

REDACTED VERSION

SOMERFIELD/MORRISONS
MERGER INQUIRY

Main Submission to the Competition Commission

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TLT Solicitors

One Redcliff Street

Bristol BS1 6TP

TEL +44 (0)117 917 7777

FAX +44 (0)117 917 7778

DX 7815 Bristol

WEB www.TLTsolicitors.com

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1. Introduction and Executive Summary

1.1 Introduction

1.1.1 This Submission relates to the acquisition by Somerfield plc ("Somerfield") of 114 smaller Safeway stores (the "Acquired Stores") from William Morrison Supermarkets Plc ("Morrisons").

1.1.2 Somerfield and Morrisons entered into a Sale and Purchase Agreement in relation to the acquisition on 25 October 2004. The total consideration under the agreement was £260.2 million. Somerfield paid £115m of that consideration; the balance of £145m was paid by Northwharf Investments (Cherry) Limited for the freehold/long leasehold interests in 51 of the Acquired Stores which it then leased to Somerfield on arm's length terms. Somerfield also agreed to acquire stock and cash floats for an estimated £35m. The annual turnover of the Acquired Stores was approximately £750 million.

1.1.3 Somerfield notified the acquisition to the Office of Fair Trading (OFT) on 8 December 2004 following completion of the transaction. The OFT had jurisdiction to investigate the transaction because the Acquired Stores turnover exceeded £70 million. The transaction did not fall within the jurisdiction of and was not notified to, the competition authorities of any other jurisdiction.

1.1.4 Following completion of the transaction, Somerfield received a set of questions from the OFT dated 7 January 2005, to which it responded on 27 January 2005. On 8 March 2005, the OFT sent Somerfield an Issues Paper, to which it responded on 15 and 16 March 2005.

1.1.5 On 23 March 2005, the OFT announced that it had decided to refer the acquisition of the Acquired Stores to the Competition Commission ("the CC") for investigation ("the OFT Decision").

1.1.6 This document which comprises Somerfield's main submission is organised as follows:

1.1.6.1 Section 2 comprises background information on Somerfield, its activities and the acquisition.

1.1.6.2 Section 3 considers product market definition in relation to one-stop stores, mid-range stores and convenience stores.

1.1.6.3 Section 4 considers geographical market definition in relation to national and local markets.

1.1.6.4 Section 5 provides a market analysis, considers the appropriateness to this Inquiry of applying the methodology applied by the CC in its

Safeway Report, discusses¹ the appropriate fascia set and explains Somerfield's methodology for the calculation of market share.

1.1.6.5 Section 6 considers Somerfield's pricing policy.

1.1.6.6 Section 7 considers barriers to entry.

1.1.6.7 Section 8 considers the potential for the acquisition giving rise to a substantial lessening of competition.

1.2 Executive Summary

1.2.1 The OFT Decision concluded that:

"...it is or may be the case that the [acquisition] has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom being the one area where there is a "problem" one-stop store and the 22 areas where there are "problem" stores in the mid-range."

1.2.2 In summary Somerfield submits that the acquisition has not and could not be expected to result in a substantial lessening of competition (SLC) within the UK or in a local market within the UK, however defined, for the following reasons:

1.2.2.1 the acquisition will increase Somerfield's share of the national market for grocery retailing to approximately 6.0%, an increment of less than 1 percentage point². This will in no way affect Somerfield's position in the UK grocery retail sector, and will not have any impact on the competitive environment in that sector, which is fundamentally driven by the rivalry that exists between Tesco, Asda, Morrisons and Sainsburys, the major multiple grocery retailers ("MMGRs"). Somerfield's post-merger share remains below even the 8% level which the CC considered would be necessary to adversely affect the competitiveness of suppliers³;

1.2.2.2 local markets may be defined by broad categories of shopping trip, reference to broad categories of store and by reference to a geographical area based on the distance at which the average consumer is likely to travel to undertake different types of shopping. However, such segmentation is only appropriate as a first step in the analysis. It is not appropriate to apply such segmentation (whether in the context of product or geographical market) in a precise or formalistic way since there is significant cross over both in terms of shopping types and store destination which inevitably blur the definition of local markets. This cross-over is particularly important with respect to mid-range stores,

¹ Safeway Report 2003, CM5950.

² see note 15

³ see paragraph 4.4 below.

which compete both with the large OSS outlets of the MMGRs, and with the many smaller players in the convenience sector;

- 1.2.2.3 In assessing competition in local markets, account must be taken of all competing fascias to include Limited Assortment Discounters, Marks & Spencer and symbol groups. Moreover, a reduction in fascias cannot be the determinative factor in this case. The analysis of a substantial lessening of competition must be based on market share combined with assessment of actual and potential competition;
 - 1.2.2.4 applying an appropriate market analysis, a maximum of [CONFIDENTIAL], and perhaps only [CONFIDENTIAL], of the Acquired Stores create an increment to Somerfield's market share that results in [CONFIDENTIAL] share or more of retail grocery sales in any local market. Somerfield suggests that the CC review should be concentrated on only those stores;
 - 1.2.2.5 in those local markets where this acquisition has resulted in Somerfield gaining a market share of [CONFIDENTIAL] or more, there is clear evidence that it is constrained by both actual and potential competition such that a substantial lessening of competition has not and is most unlikely to arise;
 - 1.2.2.6 in particular, the evidence shows that even in circumstances where Somerfield is or becomes the only fascia within a local market it nevertheless continues to be subject to effective competitive constraints, both actual and potential, that will continue to ensure consumers can rely on good service and keen prices.
- 1.2.3 The OFT Decision also concluded that:
- 1.2.3.1 the acquisition, "...did not give rise to any competition concerns at the national level", and
 - 1.2.3.2 although the OFT's analysis identified one area where the acquisition had resulted in no competing convenience store fascia post acquisition, "*there is evidence to suggest that barriers to entry in convenience stores are sufficiently low that the potential for new market entry would be sufficient to mitigate competition concerns*".
- 1.2.4 Somerfield agrees with those two findings in the OFT Decision

2. Background Information

2.1 Somerfield

2.1.1 Somerfield is the fifth largest grocery retailer in the UK with a total pre-acquisition portfolio of 1219 stores. Somerfield operates nationally across Great Britain (but not in Northern Ireland) and achieved sales of £4.52 billion excluding VAT and retail partner turnover of £215.4million⁴ in the financial year ending 24 April 2004 and at that date had 52,643 employees.

2.1.2 The Somerfield Group comprises two main store chains: the Somerfield chain (742 stores as at 26 March 2005, including the Acquired Stores) and the Kwik-Save chain (501 stores as at 26 March 2005). There are also 46 convenience/forecourt stores trading as Somerfield and 28 stores as Aberness. As will be seen below, the Somerfield stores tend to be located in higher socio-economic areas. The Kwik-Save chain are located in areas with a lower socio-economic profile. The chains are managed at a national level and have an integrated distribution system, although the format and focus of the store chains differ: The characteristics of the two store chains may be described as follows:

2.1.2.1 Somerfield: some large but mostly medium and smaller/convenience stores with a mix of brands and private label; the focus is on fresh and convenience food retailing.

2.1.2.2 Kwik Save: aims to be the best low price neighbourhood food retailer; more restricted range than the MMGRs.

2.1.2.3 Both chains are heavily reliant on promotional offers for consumer appeal supported by regular leaflet drops for each catchment area.

2.1.3 Brief History

Somerfield (its modern name) began as a family grocery store opened by J H Mills in Bristol back in 1875. Soon expanding, the business becoming a limited company with 12 stores as early as 1900. Trading continued along the same lines until 1950 when the stores were converted to self-service style supermarkets and were renamed Gateway. Then in 1970 the Gateway business was acquired by Linfood Holdings Limited which combined it with its existing store holdings to increase the number of Gateway stores to 100 across the UK.

2.1.4 Expansion continued throughout the 1980s, as smaller competing supermarket groups such as Keymarkets, Lennons, International Stores, Fine Fare and Carrefour Hypermarkets were acquired. In 1990 the first Somerfield branded store was launched together with the first own label products. By 1994 the group had been

⁴ Retail partners are independent businesses providing in-store sales within the Kwik-Save chain, e.g. in-store produce and meat.

renamed Somerfield. These changes culminated with the flotation on the stock exchange of Somerfield plc in August 1996.

2.1.5 Kwik Save had begun trading in 1959 as Value Stores Limited. Floating on the stock exchange in 1970, Kwik Save expanded through organic acquisitions and the takeover of other supermarket chains. In 1998 Somerfield and Kwik Save merged to form the UK's fifth largest supermarket chain. Since the merger of the two fascias the Somerfield group has undertaken major investment to improve store infrastructure, IT and staff training. The Somerfield group now has more than 1200 stores nationwide and continues to focus on building its position as the UK's biggest neighbourhood supermarket offering easy to shop convenience in smaller high street stores under the Somerfield fascia, whilst continuing to offer local discount supermarket shopping as Kwik Save.

2.1.6 Focus on Smaller Stores

Somerfield has established itself at the smaller end of the grocery retail market and the bulk of its stores are in the convenience, mid-range segment as defined in paragraph 3.7.3 below. Accordingly, although Somerfield has many more stores than most of the MMGRs, the Somerfield stores are very much smaller and consequently Somerfield's sales volume is much smaller than the other national players.

2.1.7 Company Ownership

Somerfield is a publicly quoted company on the London Stock Exchange. The company's ownership structure is dominated by institutional investors. The top fifteen investors, which are mostly financial institutions, account for [CONFIDENTIAL] of the shares. Current bid speculation means that the register is much more volatile than usual. The top equity holders as at 20 April 2005 are listed at Table 1 below.

Table 1: List of Main Equity Holders of Somerfield

[CONFIDENTIAL]

Source: Somerfield

2.1.8 Company Structure

An organogram identifying the group structure of Somerfield has been supplied to the CC⁵. Details of the functions of the various companies within the Group are set out in response to question 1 of the Financial Questionnaire.

2.1.9 Financial Structure

⁵ See chart at item 14 of the Off-the-Shelf Material.

Prior to the acquisition, Somerfield had ordinary share capital of 501,844,132 million ordinary shares of 10 pence each which traded in the range of 130 pence to 160 pence in the 6 months prior to acquisition. On 25 October 2004 Somerfield issued (by way of a placing in order to part fund the acquisition) a further 39,489,425 ordinary shares of 10 pence each. Somerfield's debt finance consists of a [CONFIDENTIAL]. In addition, on 17 March 2004 Somerfield completed the acquisition of the convenience business of Aberness Limited. This acquisition was part funded through [CONFIDENTIAL] given to the shareholders of Aberness. Such [CONFIDENTIAL] amount to [CONFIDENTIAL] and are [CONFIDENTIAL].

2.1.10 In addition to the matters mentioned in paragraph 1.1.2 above, further details of how the purchase of the Acquired Stores was financed, contained in the Announcement of Share Placing dated 25th October 2004 (see item 3, Off-the-Shelf Material).

2.2 Morrisons

2.2.1 Morrisons is now the fourth largest grocery retailer after its acquisition of the Safeway Plc chain of supermarkets ("Safeway"). Morrisons currently operate approximately 500 stores after the disposal of the Acquired Stores. Morrisons' annual turnover following its acquisition of Safeway is approximately £12 billion.

2.3 The Acquisition

2.3.1 Background to the Acquisition

Morrisons' interest is in the operation of One-Stop Stores (i.e. stores with a floor area in excess of 15,000 sq ft). Following its acquisition of Safeway, Morrisons was required to dispose of certain stores as a result of undertakings given to the CC as a condition of clearance for the acquisition. In addition, Morrisons wished to dispose of certain smaller Safeway stores. By letter dated 12th August 2004, Morrisons offered the Acquired Stores to Somerfield. A letter in the same terms was sent to Tesco, Asda, Sainsbury, Waitrose, Aldi, Netto and possibly others. The Acquired Stores are listed in the Main Submission Materials ("the Materials"), tab 2.

2.3.2 The acquisition was effected under the Sale and Purchase Agreement of 24 October 2004 (item 5(1) of the Off the Shelf Materials). Completion of and payment for the transfer of the Acquired Stores was to take place over the next [CONFIDENTIAL] subject to complying with certain specified conditions precedent in each case. For a number of stores, title was transferred to Northwharf Investments (Cherry) Limited with leaseback to Somerfield, the terms of which were contained within an Agreement for Lease (item 5(14) of the Off the Shelf Materials).

2.4 Purpose of the Acquisition

2.4.1 Overview

The rationale for Somerfield's acquisition of the Acquired Stores was to:

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- 2.4.1.1 [CONFIDENTIAL]
- 2.4.1.2 [CONFIDENTIAL];
- 2.4.1.3 [CONFIDENTIAL];
- 2.4.1.4 [CONFIDENTIAL];
- 2.4.1.5 [CONFIDENTIAL] and
- 2.4.1.6 [CONFIDENTIAL]⁶

2.4.2 Strategy

[CONFIDENTIAL]

2.4.3 [CONFIDENTIAL]

2.4.4 [CONFIDENTIAL]

2.4.5 [CONFIDENTIAL]

2.4.6 [CONFIDENTIAL]

2.4.7 [CONFIDENTIAL]

2.4.8 Effect of acquisition

The Acquired Stores will [CONFIDENTIAL] Somerfield's UK grocery retail market share by under [CONFIDENTIAL]. This is relatively insignificant on a national scale. However, it represents an increase in turnover for Somerfield of over £750m (15%) in its first full year and is important to Somerfield given the strategy outlined above. It will provide Somerfield with an enhanced brand presence nationally, and improve consumers' understanding of the Somerfield marque and its place in the market. [CONFIDENTIAL]

2.4.9 Financial Returns

The business case for the acquisition is set out in the Business Plan.⁷

2.4.10 In summary, Somerfield anticipates that the Acquired Stores will provide it with an estimated increase in turnover of £750m in its first full year (05/06) [CONFIDENTIAL] at the end of year [CONFIDENTIAL] and an estimated [CONFIDENTIAL] in that year.

⁶ For further details see tab 6 of the Off-the-Shelf Material and Somerfield's response to questions 7 and 8 of the Financial Questionnaire.

⁷ See Items 6 & 7, Off-the-Shelf Material and Somerfield's response to questions 7 and 8 of the Financial Questionnaire.

2.4.11 Synergies

- 2.4.11.1 The estimated, pre-tax synergy benefits and costs are set out in the Business Plan. To summarise, Somerfield expects to benefit from the transaction in several ways. The stores acquired have an average size of [CONFIDENTIAL] and therefore correspond with Somerfield's strategy of concentrating on mid-range stores. [CONFIDENTIAL]. Central overhead costs ratios were also forecast to [CONFIDENTIAL] following the transaction. Somerfield's [CONFIDENTIAL] was also expected to be favourably affected by the transaction.
- 2.4.11.2 The synergies will be [CONFIDENTIAL] in that the Acquired Stores can be [CONFIDENTIAL]. At the same time, the acquisition of the [CONFIDENTIAL] will provide Somerfield with [CONFIDENTIAL].

3. **Product Market**

3.1 Types Of Shopping

In terms of consumer demand, grocery shopping involves the purchase of a basket of individual products, the size and constituents of the basket varying according to the size and income of the household and whether the requirement is for a major replenishment of supplies, for a “top-up” of purchases or for emergency or impulse supplies.

3.2 The CC has considered grocery retailing in two investigations⁸ in recent years. In addition, the OFT has considered the sector in a number of decisions including the present case⁹. From these decisions three broad categories of shopping trips made by consumers have been identified:

3.2.1 One-stop shopping – for the main household shopping typically carried out on a weekly or fortnightly basis.

3.2.2 Secondary or “top-up” shopping – where the consumer will replenish supplies in between one-stop shopping trips e.g. to purchase time-limited or fresh products.

3.2.3 Convenience shopping – for emergency or impulse purchases.

3.3 Somerfield accepts that this segmentation of shopping types offers a practical starting point for the analysis, though differentiation between these shopping occasions is indistinct, and in any one store the composition of sales will run across all the above categories. Multi-trip primary shopping, for example, is not captured by the segmentation, nor is the growing use of internet shopping.

3.4 Consumers tend to have different concerns when they shop for broad or large baskets compared to when they shop for smaller and less diverse baskets. For the purposes of this Inquiry, the critical issue is to establish how these concerns shape the consumer’s perception of the substitutability of different stores under different shopping objectives.

3.5 The segmentation simplifies the analysis of consumers’ grocery shopping behaviour. It should not be forgotten that such behaviour is ultimately driven by the underlying determinants of the degree of store substitutability in the eyes of consumers. Thus, in Somerfield's view, the segmentation should be seen as a tool to understand, rather than the way to define, the competitive constraints applied by

⁸ See Safeway Report note 1 above, and, (CC) Supermarkets: a report on the supply of groceries from multiple stores in the United Kingdom (2000, CM 4842) (the “2000 Supermarket Report”);

⁹ See also OFT Decision 9/12/02 Tesco and T&S Stores plc; OFT Decision 23/10/03 Acquisition by the Co-operative Group of Balfour Convenience Stores Ltd, OFT Decision 25/6/04 Anticipated acquisition by J Sainsbury plc of 14 stores from Wm Morrison Supermarkets plc; OFT Decision 18/10/04 Tesco plc/Wm Morrison Supermarkets plc) OFT Decision 26/10/04 (Sainsbury/Jackson); OFT Decision May 2003/04 Tesco/ Adminstore.

different types of stores upon each other. From the consumer's perspective the objective is to acquire the necessary groceries in the most efficient and least costly manner. There are no quotas to be fulfilled in these segments; a household may choose to replenish its supplies by shopping for smaller baskets more often and forgo one-stop shopping. Similarly, the household may choose to buy a bit extra during the weekly shopping trips and to limit its other shopping to emergency items and time limited products such as milk or bread. In this way, there is significant competition at the margin between different store categories and between different shopping occasions. Households will change the pattern of their shopping whenever they find it advantageous to do so.

3.6 Somerfield suggests that whilst such a one-stop or main shopping trip can be identified as a distinct segment, it is much more difficult to draw the distinction between convenience and secondary shopping. There is very substantial substitutability for the consumer as between convenience and secondary shopping trips, particularly in terms of the type of store which the consumer might use for such a shopping trip.

3.7 Types of Stores

The CC and OFT Decisions in the grocery retail sector have defined the stores at which the types of shopping described take place as follows:

3.7.1 One-stop stores (OSS) i.e. stores in excess of 15,000 sq ft which are able to cater for the full range of shopping trips (i.e. one-stop, top-up and convenience).

3.7.2 Convenience stores i.e. stores under 3,000 sq ft which by reason of their small size carry a limited range of products and accordingly predominantly meet customers' needs for convenience emergency or impulse shopping only .

3.7.3 Mid-range stores i.e. stores between 3,000-15,000 sq ft which offer a more limited range of products than OSS and where consumers are likely to use them for a wide range of shopping requirements, including one-stop shopping and convenience shopping, and the top-up shopping occasions that fall between these extremes.

3.8 The Market in which Mid-range Stores compete

Importantly, none of the recent competition enquiries in the grocery retail sector has had cause to focus on the medium-sized stores, or to reach a conclusion on how to define the market in which they compete.

3.9 In the Safeway Report, the CC naturally focussed on one-stop shopping since it was concerned with the acquisition of Safeway by one of its four major competitors (Tesco, Asda, Sainsbury's and Morrisons), all of whom were present mainly in the one-stop shop segment.

- 3.10 The 2000 Supermarket Report found that one-stop shopping represented the main weekly or fortnightly shop, was carried out primarily at one-stop shops and represented 80% of the total grocery spend¹⁰.
- 3.11 Although the mid-range/convenience segment was reviewed, the stores in this category were not considered to be a significant element of the transaction. When appraising the medium-sized stores, the CC applied a similar methodology to that applied to its analysis of OSS, but without in depth analysis of the segment or the merits of applying such a methodology. The CC did note¹¹ *“that there was likely to be a scale moving from stores close to 15,000 feet for which the issues would be similar to the issues set out for its one-stop shop analysis to smaller stores (closer to 3,000 sq ft) for which the issues would be more similar to the issues pertaining to convenience stores”*.
- 3.12 The present acquisition is entirely different from the Safeway mergers. First, it concerns predominantly mid-range stores rather than OSS. Second, it is on a much smaller scale involving only 114 stores generating £750 million annual turnover compared to Safeway which involved 481 stores generating £8.6 billion annual turnover. Third, each of the four potential acquiring parties in Safeway was and are the four largest supermarket chains in the UK: Tesco, Asda, Sainsbury's and Morrison, each of whom had been identified by the 2000 Supermarket Report as exercising significant market power. In this case, Somerfield is the fifth placed supermarket chain with grocery sales of less than half of all its main rivals.
- 3.13 For these reasons Somerfield do not consider that the Safeway methodology, formulated in an entirely different context (i.e. and where the predominant focus was on the overlaps in OSS) should be mechanically transposed and applied to evaluate the present case. In effect, the CC now has an opportunity to formulate a methodology customised to the mid-range segment and to complete its understanding of the grocery retailing sector through a deeper analysis of this range of stores. Thus Somerfield is not asking the CC to change its approach completely but rather to take an appropriately fresh look at a fresh problem without being bound by an approach that may have been relevant for addressing the very different problems posed by the Safeway case but which are not applicable here.
- 3.14 The first point to make is that the case for arguing that mid-range stores comprise a distinct market segment is much more difficult than for OSS. One-stop or main shopping trips are a clearly defined element of consumer behaviour and generally practised. The 2000 Supermarket Report found that one-stop shopping represented the main weekly or fortnightly shop and represented 80% of the total grocery spend.
- 3.15 The 2000 Supermarket Report concluded that such one-stop shopping is carried out primarily at OSS because of the wide range of relatively lower prices which they offer. In such circumstances it was understandable that the CC defined a separate

¹⁰ See Figure 2.1 of the 2000 Supermarket Report

¹¹ Safeway Report, para 5.344

market for OSS stores, holding the view that mid-range stores did not have the power to constrain a hypothetical monopoly OSS operator.

3.16 However, as the CC will appreciate, the fact that mid-range stores do not constrain OSS stores does not mean that the converse relationship holds true. On the contrary, there is strong evidence that the pricing and competitive conduct of mid-range store operators are directly constrained by the power of the OSS operators. Secondary or top-up shopping is much more difficult to define and to differentiate from either OSS or convenience shopping. The fact that in the Safeway Report the CC did not reach a conclusion on whether mid-range stores constitute a separate market, illustrates the difficulty and underscores the danger of relying upon too rigid a methodology for defining the segment and its relationship with other segments.

3.17 In Somerfield's view, the OFT's attempt to refine the methodology for the determination of mid-range tentatively advanced in paragraphs 26-33 of the OFT Decision, involving the segmentation of the Safeway definition of mid-range into three sub segments does not assist. The OFT's methodology focused on a set of computational rules that took no account of the need for the approach to be determined by the existence of competitive constraints. The reality is that mid-range represents the transition from convenience to OSS in which the nature of shopping trips which may be carried out in any particular store moves from the emergency, impulse or top up shopping to the weekly shop. In Somerfield's view the appropriate approach was that of the CC in the Safeway Report in seeing the transition from convenience stores to OSS as a continuum. Somerfield's day-to-day business experience confirms that view. Far from being an isolated category, mid-range stores are in fact subject to effective competition from both ends (as well as from mid-range rivals). The availability of huge product ranges and lower prices in OSS stores provides a clear constraint on the prices that Somerfield can charge in its outlets, whilst the existence of a diverse and competitive convenience store sector ensures the consumer always has an alternative at the local level.

3.18 Competition Between Segments

Somerfield considers that, although the competitive influence increases as a mid-range store size increases, mid-range stores do not offer a material competitive constraint against OSS in relation to main shopping trips. This is so even though approximately [CONFIDENTIAL] of Somerfield customer trips are main shopping trips¹², the average value of those trips will be lower than an OSS main shop. Somerfield considers that a net sales area of 15,000 sq. ft is the very minimum for a store to make any realistic main shop offering that might constrain OSS and would emphasise that many OSS are over 30,000 and 50,000 sq. ft. and some in excess of 100,000 sq. ft.

3.19 However the competitive constraint exerted by OSS upon mid-range stores is severe. This reflects the fact that OSS are very much larger stores than their competitors, offer a wider range of products and because of their generally lower

¹² Somerfield Customer Focus June 04 to March 05, Materials, tab5.1

unit costs and the buying power of their operators are able to offer lower prices. The Somerfield Competitor Impact Analysis¹³ [CONFIDENTIAL].

3.20 The extent of competition between the segments in relation to the smaller shopping trips, i.e. top-up or secondary and convenience, is especially intense. OSS can and do compete effectively with smaller stores for all types of shopping missions. Indeed, the brand power, size and offering of a large OSS will attract even small scale shopping trips away from smaller stores even if they may be more conveniently placed to a consumer.

3.21 Conclusion on Product Market

Somerfield believes that the three store segments identified within grocery retail in the Safeway Report, i.e. OSS, convenience and mid-range, provided an appropriate basis for defining the product market in that case, but that a different approach is required when assessing a merger involving primarily mid-range stores. The fact that mid-range stores do not constrain OSS does not mean that OSS stores do not constrain mid-range stores, especially when those OSS operators enjoy huge buyer power advantages that accentuate the already substantial cost advantages associated with their greater size and throughput. Nor can mid-range stores escape competitive constraints by retreating into a high priced/greater convenience niche, because the convenience store sector is already present in that niche, and offers a wide diversity of choice to the consumer. Thus the mid-range grocery stores that are operated by Somerfield, and are exemplified by the Acquired Stores, should be seen as a transition between the two extremes of shopping experience and subject, therefore, to significant competition from both convenience and OSS for their offering. The inter-relationship between the different types of shopping trips (see para 3.5 above) the fact that each can be undertaken at OSS and (to an extent) mid-range stores and that there is no price differential for groceries dependant upon a consumer's shopping mission, means that product definition with reference to shopping trip is not appropriate. Accordingly, for the purposes of assessing this acquisition, the correct product market is for grocery retail sales whether at convenience, OSS or mid-range stores.

¹³ See Materials, tab 4 (Competitor Impact Analysis)

4. Geographical Market

- 4.1 In the Safeway Report, the CC concluded that the geographical market for grocery retail was essentially local, but that there are “*national dimensions of competition*”.¹⁴ This is particularly so in relation to supply side issues.
- 4.2 Consumers are reluctant to travel ‘too far’ for grocery shopping. Therefore, a hypothetical monopolist in a candidate local market may be able to benefit from a small but significant price increase. This suggests that grocery shopping markets are essentially local. However, in some instances the chains of substitution would hinder any such ability of the hypothetical monopolist, and blur the boundaries of local markets. Furthermore, the MMGRs make many of their main decisions (such as pricing, range and quality of products offered, promotions) at national level. Even on occasions when some of these decisions differ between localities the flexibility employed is limited. The fact that the market players’ business models allow only for limited local flexibility implies that wider constraints created by objectives set at the national level apply.
- 4.3 Somerfield agrees with the finding in the OFT Decision that the transaction does not give rise to any competition concerns at the national level, including in terms of upstream buyer power. Somerfield’s current share of the national market for grocery retailing (including the Acquired Stores) is only 5.6%¹⁵. By way of contrast Tesco’s market share is five times higher. In the Supermarket Report 2000, the CC found that multiple grocery retailers would only have sufficient buyer power to adversely affect the competitiveness of their suppliers if they had national market shares of at least 8%. Somerfield’s market share is appreciably below that figure.
- 4.4 In any case, the effects of higher buying volume for a retailer must be evaluated in comparison with the buying volumes of the other retailers. That is, the consequences of a retailer reaching 8% will be different if that retailer is the only one with over 5% share of the grocery retail market from the situation where there are already 3 retailers with above 15% shares. If a small buyer gets larger the bargaining positions of the suppliers are affected in two ways. First, this buyer’s relative bargaining strength vis-à-vis the suppliers will improve. This affects the suppliers negatively. However, the larger retailers’ bargaining power vis-à-vis the suppliers will deteriorate since an alternative route to the market for the suppliers is strengthened. Accordingly, Somerfield would argue that the acquisition has pro competitive consequences in so far as it increases Somerfield’s purchasing power and thereby its ability to compete effectively on a national basis with the MMGR and also gives suppliers an alternative route to market.

¹⁴ Safeway Report, para 2.65

¹⁵ Somerfield 3.6%; Kwik Save 2.0%. Source: TNS Till Roll Share of Value Sales Data 52 weeks to 27 February 2005. Somerfield estimates that this figure will include up to half of the one percentage point increment in market share anticipated as a result of the acquisition. See data supplied at item 12 of the Off the Shelf Material.

- 4.5 Whilst a larger store will be able to carry a wider range of stock than a smaller store, it does not necessarily follow from this that the size of store is an invariable determinant of catchment area. The catchment area of a store will vary (albeit to a lesser extent) with other factors such as competitiveness of its prices and the quality of its offering. However, it is even more important to recognise that any general catchment area specification applied equally to all stores across the country will fail to define the local markets properly. Thus, such specification can not serve for any purpose other than as a first screen.
- 4.6 In the Safeway Report, the CC adopted the following approach to geographical market definition at a local level:
- 4.6.1 For OSS – the geographic scope is a 10 minute¹⁶ isochrone in urban areas and a 15 minute isochrone in rural areas.
- 4.6.2 For mid-range stores – the geographic scope is a 5 minute isochrone in urban areas and a 10 minute isochrone in rural areas.
- 4.6.3 For convenience stores – the CC did not express a view on market definition on the basis that low barriers to entry meant that competition was unlikely to be a problem at a convenience store level. In this case, however, the OFT has advanced a one mile radius for mid-range stores “*closer to convenience stores*”.¹⁷
- 4.7 Whilst Somerfield accept that some formula of the type described above may be appropriate for the purposes of an initial appraisal, it is not appropriate to adhere rigidly to an arbitrary time or mileage based isochrone when evaluating the competitive constraints acting on mid-range stores.
- 4.8 To do so fails to allow for a number of factors:
- 4.8.1 the presence of competing stores, particularly OSS stores, outside the selected isochrone. Since the OSS methodology clearly anticipates that an OSS store in an urban area that is 7 minutes drive time from the mid-range store has that mid-range store location within its 10 minute isochrone, it simply makes no sense to imagine that, due to the smaller isochrones assumed for mid-range stores, that mid-range store can happily ignore the threat from the OSS, or that consumers will not regard the two as alternatives.
- 4.8.2 It will be apparent from the local market studies carried out by Somerfield in relation to each of the Acquired Stores¹⁸ that this is more than a theoretical curiosity. There are substantial competitor stores within a drive time a matter of a few minutes or even seconds of drive time beyond the

¹⁶ Reference to time periods are to drive times

¹⁷ OFT Decision, Para 28

¹⁸ see Materials, tab 3

isochrones adopted by the CC in the Safeway Report which would obviously compete with the subject store. [CONFIDENTIAL].

[CONFIDENTIAL]

- 4.8.3 the pulling power of high profile large OSS with a wide range of products and strong retail brands, e.g. Tesco, outside an isochrone may well represent a sufficiently strong “bid” to the consumer to travel beyond the defined isochrone. It is self-evident that larger shopping baskets bought in mid-range stores are vulnerable to a consumer's decision to take this custom to an OSS, but even smaller mid-range store transactions could also be vulnerable to the same phenomenon. For example, the consumer's alternative to a modest top-up shop in a mid-range store could be a decision to bring forward the timing of a one-stop shop in an OSS store, or to combine a small grocery purchase with a more substantial purchase of one of the main non-grocery items that are now available in OSS stores. This means that little if any of the mid-range store's revenue is safe from the threat of a switch to an OSS retailer;
- 4.8.4 the consumer's familiarity with and appreciation of a store in which he or she carries out the main shopping mission is likely to encourage repeat visits for lesser shopping missions. Consumers perceive benefits and potential time saving in knowing their way around a supermarket which may well be an acceptable trade-off for a longer drive time;
- 4.8.5 consumer loyalty derived from the use of loyalty cards offering discounts or other benefits (e.g. Air Miles) in return for loyalty will encourage consumers to travel further for all shopping missions and particularly those in the secondary or top-up category;
- 4.8.6 the isochrones take no account of the fact that many shoppers may shop for groceries in conjunction with other activities, e.g. travelling to and from their place of work, rather than their place of residence in conjunction with/or shopping trip for main grocery items. When they do one-stop shopping, many consumers will undertake a trip specifically for that purpose because one-stop shopping concerns large baskets which require time and high logistic effort. However, when effecting secondary shopping, less time is spent and it is easier to carry the purchases home because fewer items are purchased. This enables consumers to do their secondary shopping during trips which they undertake for other purposes. Depending on the number of households which are able to switch to shopping in other neighbourhoods that they visit regularly, even a mid-range store that is the unique store in an isochrone centred at it might find it unprofitable to increase its prices over competitive levels. Thus, in many instances the isochrone methodology is much less appropriate for analysing secondary shopping than one-stop shopping.

- 4.8.7 the pattern of substitutability will vary depending on demographic factors. For example, in inner city areas the level of substitution between all three segments is likely to be higher than in rural or suburban areas;
- 4.8.8 no account is taken of internet shopping for which most stores providing such services use a 20 mile radius for delivery. The CC Report on Safeway noted the emerging market for internet shopping in 2003 but took the view that it was not a significant factor at that time. Although internet shopping currently accounts for less than 1% of the total grocery market, Tesco's 2004/05 accounts report Tesco.com sales up 24.1% to £719 million in the year to 26 February 2005. This is almost the same as the annual turnover of the Acquired Stores. Accordingly, internet shopping does now constitute a significant source of actual and potential competition.
- 4.9 It is suggested that whilst the use of time or mileage based isochrones are undoubtedly convenient, they should not be applied rigidly. The market analysis is local and therefore needs to be undertaken on a case by case basis. Isochrones should be applied with sufficient flexibility to ensure that local market conditions are taken into account.
- 4.10 The point is evidenced by the Somerfield market share analysis undertaken in relation to the mid-range rural Acquired Store, Bridge of Weir, which comprised part of the Inquiry Group site visit.
- 4.11 **[CONFIDENTIAL]**
- 4.12 Moreover, the best that even a consistent approach to isochrone analysis can hope to achieve is a meaningful measure of market share. Of course, assessment of the impact of a merger on market share is an important building block towards the competitive analysis, but it is no more than a staging post on the way to that wider assessment. Given the dynamism and evident competitiveness of the grocery retail sector, there are strong reasons to suppose that even high post-merger shares within local markets may not confer significant market power.

5. **Market Analysis**

5.1 Before considering this assessment at a local level, it is appropriate to consider the grocery retail market as a whole. Table 2 below indicates the market shares of the major players.

Table 2 UK Grocery retail

Company	Ranking by turnover	No. of Stores	Share of UK Sales % y/e 27.2.05 (y/e 29.2.04) Ranking
Tesco	1	1878 ¹⁹	28.2 (26.5)
ASDA	2	265	16.6 (16.3)
Sainsbury's	3	508 ²⁰	15.5 (16.1)
Safeway/Morrisons	4	c.475	13.2 (14.6)
Somerfield	5	c.1400	5.6 (6.0)
Co-op	6	c.1800	5.1 (5.2)
Waitrose	7	146	3.4 (3.1)
Iceland	8	748	2.0 (2.2)
Aldi	-	268	[5.0 (4.6)] ²¹
Netto	-	136	[5.0 (4.6)] ²²
Lidl	-	364	[5.0 (4.6)] ²²

(Source TNS Till Roll Share of Value Sales Data February 2005;²²

5.2 The OFT Decision, determines the product and geographical market by a simple application of the approach adopted by the CC in the Safeway Report as described above. The OFT then pursued the CC analysis in the Safeway Report by applying a

¹⁹ including 910 ex -T&S stores

²⁰ excluding Savacentre and Bells stores

²¹ Combined market share for LADS - separate figures are not available from TNS.

limited set of “fascia” as the competitor set against which to measure competition. The fascia identified as competing with OSS were Asda, Budgens, Booths, Co-op, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose. The CC concluded that effective competitors for mid-range stores were the effective competitors in OSS plus Iceland.

- 5.3 The list of effective fascia developed in the Safeway Report seems to be linked to the competitive concerns the CC had at a national level in respect of that transaction, focusing on a separate relevant OSS market and the risks of co-ordinated effects as between the MMGR.
- 5.4 In the context of the Safeway transactions, it may have been appropriate to determine the extent of competition solely by reference to fascia. However, in this case, Somerfield would suggest that it is too blunt an instrument for the competitive assessment in this case.
- 5.5 A competitive assessment based on fascia count is inappropriate here for the following reasons:
- 5.5.1 it unfairly discriminates against retailers like Somerfield, Iceland and Co-op (see Table 2) which have significant portfolios of stores nationwide, but much smaller sales volumes than their competitors and little market power;
 - 5.5.2 it does not take into consideration the relative strength of the stores within the geographic market which can be a factor of store size but also relative offering.
 - 5.5.3 the fascia considered as rivals to OSS operators is too limited a representation of the fascia that can and do compete with mid-range stores;
 - 5.5.4 no account is taken of local competition. In its customer survey, as part of the 2000 Supermarket Report, the CC found that 15% of respondents used local specialist shops such as bakers, butchers and greengrocers for top up shopping. 5% of respondents visited other local shops for top up shopping.
- 5.6 Somerfield objects strongly to the exclusion from the analysis of store groups such as Aldi, Netto and Lidl, (“Limited Assortment Discounters”) (“LADS”), any symbol group (such as Spar and Londis) and Marks & Spencer. Evidence in support of the fact that Somerfield competes head to head with the LADS was submitted to the OFT and has also been provided to the CC²³.
- 5.7 The TNS research reveals that customer profile of Somerfield is at least as close to LADS as to MMGRs. It also shows that there is significant customer interaction between Somerfield and LADS. For example, [CONFIDENTIAL] Somerfield customers also visit Lidl and [CONFIDENTIAL] of Lidl customers visit Somerfield.

²³ See "Hard Discounters - Competitive Interaction" - Slide show sent to the CC with other materials sent to the OFT in response to staff meeting of 8 April 2005

The extent of competition provided by LADS is evident from the impact studies done by Somerfield which show that [CONFIDENTIAL]. The following supports the competitive threat from LADS:

- 5.7.1 [CONFIDENTIAL].
- 5.7.2 [CONFIDENTIAL].²⁴
- 5.7.3 The LADS are seeking to expand their UK store portfolios aggressively. 27 of 50 successful mid-range store planning applications between 2003 - 2004 were by LADS. Their increased market share in the last year is described in Table 2.
- 5.7.4 AC Nielsen - produced data for Netto showed that sales to shoppers from socio-economic groups ABC1 has increased from 25.2% in 2002 to 32.8% in 2004.
- 5.7.5 It is illogical to treat "Kwik Save", which presents a similar offering from similar size stores to the LADS and was considered a "limited range discounter" by the 2000 Supermarket Report, as an effective competitor but exclude Netto, Lidl and Aldi.
- 5.8 The impact which the inclusion of these fascia would have on the OFT's assessment in local market is demonstrated by the individual Somerfield local market assessments in tab 3 of the Materials. [CONFIDENTIAL] OFT identified "problem stores" would not have been considered a problem had account been taken of local LADS within the isochrone applied.
- 5.9 The CC should take account of the fact that Aldi, Lidl and Netto are major players in Continental Europe. In Germany, for example, discount retailers represent 30% of the grocery retail market. The LADS are expanding in the UK and it is likely that they will continue to do so. LADS focus on the top 1500 lines representing 60%-70% of total grocery sales. They are thus able to compete with Somerfield on core grocery products without having to carry the cost of a full range of products. Somerfield's top [CONFIDENTIAL] lines represent [CONFIDENTIAL] of its revenue from grocery sales.
- 5.10 Marks & Spencer has had a significant impact on top-up, secondary and convenience shopping and puts forward a high quality and extensive fresh food offering in direct competition to Somerfield's mid-range and high street stores. This is due to expand with the launch of the M&S "Simply Food" stores. M&S UK market share for Core Grocery sales is 4.4%²⁵
- 5.11 Having applied the market definitions adopted by the CC in the Safeway Report and considered the impact of this transaction by reference to the limited fascia set

²⁴ Source RTP database (monitoring planning applications throughout the UK)

²⁵ Source TNS data - item 12 of Off the Shelf Materials

described above, the OFT identifies the following so-called “*problem stores*” as set out in Table 3:

Table 3: List of acquired stores identified as problem stores in OFT Decision

<u>Store</u>	<u>Reduction in Fascia</u>	<u>Size (sq ft)</u>
<u>OSS</u>		
Johnstone, Houston Square	4 to 3	15,700
<u>Mid-range</u>		
Glasgow, Springburn	4 to 3	13,600
Aberdeen, Cornhill	4 to 3	12,000
Renfrew	4 to 3	14,400
Leeds, Chapel Allerton	4 to 3	9,841
Ponteland, Main Street	4 to 3	12,000
Bridge of Weir	4 to 3	3,500
Saltcoats	4 to 3	14,000
London, Camberwell	4 to 3	13,600
London, Balham	4 to 3	14,000
Leeds, Oakwood	3 to 2	10,320
Broughty Ferry, Brook Street	3 to 2	9,700
Wickham, Oakfield Road	3 to 2	9,800
Glasgow, Knightswood	3 to 2	13,820
Carluke	3 to 2	8,500
Frome, King Street	3 to 2	9,506
South Shields	3 to 2	8,700
Middlesbrough, Linthorpe	3 to 2	9,500
Loftus	3 to 2	3,500
Kelso, Roxborough Street	3 to 2	7,400
Preston Pans	3 to 2	7,100
Peebles (with PFS)	2 to 1	12,000
Pocklington, The Balk	2 to 1	10,000

5.12 In relation to the stores identified above, the OFT expresses the view that the acquisition “*has resulted or may be expected to result in a substantial lessening of competition*”²⁶. However, the OFT Decision provides no analysis of effective competition in any of the local markets and appears to base its conclusion solely on the perceived reduction in fascia count.

5.13 Somerfield considers that such an approach is wholly inadequate. To determine SLC it is necessary as a starting point to consider not just the quantity but quality of competition in the local market and to identify the market shares of the competitor set

²⁶ OFT Decision, para 54

in each local market. Then, having determined the impact of the transaction on the structure of the market, it is necessary to identify a valid theory of competitive harm (i.e. whether the concern with the identified increase in concentration is that it will lead to unilateral or to co-ordinated effects), and then to test that theory against the available facts on how the market actually works. The OFT's approach failed to identify a valid measure of the impact of the merger on competition, and did not even attempt to identify a theory of competitive harm that might give rise to an SLC.

5.14 In order to conduct a sense check on the accuracy of the fascia approach, it is necessary to establish whether Somerfield's market share is in line with its share of fascia within the isochrone. As we show below, when such market share analysis is carried out, Somerfield's actual share of sales in an isochrone will be lower than might be expected purely by counting fascia. The reason for this is as follows:

5.14.1 the isochrones are too small, such that a substantial proportion of the expenditure from households within that isochrone is likely to go to retailers located outside the isochrone. This will be especially true where (as is often the case) one or more OSS lie just outside the isochrone.

5.14.2 the set of competing stores is too narrow, such that some expenditure of households within the isochrone would go to other mid-range stores such as LADS, or a symbol group or Marks & Spencer. Whilst ignoring such retailers in the context of an inquiry focused on OSS retailing may have been legitimate, it is clearly not valid to do so when assessing a merger that affects mid-range stores.

5.14.3 on average, the Somerfield store is smaller than the others in the set - so would not pick up its "fair share" in any event.

5.15 Somerfield have produced two local market share analyses in relation to each of the Acquired Stores. The first, the [CONFIDENTIAL] assesses Somerfield's local market share for grocery retail (and its increment as a result of the acquisition) within the primary isochrone applicable in the Safeway Report. By using [CONFIDENTIAL] Somerfield calculated the weekly grocery market for that isochrone and then obtained Somerfield share of that market with reference to its local Somerfield/Kwik Save turnover. The CC would of course be able to obtain precise turnover figures from the competitor set to provide more accurate figures. The local grocery market for the isochrone was assessed by:

5.15.1 calculating the average annual UK household spend on groceries by [CONFIDENTIAL].

5.15.2 calculate the average annual household spend on groceries in each local market by reference to [CONFIDENTIAL].

5.16 The second set of data is that produced by Chorus-Experian in 2003 on grocery shopping behaviour within the primary isochrone applicable under the Safeway Report. The Experian Data will not take account of market changes or new entrants

since 2003, but it does offer a useful check on the [CONFIDENTIAL] market share analysis and gives an indication of local market shares of competing fascias.

- 5.17 Somerfield considered that it was not appropriate to differentiate in the market share analysis between groceries purchased as part of a main, secondary/top-up, convenience or impulse shopping trips. As is explained in paragraphs 3.15 to 3.18 all shopping trips undertaken at a mid-range store are subject to competitive constraint from either or both OSS and convenience stores. It is not the case that there is any price differential referenced by a consumer's shopping mission.
- 5.18 [CONFIDENTIAL]. Thus, a substantial part of Somerfield [CONFIDENTIAL] in mid-range stores are [CONFIDENTIAL]. There is no scope for Somerfield to [CONFIDENTIAL]. There would be no merit in trying to establish market size for different segments since, like all grocery retailers, Somerfield needs to base pricing decisions on total sales and not only on a segment.
- 5.19 Furthermore, as stated above, households do not need to fulfil specific quotas under different shopping missions. Even a mid-range store that caters only for top-up shopping cannot ignore the fact that its customers can increase their main shopping baskets at OSS and limit their purchases from the mid-range store to minimum necessity items in response to a price increase. Such inter-segment substitution makes any attempt to define a separate market for top-up purchases inappropriate.
- 5.20 As per the basket analysis in the Materials, tab 6.2, one-stop shopping trips undertaken at Somerfield stores of over 10,000 sq ft represent at least [CONFIDENTIAL]²⁷ of those stores' turnover. It is appropriate to consider the competitive constraint applied by OSS upon Somerfield's own main shop customers as well as the competition between Somerfield and MMGR for top-up/secondary shopping customers.
- 5.21 Somerfield consider that as a first filter it is appropriate to assume that there will be no anti-competitive effects where there is no reduction in fascia within the relevant isochrone when applying the geographical market analysis under the Safeway Report. As suggested in Section 4 above, these Safeway isochrones fail in particular to take into account the effect upon mid-range stores of competitor OSS stores outside this isochrone. However, existence of these competitor OSS stores outside the isochrone will not affect this first filter unless the OSS is a Somerfield store. Somerfield can confirm that there is no example of that here.
- 5.22 Of those 43 Acquired Stores where there is a reduction of fascia within the designated isochrone as a result of the acquisition, [CONFIDENTIAL] result in an increment in local market share under the [CONFIDENTIAL] analysis, which results in a local market share in excess of [CONFIDENTIAL]. These are: [CONFIDENTIAL].

²⁷ This is based on all shopping trips where the spend is over [CONFIDENTIAL]; It is submitted that a main shop may take place where there is a lower spend.

- 5.23 As is stated in the Notes of the Market Share analysis, in each of these 7 cases, the Experian Data suggests that the local market share may be significantly overstated. This is because in those cases, the increment in Somerfield market share under the [CONFIDENTIAL] analysis is far in excess of the market share attributable to the Acquired Store under the Experian Data. Somerfield would suggest that this discrepancy indicates that the isochrone used for the [CONFIDENTIAL] is too small and customers are coming from further afield. This is borne out in the Savercard analysis for [CONFIDENTIAL] in the Materials, tab 4.

Table 4: Market Share Analysis - Comparison of [CONFIDENTIAL] and Chorus Data

[CONFIDENTIAL]

- 5.24 The Experian analysis would suggest that in only 3 cases, the acquisition meant an increment in market share which results in a Somerfield market share of over 40%.
- 5.25 The CC will appreciate that, even where the acquisition does lead to a market share in excess of [CONFIDENTIAL], this does not necessarily mean that there is SLC. Somerfield addresses this point further in Section 8.
- 5.26 For [CONFIDENTIAL], Somerfield's pre-acquisition market share was very low. Thus, in that case the acquisition leads to merely a change in the name of an effective store in the local market and should not be expected to raise concerns about substantial lessening of competition. Somerfield would highlight those comments and competitor impacts referred to in the individual Market Share analysis, the summary in Materials, tab 2 and in the original submissions (related to the OFT identified "problem stores") which were sent prior to the reference and which have been copied to the CC.

6. **Somerfield's Pricing Policy**

Introduction

6.1 [CONFIDENTIAL]

6.2 [CONFIDENTIAL]

6.3 [CONFIDENTIAL]

6.4 [CONFIDENTIAL]:

6.4.1 [CONFIDENTIAL]

6.4.2 [CONFIDENTIAL]

6.4.3 [CONFIDENTIAL]

6.4.4 [CONFIDENTIAL]

6.4.5 [CONFIDENTIAL]

6.5 [CONFIDENTIAL]

[CONFIDENTIAL]

6.6 [CONFIDENTIAL]

[CONFIDENTIAL]

[CONFIDENTIAL]

[CONFIDENTIAL]

[CONFIDENTIAL]

[CONFIDENTIAL]

▪ [CONFIDENTIAL]

▪ [CONFIDENTIAL]

6.7 [CONFIDENTIAL]

REDACTED VERSION

[CONFIDENTIAL]

Promotional Interaction

6.8 [CONFIDENTIAL]

6.9 [CONFIDENTIAL]

6.10 [CONFIDENTIAL]

6.11 [CONFIDENTIAL]

6.11.1 [CONFIDENTIAL]

6.11.2 [CONFIDENTIAL]

6.12 [CONFIDENTIAL]

6.13 [CONFIDENTIAL]

[CONFIDENTIAL]

6.14 [CONFIDENTIAL]

6.15 [CONFIDENTIAL]

6.16 [CONFIDENTIAL]

6.17 [CONFIDENTIAL]

6.18 [CONFIDENTIAL]

6.19 [CONFIDENTIAL]

[CONFIDENTIAL]

6.20 [CONFIDENTIAL]

6.21 [CONFIDENTIAL]

6.22 [CONFIDENTIAL]

6.22.1 [CONFIDENTIAL]

6.22.2 [CONFIDENTIAL]

6.22.3 [CONFIDENTIAL]

6.23 [CONFIDENTIAL]

[CONFIDENTIAL]

REDACTED VERSION

6.24 [CONFIDENTIAL]

6.24.1 [CONFIDENTIAL]

6.24.2 [CONFIDENTIAL]

6.24.3 [CONFIDENTIAL]

6.24.4 [CONFIDENTIAL]

6.24.5 [CONFIDENTIAL]

[CONFIDENTIAL]

[CONFIDENTIAL]

6.25 [CONFIDENTIAL]

[CONFIDENTIAL]

[CONFIDENTIAL]

[CONFIDENTIAL]

6.26 [CONFIDENTIAL]

6.27 [CONFIDENTIAL]

6.28 [CONFIDENTIAL]

[CONFIDENTIAL]

6.29 [CONFIDENTIAL]

REDACTED VERSION

[CONFIDENTIAL]

[CONFIDENTIAL]

[CONFIDENTIAL]

6.30 [CONFIDENTIAL]

6.31 [CONFIDENTIAL]

[CONFIDENTIAL]

6.32 [CONFIDENTIAL]

7. Barriers to Entry and Expansion

- 7.1 In paragraph 38 of the OFT Decision, the OFT asserts that in relation to OSS, barriers to entry are high and that *“new entry is therefore not considered to be a countervailing factor in the one-stop segment in this case”*.
- 7.2 New entry may take a variety of forms. It is accepted that *“green field”* entry involving establishing a nationwide network of stores, the logistical and distribution infrastructure, coupled with the creation and marketing of a national brand would involve a substantial financial investment and a considerable amount of time. However, new entry may also be achieved by the acquisition of an existing chain of stores, e.g. Wal-mart’s acquisition of Asda. Realisation of such an entry strategy depends crucially on whether there are grocery retail chains of size that can be brought to viable scale quickly if taken over. Since it is relatively unlikely that a potential entrant would be able to take over Tesco or Asda, growth of smaller fascias such as Somerfield helps keep this entry strategy available.
- 7.3 New entry should not be considered only at a national level. Indeed, in this case the focus must be on new entry at a local level and here it is submitted that barriers to entry are not high. Most local entry is likely to be *“incremental entry”* where an existing fascia will open a new store at a local market in which it did not exist before.
- 7.4 In the Safeway Report, the CC identified *“scale economies”* and *“building permissions”* as barriers to entry into the OSS sector. The scale economies do not constitute a barrier for an existing fascia considering entering into a given local market as long as it has a distribution centre that can serve the new store. On the other hand, the building permissions are much less of a concern for the range of stores affected by this transaction. First, the permissions are easier to obtain for such stores and second, there is a functioning market for existing retail stores of such size.
- 7.5 Supermarkets are bought and sold between the national chains on a regular basis. Furthermore, there has been a substantial growth in the number of new stores. The Materials at tab 7 identify the number of planning applications for new build stores which have been made in the past three years (May 2002 to April 2005) and those which have been successful. [CONFIDENTIAL].
- 7.6 Nevertheless, the figures provided demonstrate that during the three year period covered an average of 81 permissions were granted for new stores per annum. This figure is likely to be an underestimate since it does not include planning applications for stores made by developers or agents representing one of the store chains. [CONFIDENTIAL] in particular tends to use agents for such applications.
- 7.7 In addition to new entry through store acquisition or new build in a local market, the expansion of existing stores also offers the potential for new competition. See the spreadsheet in the Materials at tab 7 for details of store extensions. There is no reason to suggest that other supermarket chains have not or could not carry out similar expansion programmes if sales opportunities in any locality made it worthwhile to do so.

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- 7.8 In response to the regulatory constraints faced by the MMGRs in expansion of the OSS segment underlined by the CC ruling in the Safeway Inquiry, the MMGRs and in particular Tesco and Sainsburys have been expanding their interests in the smaller stores and in particular convenience stores:
- 7.8.1 On 9th December 2002, the OFT approved Tesco's acquisition of T&S Stores Plc comprising 850 convenience stores;
 - 7.8.2 On 5th March 2004, the OFT approved Tesco's acquisition of 45 convenience stores from Adminstore Limited;
 - 7.8.3 On 18th October 2004 the OFT approved Tesco's acquisition of 10 OSS stores from Morrison;
 - 7.8.4 On 26th October 2004 the OFT approved Sainsbury's acquisition of Jacksons Stores Limited an independent retailer operating 114 stores in Yorkshire and the North Midlands of which 112 were convenience stores and 2 were mid range stores.
- 7.9 The sanctioning by the OFT of the MMGRs move into the smaller format stores has given them the opportunity to grow their business in grocery retailing making use of their substantial market power, logistics and distribution systems and financial resources in a sector where competition is relatively weak and fragmented. Furthermore, expansion in that segment is at present at least free of regulatory constraint given the OFT and CC view as to the absence of barriers to entry in the convenience segment.
- 7.10 There are few barriers to the MMGRs increasing their share of the convenience and mid-range segments either through acquisition or by the creation of new stores. Clearly this trend operates as an important competitive constraint on existing competitors in both convenience and mid-range segments.

8. Potential for Acquisition Giving Rise to Substantial Lessening of Competition (SLC)

- 8.1 Having defined the relevant market(s) and assessed the impact of a transaction on market structure, the starting point for any SLC assessment must be an analysis of whether the change arising from the merger is expected to reduce competition. As the CC's guidelines state, there are two broad classes of theory of SLC in horizontal mergers: either the merger reduces competition due to its unilateral effects (i.e. essentially giving the post-merger firm sufficient market power to raise prices on its own initiative); or the merger increases the risk of co-ordinated effects (i.e. creating a situation in which tacit collusion amongst a group of firms will increase as a result of the merger).
- 8.2 A natural reference point for the SLC discussion is the CC's analysis in the Safeway merger cases. In that case, the CC was primarily concerned that a decrease in the number of national players from four to three might lead to co-ordinated action, and the concern as set out in the CC report relates essentially to the risk that such behaviour would take place at a national level, caused by the increase in concentration that would arise from a merger between Safeway and one of the other leading OSS retailers.
- 8.3 However, there are significant differences between the present transaction and the Safeway Merger cases which make it inappropriate to follow the framework developed there. It is inconceivable that a transaction involving such a small increment in national market share will change the co-ordinated action possibilities of the market players at a national level. Indeed, Somerfield would argue that, given the evident vigour of competition amongst the MMGRs, and Somerfield's own modest position in the sector, no action by Somerfield would induce any change in the likelihood of co-ordinated behaviour by the MMGRs. In the current situation, Tesco and Asda are driving the market with the rest of the players struggling to catch up in offering equally attractive deals to their customers. The apparent asymmetry in the conditions faced by the two tiers of the market (i.e. Tesco and Asda against the rest) would hamper any co-ordinated action.
- 8.4 In terms of the national market, the modest increment in Somerfield's purchasing power represents less than 1%, resulting in a post merger Somerfield market share of approximately 6.0%²⁸. This remains below the 8% level above which the CC considers there could be an adverse effect on the competitiveness of suppliers. On the contrary the improvement in Somerfield's purchasing position is likely to stimulate competition given that the Acquired Stores have been removed from the Morrison estate, strengthening the position of the fifth national player in the market.
- 8.5 The CC's analysis in the Safeway mergers also considered the situation in local markets, and indeed the divestments Morrisons was obliged to offer as a condition of

²⁸ Somerfield's current share of the national market for grocery retailing (including the Acquisition Stores) is only 5.6% - see note 15

clearance was based on an assessment of competition in local markets. It is in theory possible to have concerns based on either unilateral or co-ordinated effects concerns, but in the context of the current transaction the case for a co-ordinated effects SLC at a local level can readily be dismissed. A co-ordinated effects concern at local level would need to envisage a post-merger decision of Somerfield and the competing fascia owners who made up the oligopoly group reaching an understanding to impose a localised price increase. Since the Safeway Report, (and indeed the 2000 Supermarkets Report) concluded that mid-range stores do not constrain the pricing of OSS stores, this possibility can be dismissed out of hand. The presence of localised co-ordinated effects would require an OSS store owned by, for example, Tesco, choosing to depart from its national pricing policy in a locality in order to take advantage of a perceived SLC opportunity that could only apply in part of the isochrone for that store. There is no evidence whatsoever that this has or could occur.

- 8.6 Thus, the only possible concern for the current transaction is whether it might give rise to strong unilateral effects in some local markets and lessen the level of competition in those markets. This is a theoretical possibility that needs to be evaluated on a case by case basis rather than applying the same recipe to all local markets. The fascia count rule used by the CC in the Safeway Report is evidently not apt for this task, since the "4 to 3" rule itself is based on a theory of co-ordinated effects, not unilateral effects, and cannot account for the real competitive dynamics in these local markets. Its mechanical structure does not permit differentiation between different qualities of competitive threat by different fascias and different stores, and the rule adopted in the Safeway Report is in any event set at a level that is inappropriate for an inquiry into unilateral effects on a local basis.
- 8.7 There is no evidence at a local level in any of the markets of the Acquired Stores suggesting that Somerfield will acquire the power to impose a localised price increase. At a local level, Somerfield is subject to intense competition in the markets concerned, not least because the Acquired Stores are predominantly mid-range stores and are therefore subject to competition from both the OSS and convenience segment in addition to being subject to competition within the enlarged competitor set described at paragraphs 5.6 to 5.10 inclusive.
- 8.8 If there is potential for unilateral effects arising through the exercise of market power within a local market, one would expect to see the prices in stores in localities with limited or no competition to be significantly higher than in those localities where competition exists.
- 8.9 Table 10 below provides an analysis of "single fascia stores" (i.e. those stores in areas where there is no competing fascia within a 5km radius) within the Somerfield pre-acquisition estate, the Acquired Stores and a combination of the two. It will be apparent from this analysis that [CONFIDENTIAL] of single fascia stores are [CONFIDENTIAL] compared with [CONFIDENTIAL] which is the [CONFIDENTIAL]. This would suggest that even in areas where there are no other fascias within the local market, Somerfield's pricing is consistent with its pricing nationally.

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- 8.10 On the basis that the mid-range segment tends to support largely top-up shopping, price and non price terms are subject to significant constraints from convenience stores and OSS. In relation to OSS, this is not only on the basis that an OSS might offer a more attractive alternative destination for top-up shopping, but also because the consumer may decide to increase his or her main shopping purchase at an OSS if it were felt that there was a significant price advantage in doing so.
- 8.11 In conclusion, therefore, Somerfield consider that there is no evidence that the acquisition will bring about any change in the national market or in any local markets in which the Acquired Stores are located which might be expected to reduce competition. At a national level the strengthening of Somerfield as a fifth competitor will enhance competition in offering to volume suppliers an alternative buyer. At a local level, even in areas where the acquisition leads to a reduction of fascia headcount, this would not lead to any risk of co-ordinated or unilateral effects. The evidence suggests that even if post merger Somerfield is the sole fascia within a local market, it will remain subject to significant competitive constraints presented by both actual and potential competition from competitors in adjacent areas as well as new entrants in local markets where barriers to entry in the mid-range segment are low relative to OSS and even lower in the convenience segment.

Details of Somerfield Stores Pricing System

- 1.** [CONFIDENTIAL]
- 1.1 [CONFIDENTIAL]
- 1.2 [CONFIDENTIAL]
- 1.3 [CONFIDENTIAL]
- 2.** [CONFIDENTIAL]
- 2.1 [CONFIDENTIAL]
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 - 2.2.2 [CONFIDENTIAL]
 - 2.2.3 [CONFIDENTIAL]
- 2.3 [CONFIDENTIAL]
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 - (i) [CONFIDENTIAL]
 - (ii) [CONFIDENTIAL]
 - (iii) [CONFIDENTIAL]
 - (iv) [CONFIDENTIAL]
 - (v) [CONFIDENTIAL]
- 3.** [CONFIDENTIAL]
- 3.1 [CONFIDENTIAL]
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Makes Sense Range

3.9 [CONFIDENTIAL]

3.10 [CONFIDENTIAL]

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4. [CONFIDENTIAL]

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5. [CONFIDENTIAL]

5.1 [CONFIDENTIAL]

5.2 [CONFIDENTIAL]

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6. [CONFIDENTIAL]

6.1 [CONFIDENTIAL]

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6.3 [CONFIDENTIAL]

6.4 [CONFIDENTIAL]

Index to Main Submission Material

N.B.: Where it has not been feasible to provide a hardcopy, for instance in relation to large spreadsheets, the information is provided in soft copy only.

Tab	Document Description	Confidential	Soft Copy on CD-ROM
1	Glossary of Acronyms used in the Main Submission	N	Y
2	List of Acquired Stores	N	N
3	Summary - Local Market Share Analysis:		
	- including Chorus Competitor Fascia Market Share information (Soft Copies Only)	Y	Y
	- excluding Chorus Competitor Fascia Market Share information (Soft Copies Only)	Y	Y
	- OFT Store and Competitor Analysis - Methodology	Y	Y
	- Chorus Data - Methodology	Y	Y
4	Somerfield Competitor Impact Analysis (Soft Copy Only)	Y	Y
5	Limited Savercard Analysis - 13 Acquired Stores	Y	Y
6	Shopping Mission and Basket Analysis:		
	- Customer Focus - Shopping Mission June 2004 - March 2005	Y	Y

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	- Basket Range Analysis - stores over 10,000 sq ft (Soft Copy Only)	Y	Y
7	Spreadsheet (Soft Copy Only): Details of Planning Applications for Stores (May 2002 - April 2005)	Y	Y
	Spreadsheet: Details of Store Extensions	Y	Y