

Summary

1. On 6 December 2005 the Office of Fair Trading (OFT) referred the proposed acquisition of Ottakar's plc (Ottakar's) by HMV Group plc (HMV) through Waterstone's Booksellers Ltd (Waterstone's) to the Competition Commission (CC) for investigation and report. The reference was made under section 33(1) of the Enterprise Act 2002 (the Act). We are required to publish our final report by 22 May 2006.
2. HMV is a UK-based company formed in 1998 and trading in the UK mainly under two brands: HMV and Waterstone's. Its book retailing business is primarily carried out through its Waterstone's branded stores. There were 190 Waterstone's stores in the UK on 31 December 2005. Waterstone's range of titles stocked varies according to the size of the store, but is typically 30,000 to 40,000. Total sales for the year ended 30 April 2005 were £446 million, of which £416 million were in the UK.
3. Ottakar's was formed in 1987 with the aim of establishing a chain of bookshops in market towns in Great Britain. It has grown both organically and through acquisition and had 141 stores on 31 December 2005. Ottakar's range of titles stocked varies according to the size of the store, but is typically 20,000 to 30,000. Total sales for the year ended 28 January 2006 were £176.5 million.
4. HMV announced its bid for Ottakar's on 8 September 2005. This was recommended to shareholders by the independent directors of Ottakar's on 13 September 2005. HMV said that the proposed merger would enable Waterstone's to compete more effectively with growing competition from Borders (UK) Ltd (Borders), WH Smith PLC, (WH Smith) the Internet retailers and the supermarkets, as well as other specialist retailers.

5. We concluded that arrangements were in progress or in contemplation which, if carried into effect, would result in the creation of a relevant merger situation.
6. Consumer demand for new books has risen over the past five years, and is forecast to continue to grow. There are almost 2 million titles in print and over 180,000 new titles were published in 2005, of which around 120,000 were published for the consumer market. Best-sellers, defined as the top 5,000 titles in a calendar year, accounted for around half of sales in 2005 (the remainder are defined as deep-range titles).
7. Since the end of the Net Book Agreement in the second half of the 1990s, publishers have continued to recommend retail prices (recommended retail prices (RRPs)), but retailers have increasingly discounted the prices of some titles below RRP and new types of retailer have entered the market.
8. Retailers include specialist 'bricks and mortar' retailers such as Waterstone's, Ottakar's, Borders, and independent bookshops; bricks and mortar retailers for whom books are an important category such as WH Smith; supermarkets and major multiples; and distance sellers including Internet retailers (such as Amazon.co.uk Limited (Amazon)) and book clubs. The market share of the Internet retailers and the supermarkets in particular has grown over the last five years whilst book clubs have suffered a significant decline in market share.
9. Retailers and wholesalers negotiate discounts off RRP with publishers. Retailers can monitor their sales quickly and accurately and can use IT systems both to manage the books stocked and to identify titles which are selling well in some of their stores but not in others, potentially giving rise to decisions to stock those titles more widely.

10. We concluded that the situation which would be expected to prevail without the proposed merger (the counterfactual) was that of an independent Ottakar's. Given the current tough trading conditions, we expected that Ottakar's would introduce a number of measures, including the implementation of an improved stock management system and a reduction in costs.
11. We concluded that the product market was the retail sale of new books to consumers, although we believed it appropriate to assess separately the competitive effects of the proposed merger in terms of sales of deep-range titles and best-sellers. We concluded that the geographic market was no wider than the UK, but that we should look separately at local, regional and national aspects of competition. We also considered possible vertical effects.

Assessment of the competitive effects of the proposed merger

Competitors and underlying factors affecting competition

12. Specialist bricks and mortar book retailers include Borders, Blackwell UK Limited (Blackwell), smaller regional chains such as Methvens Booksellers, and the independent bookshops. Borders' superstores carry a very extensive range of books, typically 50,000 to 80,000 titles, whilst its Books etc stores have around 20,000 to 30,000 titles. Borders said that it planned to continue to expand its superstore format, opening around seven stores each year for the next five years.
13. Independent bookshops differ hugely in size and range. We were told that independent bookshops were often situated in tertiary sites away from town centres, or in smaller towns without one of the large chains.
14. Bricks and mortar retailers for which books are an important category include, in particular, WH Smith. WH Smith has 545 high street stores, of which about 350 have

a typical range of 5,000 to 10,000 titles, and the remainder have a typical range of 10,000 to 20,000 titles. WH Smith said that it focused on selling and promoting new titles and best-sellers in its high street stores. It was currently trialling the creation of two stores in a small number of towns, with each store having different mixes of products. It stated that its future strategy would be influenced by the success or otherwise of these trials.

15. All the major supermarkets sell books in some or all of their stores. Although the supermarkets focused initially on paperback best-sellers, cookery books and children's books, they are now starting to stock a wider range of titles. We were told that the major supermarkets were seeking to expand their non-food sales, including books.
16. Amazon is the UK's largest Internet book retailer and sells a very wide range of new and used books as well as a large variety of other products. Other Internet retailers include Tesco.com and BOL.com. Other distance sellers include book clubs and direct selling organizations.
17. We estimated that the combined UK market share of Waterstone's and Ottakar's in 2005 was around 24 per cent of all books and a somewhat higher proportion of deep-range titles. The UK retail market for books is not concentrated at national level and concentration has changed little during the past five years. We estimated that the four largest retailers (WH Smith, Waterstone's, Ottakar's and Borders) have 45 per cent of the market and 55 per cent of the deep-range segment.
18. For the market as a whole, average selling prices were around 60 per cent of RRP for the nine best-selling titles in 2005, rising to about 90 per cent of RRP for deep-range titles. We were told that most deep-range titles were not discounted by bricks

and mortar retailers but were discounted to a greater extent by supermarkets and Internet retailers.

19. Price-promoted books are prominently displayed by the retailer, and we were told that price promotion had a significant impact on sales. The publishers told us that price promotion by authoritative specialist retailers was particularly important for new titles, including those by previously unknown authors or in innovative genres. However, several parties told us that the range of possible promotional activity included media coverage, direct advertising, publicity events including book signings, and other in-store non-price promotion, as well as price promotion.

Local competition

Existing degree of competition

20. We concluded that local competition, to the extent that it exists, is concentrated on nearby stores (within the same shopping location), and also encompasses out-of-town stores which may themselves be shopping destinations, such as supermarkets and Borders' superstores. Waterstone's and Ottakar's do not in general have such destination stores and therefore our assessment of local competition was focused on nearby locations, in particular 33 overlap areas, located over the entire breadth of Great Britain.
21. Competition in book retailing at the local level between existing stores is concentrated on two non-price factors, range of titles in stock and quality of in-store service.
22. We concluded that Waterstone's and Ottakar's were broadly similar in the extent to which decisions about overall range and new title selection were made centrally. Both HMV and Ottakar's have said that local managers had autonomy over some

aspects of their stores, for example the layout of the stock, the selection of staff and some of their range.

23. We found a measurable difference in existing levels of service quality between overlap and non-overlap stores in only two areas—book signings and store refurbishments (an indicator of store environment). However, we did not consider book signings to be a key competitive variable, since they are not central to a bookshop's offer for most customers. On refurbishments, although Waterstone's and Ottakar's may have used these to compete at a local level to a limited extent, we did not consider this to be significant.
24. We concluded that there was no systematic and substantial difference in range or service quality in overlap stores compared with non-overlap stores.

Effects of the proposed merger

25. Following the proposed merger, the merged entity would continue to face local competition from, among others, WH Smith, the supermarkets, and the Internet retailers in the overlap areas, just as it does in non-overlap areas. The merged entity would not have an incentive to depart from national pricing by reducing discounts in overlap areas. HMV argued that the proposed merger would lead to a positive uplift in range at Ottakar's stores once Waterstone's stock management system was introduced and our analysis supported this. In the short term, we did not believe that the proposed merger would result in a substantial lessening of competition (SLC) in relation to range. In the longer term, we did not consider that store closures would lead to an SLC.

26. We found no evidence that competition at the local level had a significant effect on service quality, and, reinforced by our counterfactual, we concluded that the proposed merger would not result in an SLC at the local level.
27. We were unable to conclude that Scotland formed a separate geographic market, or that the competitive situation in Scotland was substantially different from that in the rest of the UK. We therefore did not find an SLC as a result of the proposed merger in Scotland or any other geographical area of the UK.

National competition

Existing degree of competition

28. We found there to be a range of competitors to Waterstone's and Ottakar's offering full national coverage. Evidence from our survey suggested that supermarkets were not as close competitors to Waterstone's and Ottakar's as WH Smith, Borders and the Internet retailers, although we expect the supermarkets to continue to increase their range of titles and market share as they expand the proportion of their floorspace devoted to non-food items.
29. We found that there was heavy discounting off RRP for best-sellers, with the supermarkets and Internet retailers charging the lowest prices. Discounts off RRP offered by Waterstone's, Ottakar's, WH Smith and Borders have increased in recent years as they have sought to prevent erosion of market share by supermarkets and Internet retailers offering books at lower prices. The reduction in prices by the high street chains on deep-range titles is much less marked than for best-sellers. Waterstone's and Ottakar's told us that they sold the vast majority of deep-range titles at RRP. A larger proportion of deep-range titles is discounted by Internet retailers.

30. Results from our survey suggested that range and convenience of location were the most important non-price factors to customers when choosing a bookshop. Our survey also showed that respondents rated Waterstone's and Ottakar's better on range, quality of the store environment and quality of service than the next best alternative, but slightly worse or no different on the price of books.
31. We considered that retailers' promotion and grading of new titles was an important means by which publishers competed to make their books and authors successful. However, it was not clear to us that retailers regarded the selection of titles to price-promote as a significant element of competition. In particular, the competitive advantage of a successful price promotion to the retailer was limited, given the rapid availability of sales information which allowed other retailers to identify and promote titles successfully launched elsewhere. At present, there is some difference between Waterstone's and Ottakar's decisions on which books to promote, although they overlap on the majority of their price promotions.

Effects of the proposed merger

32. At the national level, we found no evidence of significant direct price competition on best-sellers or deep-range titles between Waterstone's and Ottakar's. We did not find in general that Ottakar's was more decentralized in terms of selecting range and in any case, given our counterfactual, we believed that Ottakar's would seek further to centralize decision-making and cut costs whether or not the proposed merger went ahead. In addition, Waterstone's stock management system allows it to respond quickly to customer demand, even if a title were not well stocked initially. HMV said that degrading its service post-merger, or particularly its range, would risk alienating a substantial share of the merged entity's customers. We did not consider it likely that the merged entity would willingly reduce nationally determined range or service quality.

33. We did not believe that the incentives on publishers to publish new titles or authors to write new books would change as a result of the proposed merger. Nor did we consider that there might be an SLC arising from a reduction in the number of titles promoted given that publishers have alternative ways of promoting books, and any titles not promoted by the merged entity following the proposed merger could still be promoted by other retailers or by other methods. In any event, we did not believe that competition for promotions was significant between retailers, nor between Waterstone's and Ottakar's in particular. We therefore did not consider that the merged entity would seek to, or be able to, exploit its market position by reducing promotions.

Vertical effects

34. We thought it more likely than not that there would be a small improvement in Waterstone's buying terms as a result of the proposed merger. We were told that, in response, publishers might increase RRP or reduce their discounts to other retailers, most likely independents, given their relative lack of bargaining power. Publishers told us that the level of RRP depended primarily on what the consumer was willing to pay. The parties argued that, if publishers were able to increase RRP, they could have done so equally well before the proposed merger. We did not think that publishers would be likely to be able to increase RRP purely as a result of the proposed merger. Nor did we believe that publishers would reduce discounts to independents or other retailers as a response to an improvement in buying terms for the merged entity. In any case, to the extent that the competitive constraint from independents is not very strong, this would be unlikely to result in an SLC.

Conclusions on SLC test

35. We provisionally concluded that the proposed acquisition of Ottakar's by HMV through Waterstone's may not be expected to result in an SLC in the market for the retail sale of new books (best-sellers or deep-range titles) at a national, regional or local level in the UK.