advocated by the 2010 OFT/CC merger guidelines.[8] It is also part of an ongoing move away from the traditional focus on formal market definition and market share assessments in merger cases towards the direct assessment of competitive effects.

It remains to be seen how the constraint from the Internet will be treated in future merger investigations involving bricks-and-mortar retailers. It may be the case that local effects will play a smaller role in some markets as geographical boundaries are gradually eroded by the use of the Internet. Analysis of the interaction between the on- and offline sales channels, and the design of consumer surveys that capture the constraint from the Internet, are likely to become increasingly important elements of many retail merger cases going forward.

[1] For more information, see European Commission (2005), 'Commission Notice on Case Referral in Respect of Concentrations', *Official Journal of the European Union*, C56/02.
[2] Others include segments of consumers and the time of the purchase. For further details, see Niels, G., Jenkins, H. and Kavanagh, J. (2011), *Economics for Competition Lawyers*, Oxford: Oxford University Press, pp. 29–31.
[3] In retail merger cases, delineation of the geographic market usually requires identifying how far customers live from a store. If the company's products are available online then consumers could be located anywhere.
[4] The SSNIP test is used in merger investigations, where the respondents' answers are key inputs into the 'hypothetical monopolist' test for defining relevant markets.
[5] Competition Commission (2011), 'Thomas Cook / Co-operative Group / Midlands Co-operative merger inquiry: Final report', August, p. 33.
[6] The CC estimated that around 472 Thomas Cook stores, 287 CGL stores and 80 Midlands stores would be in overlapping areas.
[7] The retention level is the minimum proportion of customers who currently purchase a holiday from a third-party tour operator at a JV store who must be retained following foreclosure, despite these holidays no longer being offered by the JV parties, in order for the foreclosure to be profitable.
[8] Competition Commission and Office of Fair Trading (2010), 'Merger Assessment Guidelines: A Joint Publication of the Competition Commission and the Office of Fair Trading'.

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

Other articles in the October issue of *Agenda* include:

- **competing with 'free'? The damages of music piracy**
- **crime doesn't (always) pay: what determines the level of fines?**
- **regulatory reform: changes and consequences in the legal services sector**

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com

© Oxera, 2011. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.