Redacted Version

Somerfield/Morrisons Stores Merger Inquiry

Response to Provisional Findings Report

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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

Response to Provisional Findings Report

Acquisition by Somerfield plc

of 115 stores from Wm Morrison Supermarkets plc

Contents

1. Introduction

1.1 This is Somerfield's response to the Provisional Findings report of the Competition Commission dated 29 July 2005 in relation to its Inquiry into the acquisition by Somerfield of 115 stores from Morrisons.

1.2 Although this response is not due until 16 August 2005, Somerfield is anxious to complete the response and submit it to the CC in advance of the Remedies Hearing set for 9 August 2005.

1.3 Somerfield has, through its Main Submission, at two hearings as part of this Inquiry and in documents provided in response to points raised at those hearings, set out its views on the impact of this acquisition upon local markets, the methodologies that might be employed by the CC in analysing that impact and on whether any substantial lessening of competition would be expected. Somerfield has also had the benefit of seeing working papers of the CC as part of the process, setting out details of the proposed methodology to be employed by the CC. Somerfield has provided written submissions in response to each of these working papers.

1.4 However, rather than restate these arguments at length within this document, Somerfield believes it is more productive to focus upon those elements of the CC's methodology which were developed by the Group or revealed to Somerfield for the first time in the Provisional Findings.

1.5 Accordingly, much of this document will focus on the Stage 2 methodology.

1.6 Somerfield had the opportunity to view and comment upon sections 1 (the reference) to 4 (Background) of the Provisional Findings prior to their publication. Somerfield has no further comment on these sections and does not challenge the CC's jurisdiction to undertake this Inquiry.

1.7 Somerfield does not disagree with the CC's analysis of the effect of the merger on national competition and makes no further comment on that analysis in this document.

2. **Key Points**

2.1 There are three key points that Somerfield specifically draws to the Group's attention:

2.1.1 **Substantial Lessening of Competition -** Somerfield considers that, based on the analysis set out in its Provisional Findings, the CC is unable to establish a substantial lessening of competition ("SLC") to the statutory standard in respect of any of the markets affected by the transaction. It therefore has no legal basis on which to order remedial action;

2.1.2 **Stage 2 Methodology -** Without prejudice to that primary contention, Somerfield suggests that while, in principle, the approach to Stage 2 methodology adopted by the CC is capable of identifying markets in which there may be valid concerns about SLC, the CC should recognise the inherent limitations in the data available to it and apply the methodology with much greater circumspection than it has in the Provisional Findings;

2.1.3 **Individual Stores -** Somerfield has various additional points to make about individual stores that might lead the CC to reconsider their inclusion on the list of 14 "problem" stores.

Substantial Lessening of Competition

2.2 The legal test that must be met if the CC is to order remedial action is that SLC must have resulted or that it may be expected.

2.3 However, its conclusion at paragraph 7.18 is that, in respect of the 14 stores identified, the “acquisition is therefore in our view likely to give rise to the prospect of an SLC.” This heavily qualified wording does not meet the statutory test which requires the CC to find either that an SLC has resulted from the merger or it may be expected (i.e. is to be expected on a balance of possibilities).

2.4 Nor does this assessment measure up to the CC Guidelines:

“When doing so it will <u>not</u> be sufficient for the Commission <u>to believe</u> that an SLC is possible: for the Commission to reach an adverse decision either the merger must have resulted in an SLC or the Commission <u>must expect</u> such a result.”[1]

2.5 The CC has allowed itself to get into a position where it is prepared to consider ordering divestment of an Acquired Store on the slender basis that there is a theoretical possibility that Somerfield will rest on its laurels (“worsen their offer in one or all of [PQRS], … *simply as a result of letting standards slip in the face of weak competition*”: para 7.3).

2.6 The Provisional Findings give no explanation of the basis on which the CC expects such an outcome to occur. No explanation is given for the apparent conclusion that the CC positively expects Somerfield's prices to rise significantly or its QRS offer to be significantly worsened in the identified locations. In fact, it is a fair inference from the document that the CC does not expect (on a balance of probabilities) that

[1] emphasis added

Somerfield's prices will rise significantly in the identified local markets. It is difficult to see why so much stress would otherwise have been placed on the fact that the Inquiry was concerned also with non-price aspects of QRS. Yet no, even theoretical, basis is put forward which would explain why the CC expects Somerfield to worsen its QRS offer. The CC simply states that "there is a straightforward economic logic to the notion that an SLC will lead to adverse effects for customers" (para 7.35).

2.7 Somerfield considers that the CC has merely identified a potential lessening of competition and labelled it "significant", presuming that adverse effects will follow. It is submitted that that is legally insufficient. The defects in the analysis cannot be overcome by an attempt to reverse the burden of proof in paragraph 7.35 ("unless presented with strong evidence to the contrary"). The CC must have a firm basis for its expectation that allows it to be convinced that the adverse effects will (on the balance of probabilities) follow. A theoretical possibility that Somerfield could behave in a certain way is not sufficient to ground a belief that it will or is more likely to do so than not.

2.8 In any event, Somerfield submits that it has indeed provided such evidence and that the evidence has not been adequately dealt with by the CC. A particular example is the description in paragraphs 7.34 and 7.35 of Somerfield's price tiering which is inadequate to do justice to the submission that Somerfield has made to the CC. In particular, the sentence "Somerfield does have a policy of *local* price tiering which would allow *such* higher prices" ignores the hard evidence that this discretion is not used, even though the option exists. Elsewhere, the CC goes so far as to state that the Somerfield's existing policies on price and quality are essentially irrelevant: there would still be concerns about adverse effects on consumers (paragraph 7.3). These illustrations highlight the extent to which the CC has relied on theoretical possibilities of SLC, instead of using the available information to assess whether such an outcome is likely to arise. To anyone who asks why there might be such actual concerns, the Provisional Findings provide no answer.

2.9 The CC has put the cart before the horse. The evidence before it of Somerfield’s behaviour in entirely comparable markets over the medium and long term provides the strongest possible indication that there will not be any, or at least any significant[2], adverse effects resulting from the merger (strictly, from any of the multiple mergers under examination). That suggests that there is sufficient competitive constraint on Somerfield as matters stand to prevent it from raising price or otherwise worsening its (P)QRS offer in “monopoly” conditions elsewhere, and therefore that such constraints are likely to exist in the markets affected by the mergers. The CC has given no reason why Somerfield's practices in the identified local markets are likely to differ from those already found in the real world.

2.10 Somerfield therefore considers that the CC’s analysis is legally as well as economically defective.

[2] It is submitted that the one hour reduction in opening hours at one of the Pocklington stores, an operational matter which Somerfield regards as fully explicable and justified, could not be regarded as significant even if the CC were to take the view that it was an adverse effect, and one resulting from the merger.

Stage 2 Methodology

2.11 Somerfield acknowledges the effort that the CC has made to develop an approach that goes beyond the fascia count methodology which was (as Somerfield has consistently said) appropriate for the OSS mergers under consideration in the Safeway report but is not appropriate for considering a merger in the mid-range segment. Somerfield also repeats the view expressed at its second hearing that, in principle, diversion ratios are a good way to test for SLC in the circumstances of the present transaction.

2.12 However, Somerfield believes that there are serious flaws in the CC's Stage 2 methodology and its application.

2.13 The CC has chosen a 14% diversion ratio as being equivalent to a post-merger market share of 25% and finds SLC where that threshold is attained. This is to misapply the CC Guidelines which say only that a post-merger market share of this level is sufficient only "to raise potential concerns"[3].

2.14 Somerfield submits that the threshold diversion ratio of 14% adopted by the CC and used as a quasi-automatic prohibition (because, as is explained in this Response, the other condition set by the CC, a 5% illustrative price rise, is illusory) is on any view far too low.

2.15 The threshold is set in order to identify SLC arising from unilateral effects. Even taking the diversion ratio analysis at face value, evidence that in the event of the unavailability of an Acquired Store only £1 in every £7 of its revenue would be diverted to a Proximity Store (with £6 in every £7 ending up elsewhere), will not demonstrate that "the ability of the merged firm to exercise market power independently, without the need to second guess the strategies of other firms in the market"[4] would be appreciably enhanced.

2.16 The CC's own analysis explicitly draws attention to the fact that a 14% diversion ratio is what would be found in an 8 to 7 merger in symmetric market conditions. However, it does not acknowledge that a merger in a market with such low levels of concentration and so many competitors would never be prohibited. Furthermore, as Somerfield demonstrates in this Response, it is incorrect to assert that a 14% diversion ratio is implied in a merger between two firms leading to a 25% market share.

2.17 Somerfield suggests that, even if an accurately calculated 14% diversion ratio were appropriate, which it is not, the shortcomings in the data on which the diversion ratio analysis is founded are such that a higher threshold must be set if the CC is to use it to determine levels above which SLC is presumed. The need to take a higher threshold ratio is all the more pronounced as the diversion ratios have been calculated on the basis of a small number of responses to a single question in the NOP survey in circumstances where both question and answer raise considerable difficulties of interpretation.

2.18 The CC take an avowedly conservative approach in Stage 1, undertaking extensive recentring analysis to capture any conceivable competition concerns. This must be

[3] Competition Commission Guidelines June 2003 paragraph 3.4
[4] *ibid* paragraph 3.28

balanced by a more critical approach to possible problem areas in the Stage 2 process when evaluating the potential risk of SLC. Such a critical approach is not achieved by adopting a 14% diversion ratio threshold.

2.19 Accordingly, Somerfield submits that, whilst diversion ratios may be an appropriate way to detect lessening of competition, a 14% threshold is far too low to identify a "substantial" lessening.

2.20 For reasons explained in this Response, Somerfield maintains that, as it suggested at the second hearing, a diversion ratio of at least 25% (and probably somewhere between 25% and 33%) would be more consistent with the requirement to identify a substantial lessening and also with the CC's normal practice.

2.21 As already noted, the other measure purportedly used as a factor in identifying SLC, the "illustrative price rise" threshold, is illusory in the circumstances as it is based on a simplistic theoretical model that bears no relation to the observed facts of how pricing decisions are made in the supermarket sector. Under the extremely simplified assumptions of this model, the SLC condition of a 5% price rise is automatically satisfied when a diversion ratio exceeds 14% and margins exceed 22.6%, which will almost always be the case.

2.22 The CC's use of a formula derived on the assumption of iso-elastic (rather than linear) demand and its choice of 5% as the threshold level for considering that SLC is present appear completely arbitrary.

2.23 Furthermore, the theory is contradicted by the CC's own margin concentration analysis. This suggests that a merger which results in a local duopoly becoming a local monopoly would result in a decline in PQRS that is equivalent to a 1.8% price rise. For the same merger, however, the CC's "illustrative price rise" theory predicts a 17% price rise under conservative assumptions of 30% diversion ratio and 25% pre-merger margin. They cannot both be right. Somerfield highlights the specific case of the Johnstone store where the illustrative price analysis predicts that a 20p tin of tomatoes will go up in price to almost £4 after the merger, even though the store will continue to face competitors nearby. Somerfield suggests that the "illustrative price analysis" is simply not credible and should be abandoned by the Group.

2.24 Somerfield strongly maintains that its market share estimates are useful as a sense and proportionality check on the result that may be obtained from diversion ratio analysis. The CC should be very cautious before making a judgement of SLC in circumstances where Somerfield's aggregate local market share post-merger is less than 12%.

2.25 Somerfield strongly disagrees with the CC's view that, in the absence of diversion ratio analysis, it can judge the prospective unilateral effects of the merger by comparing the distance between the Acquired Store and the Proximity Store and the Acquired Store and the nearest OSS rival. It is extraordinary that Somerfield might be required to divest 3 stores on grounds simply that each is too close to an existing store.

2.26 The CC bases its reliance on these distance ratios by its observation during this Inquiry that those ratios have mirrored revenue diversion ratios. However, there are a significant number of exceptions. The CC makes a finding of SLC in **Littlehampton** on the basis of a low distance ratio of 20.6%. The Kilsyth and London Camberwell stores have distance ratios of 9.7% and 10.3% respectively, and neither demonstrated diversion ratios that created a competition concern for the CC.

Individual Stores

2.27 **Paisley -** The CC removed Frome from its list of "problem" stores on the basis that a new Asda within 3 minutes drivetime was expected to open in the near future. By the same logic, in the case of Paisley, it should be highlighted that Morrisons has received planning consent for and is in the process of construction of a Class 1 retail superstore (36,167 sq ft) and associated car parking, petrol filling station and car wash facilities at Mill Street/Seedhill Road, 1.06 minutes drivetime from the Acquired Store. From the CC's own Competitor Impact Analysis, Morrison's entry should be sufficient to reduce the 21% revenue diversion ratio to below the threshold currently set.

2.28 Somerfield would also observe that, specifically in respect of Paisley, it is all the harder for the CC to defend its view that PQRS will worsen when it is appreciated that [CONFIDENTIAL]. In addition, Somerfield argues that it was wrong for the Paisley store to be passed for consideration under Stage 2 on the basis that the Stage 1 fascia reduction rule identified that the population in only 16% of the primary isochrone could be affected by the merger.

2.29 **Yarm -** Planning permission has been granted for a new 17,600 sq ft Lidl and a 16,000 sq ft Netto store, both located within the 10 minute isochrone. Construction has begun on the Netto store. Average competitor impacts for these two fascia would suggest that entry, particularly of the closer Lidl store, should be sufficient to reduce the 22% revenue diversion ratio to below the threshold currently set. Somerfield also highlights a very high distance ratio (263%) and very low market share (7.8%) as grounds for extreme caution before the CC should confirm a ruling that SLC has taken place or may be expected in respect of Yarm.

2.30 **Poole, Bearwood** - In this case the revenue diversion ratio is based on a very low customer diversion ratio (14.9%). This is particularly in circumstances where only 58% of the primary isochrone was affected on Stage 1, market share is just 11.0% and there is a distance ratio of 74%.

2.31 **Newark** - Asda plan to open a new 65,000 sq. ft. store on a redevelopment site on the location of the former Potterdyke car park, 3.55 minutes drivetime from the Acquired Store. Simons of Lincoln, in a joint venture with Asda, have been chosen by the Council to develop the site with the support of the Local Authority. Entry should be sufficient to reduce the 23% revenue diversion ratio to below the threshold currently set.

2.32 **Johnstone -** The CC's objection (with which Somerfield disagrees) to consideration of local market shares in its assessment of mid-range stores (i.e. that the market shares for all groceries include main shopping trips that would not be undertaken at mid-range stores) cannot apply to the assessment of market impact of the acquisition at Johnstone, an OSS. As already noted, the CC Guidelines state that mergers which result in a market share of below 25 per cent are less likely to raise competition concern. Based on the Somerfield market share data, relied upon by the CC as part of its margin concentration analysis, the acquisition in Johnstone results in a post-merger local market share of only 16.9%.

2.33 Furthermore, in the Johnstone isochrone there are numerous opportunities for new grocery retail development. Morrisons have submitted a planning application for a supermarket on a vacant site in Burntville (42,500 sq ft), 0.65 minutes drivetime from the Acquired Store. A planning application has also been submitted by St Mirren Football Club Limited for a new food store within the isochrone. Somerfield believes [CONFIDENTIAL] may be the eventual store operator. The outline application seeks approval for the erection of a Class 1 retail superstore, ancillary car park, landscaping, petrol filling station and ancillary works.

2.34 **Kelso, Roxborough Street -** Not contained within the data previously submitted to the CC is a new Lidl store which opened at Shedden Park Road, Kelso on 9th December 2004 with area of circa 15,000 sq ft gross. The Lidl store is 0.65 mins drivetime from the Acquired Store. It is evidenced in a 14% customer diversion ratio from the NOP survey.

2.35 Pre-merger, Kelso had a Safeway (main shop), a Co-op and a small Kwik Save (discounter). It now has a Somerfield, a Co-op and a much larger discounter. Somerfield suggests that the situation is comparable. This is supported by evidence that sales at the Acquired Store have not increased as a result of the Kwik Save closure.

2.36 **Filey** - Somerfield acknowledges that the CC must consider each store acquisition on its merits and that, technically, the CC is not bound by the decisions or methodology of the OFT in its decisions of the following mergers Tesco/T&S (2002), Tesco/Adminstore (2004) and J Sainsbury/Jackson Stores (2004).

2.37 However, these OFT decisions have cleared the purchase by 2 of the 3 largest grocery retailers in the UK of over 1000 convenience stores. Although the OFT did so after undertaking a review of barriers to entry in the convenience sector generally, there was no specific investigation by the OFT either of population or community sizes serviced by local grocery outlets in relation to any of these 1000-plus stores, nor was there any assessment in relation to planned or potential developments in the catchments surrounding these stores.

2.38 It is widely considered that these momentous decisions by the OFT to allow the unchecked expansion of Sainsburys and Tesco into the convenience end of the market have had the greatest single impact upon the UK grocery retail market in the last 5 years (perhaps excepting the Morrison/Safeway merger). In these circumstances it is utterly perverse, in an Inquiry concerned with just three convenience stores, to override the jurisprudence relating to over 1,000 convenience stores in order to block the acquisition by the fifth largest national player of just one store.

2.39 Specific details relating to other stores are contained in sections 10 and 12.

3. **Substantial Lessening of Competition**

3.1 Section 22 of the Enterprise Act 2002 requires that in respect of completed mergers, the questions which the CC has to answer are:

3.1.1 "whether a relevant merger situation has been created; and

3.1.2 if so, whether the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition within any market or markets in the United Kingdom for goods and services."

3.2 This section considers the legal meaning of substantial lessening of competition by reference to the Act, the CC Guidelines and the decisions of the OFT. These principles of interpretation and then applied to the Provisional Findings in the relevant sections of this Response to establish whether the report properly addresses the issue of SLC and whether its conclusions are justified.

3.3 The Guidelines provide that where the CC has decided that there is a relevant merger situation (as here) it must consider whether the merger results in, or may be expected to result in, an SLC. The CC Guidelines provide:

3.4 *"When doing so it will not be sufficient for the Commission to believe that an SLC is possible: for the Commission to reach an adverse decision either the merger must have resulted in an SLC or the Commission must expect such a result."*[5]

The SLC Test

3.5 The substance of the SLC test was explained by the then Chairman of the CC in 2002[6] in the following terms:

"…any horizontal merger within a market, of necessity, takes a competitor out of play. Does this automatically mean that the SLC test has… been passed? Clearly not, because the merged firm could be a stronger competitor, or because any "automatic" loss of a competitor might not be substantial enough."

3.6 The SLC test requires a comparison of the prospects for competition with and without the merger. A transaction does not lessen competition substantially if there will remain sufficient post-merger competitive constraints to ensure that competition continues to discipline the commercial behaviour of the merger firm.

3.7 The CC sees competition:

"…as a process of rivalry between firms seeking to win customers' business over time."[7]

[5] emphasis added
[6] The Enterprise Act: Aspect of the new Regime Speech to the Regulatory Policy Institute Summer Conference by Dr Derek Morris, Chairman Competition Commission, 27th June 2002
[7] emphasis added

3.8 The SLC test will normally involve four distinct elements:

3.8.1 the market framework within which the competitive relationship of the merged parties can be assessed;

3.8.2 the structure of competition within that framework;

3.8.3 the operational features of competition in terms of external constraints (e.g. from competitors in the market, or in adjacent markets);

3.8.4 if a material SLC risk has been identified the efficiency benefits which might arise to outweigh the risks of SLC.

3.9 In carrying out its assessment in the context of the completed merger, the CC may have regard not only to the post-merger market structure, but also to the post-merger conduct of the merged entity and its anticipated future conduct. In the latter event, it is clear that where the CC is seeking to rely upon speculative arguments as to what the merged entity may do, the burden of proof is higher. Post-merger conduct must, if it is to be relied upon, raise not merely theoretical, but *"specific and substantive concerns*".[8]

3.10 The CC must also consider whether the merged entity will have sufficient incentive to adopt an anti-competitive policy post-merger. In this context, evidence of Somerfield's conduct in analogous situations will be relevant.

3.11 The CC must explain with precision the basis for its concern and adduce compelling evidence supporting its theory. Mere assertions as to possible or hypothetical courses of conduct will not be sufficient. In *Eastman Kodak Company/Bell & Howell* Company[9] the Director General of Fair Trading expressed the point in the following terms:

> "There is a theoretical possibility that the merger would alter Kodak's policy in respect of supply of spare parts. However, it is not clear that there would be an incentive for Kodak to do so since limiting supplies of Minolta spare parts would be likely to affect adversely both Kodak's sale of Minolta equipment and Kodak's share of the servicing market. In any event, any company in Kodak's position would have regard to competition law. …In these circumstances, I consider that recommending a reference to the CC on grounds of a theoretical possibility of Kodak limiting access to spare parts after the merger would be disproportionate."

3.12 The principles of interpretation described in this section are applied to the Provisional Findings in the relevant sections of this Response to establish whether the report properly addresses the issue of SLC and whether its conclusions are justified.

[8] Synopsis Incorporated / Avanti! Corporation; OFT Advice of August 22, 2002
[9] OFT Advice, May 24, 2001

4. Stage 1: Identification of Possible Problem Local Markets

4.1 For its Stage 1 analysis, the CC has identified the relevant product market for this Inquiry as secondary shopping at grocery stores with in excess of 3,000 sq ft sales area but excluding Iceland, Marks & Spencer, the LADs and Symbol groups. The CC has reapplied the geographic markets used in the Safeway report.

4.2 The CC applies a 4 to 3 fascia reduction rule to the primary isochrone in order to identify local markets where acquisitions might be expected to result in an SLC. In addition, applying a conservative approach, the CC carries out the same test by recentring of isochrones around Somerfield's existing stores as well as the Acquired Stores, around competitors' stores and around local population centres (including very disaggregated census output areas). Failure to meet any of these reduction rule tests result in the store in question being passed for consideration under Stage 2.

Relevant Product Market & "Competitor Set"

4.3 The CC defines the product market relevant to the Stage 1 analysis as secondary shopping done at grocery stores above 3,000 sq ft (but excluding Iceland, Marks & Spencer, the LADs and the symbol stores). Somerfield believes that this product market definition is erroneous.

A product market cannot be defined as 'secondary shopping' because a separate product as such is not offered in any store. The conditions of purchase of a product at any grocery retail store are not determined by the shopping mission of the consumer

4.4 This seems to us to be a fundamental conceptual error. Any product market definition exercise must start from a candidate market defined from products that are actually supplied to the market. The CC could start with a candidate relevant market such as 'grocery shopping done at mid-range stores' which exists as a tangible product. In this case the CC would need to consider whether mid-range grocery shops are worth monopolising. The CC's evidence that OSS stores provide the primary constraint on Somerfield strongly indicates that mid-range stores compete in a wider market that includes OSS stores. Therefore, the product market should have been defined as 'grocery shopping at stores above 3,000 sq ft' which can serve as a product market, unlike 'secondary shopping at stores above 3,000 sq ft' which cannot.

4.5 Furthermore, Somerfield does not understand how such a product market definition can be reconciled with the findings of the CC's margin concentration analysis,[10] where based on market shares calculated in relation to all grocery shopping, the CC finds that the markets may be properly defined relevant markets, especially in rural areas.

The CC's claim that its market definition, by only being applied at Stage 1, does not affect the final results of the Inquiry is misleading.

[10] This point is made to show the inconsistency in the CC's approach when its margin-concentration analysis is taken at face value. Somerfield has a number of reservations about that analysis which are detailed in Section 7 of this Response.

The diversion ratio analysis at Stage 2 itself is unaffected by the market definition. However, the CC's complete reliance on diversion ratios at Stage 2 is partly due to reluctance to take account of the market share data presented by Somerfield on the basis that the data does not relate to secondary shopping. Since there are legitimate concerns about producing diversion ratios from the NOP survey, the market shares would provide a useful sense-check to understand whether customers in those locations have credible and suitable alternatives to switch to in response to a worsening of PQRS. See Section 9 below.

The CC's exclusion of some competitors from the market relies on a misinterpretation of the facts and its own analysis.

4.6 Market definition is concerned with own price elasticity of the candidate product group's demand and not about relative or absolute levels of cross price elasticity of Somerfield's demand with respect to other grocery retailers. The CC's finding that the impact of a store opening by one of the excluded competitors is significantly less than that of Tesco or Asda cannot be used to conclude that the excluded retailer exerts an insignificant influence. The fact that the impact of the excluded competitors is significantly less than the impact of Tesco does not mean that the impact of those excluded competitors is insignificant.

4.7 The CC's impact analysis cannot shed any light on the own price elasticity of any candidate product group demand. But even if it were capable of doing so, the threshold for exclusion from the set must be set at an absolute level. In regard to this, Somerfield indicated that it could not understand on what basis the CC proposes to exclude from consideration fascias with adjusted average impacts of -8.8% and -16.3% while including fascias with adjusted average impacts of -9.4% and -11.9%. The CC's response to this is apparently contained at para 6.43 where it states that NOP survey results show that Coop is the second choice for 9% of the respondents where it is present while LADs together constitute a second choice for 5%[11] of the respondents in locations where they are present[12]. However, a second cross comparison cannot justify a comparative approach to a problem which requires setting an absolute threshold in the first instance.

Different treatment of Kwik Save

4.8 Somerfield finds it hard to reconcile the CC's approach to LADs with the approach taken to Kwik Save. Somerfield questions the CC's argument that it is reasonable to exclude LADs but include Kwik Save due to supply-side substitution. If this type of limited range store cannot constrain mid-range stores of Somerfield then, on the CC's analysis, before the transaction the Kwik Save store would not have been constraining the Acquired Store. Therefore, rebranding these stores as Somerfield cannot change the competitive threat faced by the Acquired Store when it is under Somerfield's control. On the other hand, it seems too hypothetical to argue that, absent the transaction, these stores would have been rebranded to Somerfield at some uncertain future period, so the transaction reduces the potential competitive threat to be faced by these would be Somerfield conversions in the future. It is also questionable to

[11] The individual figures are given Aldi 1%, Netto 4% and Lidl 5%.
[12] The CC does not provide information on how these figures were calculated and how "presence" was defined.

describe the re-branding of a Kwik Save store to Somerfield as "supply-side substitution", since the switch requires specific investments to be undertaken, even if the two groups share some common facilities.

4.9 The CC proposes a new argument (at paragraph 6.45) that, in addition to the arguments of supply-side substitution, it is not inconsistent to include Kwik Save in the competitor set but exclude the LADs, because there are 2 instances (Middlesbrough & South Shields) where there is a customer diversion ratio of one-third and one-half[13] to a Kwik Save, which is in excess of any diversion ratio to the LADs. Accordingly, Kwik Save stores "can generally be regarded as more in competition with the acquired stores than the LADs".

4.10 The evidence does not justify that conclusion. Kwik Save is the most established brand in the UK offering limited assortment and it is acknowledged that Kwik Save now carries significantly more SKUs than the LADs. However, the CC acknowledge that where Netto is present and close to the Acquired Store its impact is significant, generating customer diversion ratios of 26% (Bedlington), 24.4% (Birtley) and 32.4% (Doncaster). These results suggest that the CC should reconsider its dismissal of the single but significant Netto Competitor Impact upon Somerfield (18% Impact on Somerfield store turnover).

Exclusion of LADs from the competitor set as an effective barrier to expansion

4.11 The supermarket merger control regime operates as a barrier to expansion for those operators who are not within the competitor set identified by the CC within this and the Safeway report. This particularly affects the LADs who have had problems in acquiring new stores due to site planning and site supply constraints (see paragraph 8 of Netto's third party hearing summary). Netto relies on acquiring many of its new stores from existing retailers.

4.12 On the fascia count analysis adopted in the Safeway report, and at Stage 1 of this Inquiry, the LADs would be at a significant disadvantage (in comparison with any grocery retailer within the defined competitor set) from acquiring a number of stores from that competitor set. Looking at the local market, grocery retailers within the competitor set only have a potential problem where there is an "overlapping" store i.e. where there is an existing store of that retailer in the same isochrone as the store to be acquired. For the LADs, there will always be a reduction in fascia count in an isochrone when a store is acquired from a recognised grocery retailer, except where the selling retailer has 2 stores within that isochrone.

4.13 Wherever that reduction reduced the competitor set from 4 to 3, there would be a problem and, prima facie, the LADs would be restricted from purchasing that store.

4.14 In their submissions and hearings, the LADs have requested to be treated as part of the competitor set. It may be that the LADs are not used to purchasing a large number of stores from a supermarket retailer at the same time but, in relation to this transaction, Somerfield believes a number were interested in acquiring 30 or more stores. Such an acquisition would have exceeded the asset test (£70 million turnover required) for investigation by the OFT under the Enterprise Act 2002. In Somerfield's

[13] In fact, the customer diversion ratios are 23% for Middlesbrough and 41% for South Shields.

view, the regulatory framework should not be structured such as to limit ownership of stores currently providing grocery retail to the restricted "competitor set" defined by the CC.

4.15 With this in mind, the CC will note Aldi's stated plans[14] to "try to dispel its cheap and cheerless image with customers" by investing £500 million over the next five years and increasing its portfolio from 283 stores to 500 in an attempt to gain a 5 per cent share of the market.

Relevant Geographic Market

4.16 The CC accurately represents Somerfield's view on geographic isochrones at paragraph 6.55.

Fascia Reduction rule tests applied at Stage 1

4.17 The CC applies a 4 to 3 fascia reduction rule to the primary isochrone in order to identify local markets where acquisitions might be expected to result in an SLC. In addition, applying a conservative approach, the CC carries out the same test by recentring of isochrones around Somerfield’s existing stores as well as the Acquired Stores, around competitors’ stores and around local population centres (including very disaggregated census output areas). Failure to meet any of these reduction rule tests would mean the store in question would pass for consideration under Stage 2.

4.18 Somerfield has detailed its concerns with the use of fascia count methodology generally in its Main Submission (paragraph 5.5). Somerfield welcomes the acknowledgement by the CC (at paragraph 6.81) that simple fascia reduction does not capture the full competitive effect of the merger. However, Somerfield is disappointed that the CC then decides to replicate the fascia reduction rule tests used in the Safeway report as the best available indicator of competition concerns at Stage 1.

4.19 The CC criticises use of market shares at Stage 1 on grounds that grocery market shares would not reflect its relevant product market (the definition of which is challenged, see paragraphs 4.3 to 4.5 above), as it would include main shopping at OSS stores. The CC dismisses the use of the HHI concentration ratio criterion. However, the CC does not explore why the deficiencies apparent in fascia reduction analysis will be less than if the other methodologies are used. In its working papers, the CC sought to justify use of fascia count as it would be more appropriate than market shares if “convenience” is the primary factor in the consumer’s decision (whereas market share could be valid in cases where “PQRS” factors have motivated choice). Somerfield disagreed with this approach in its response at the time and this rationale is not repeated by the CC in the Provisional Findings Report.

4.20 The deficiencies of the fascia reduction rule when applied to this merger could explain the acknowledged "conservative" approach adopted at Stage 1, by carrying out additional recentred reduction rule tests. However, if a conservative approach is adopted in the first stage of the analysis to capture any conceivable competition problems then this must be balanced by a more critical approach to possible problem

[14] The Times 25 July 2005

areas in the Stage 2 process when evaluating the potential risk of SLC. The CC will see that Somerfield has concerns in this regard in Sections 5 to 8 below.

4.21 In any event, Somerfield questions whether such a conservative approach using extensive recentred reduction rule tests was appropriate in this case. To date, fascia reduction rule analysis has been restricted to assessment of the primary isochrone in all OFT/CC investigations except that leading to the Safeway report. The analysis was justified in the Safeway report because of the recognised market power of participants and limited number of overlapping OSS stores. Accordingly, only 52 stores from a total 481 stores failed these recentring tests. In this case, involving mainly mid-range stores, 67 of the 115 stores fail the tests, reflecting (and discriminating against) Somerfield's proportionately higher number of stores in its portfolio.

4.22 Somerfield expressed these concerns in a letter to the Inquiry Group in April 2005 when it was first decided by the Group to engage GeoBusiness to "verify" the OFT analysis of the merger against the Safeway reduction rule tests. In particular, Somerfield was disappointed that time constraints would mean that this analysis would be the only independent store catchment analysis that would be presented to the Group and that the instruction did not enable Geo Business to review, modify and refine the isochrones used in the Safeway report.

4.23 Somerfield has other objections in principle to the use of recentring analysis:

4.23.1 Through its re-centring analysis, the CC aims to understand whether there is a set of consumers for whom the transaction would raise competition concerns. Somerfield agrees with the ultimate aim but disagrees with the tools proposed. The proposed CC methodology is designed to search for a group of consumers who, if they constituted the “whole market,” would be susceptible to a unilateral price rise. Instead, the approach should be capable of explaining whether those consumers would be facing higher prices or lower quality due to the transaction, which should be the focus of the entire Inquiry.

4.23.2 The SSNIP test methodology was developed in order to avoid basing competitive concerns on a group of (infra-marginal) consumers who do not constitute a market. As long as there is enough competition in the properly defined market, arising from (marginal) consumers who could and would switch demand, there should be no concern for any consumer.

4.23.3 The consumers within the overlap of the catchments of the Acquired Store and the Proximity Store would not face any deterioration in market conditions if both stores face enough competitive constraints in their own catchments.

4.24 Included in the potential "problem" stores at Stage 1 are acquisitions affecting in some cases populations of only 1-5% of the primary isochrone. No evidence is adduced by the CC as to how such a small group of consumers can reasonably be considered to constitute a geographical market. The CC Guidelines[15] require that in

[15] Paragraph 2.25 of the CC Guidelines

considering the geographical market, the test must look to whether SSNIPs of the products would not be profitable, for instance, because customers would switch to products or stores in neighbouring areas. This approach is ignored by the CC.

4.25 3 of the remaining 14 "problem" stores at Stage 2 were only considered a problem at Stage 1 after population recentring. These are: Paisley (16% of population of primary isochrone affected); Poole Bearwood (58%) and Bedlington (90%). At the second hearing with Somerfield, the CC considered that this was a strength of the Stage 1 methodology in identifying problems that would otherwise have gone unnoticed. Somerfield would question its utility where only 3 of the 39 stores identified by the recentring analysis at Stage 1 presented a problem at Stage 2. Also for the reasons given above and its concerns over the robustness of the Stage 2 analysis, Somerfield would urge that the CC revert to primary isochrone analysis and exclude those three stores from analysis at Stage 2.

5. Stage 2: Assessment of Local Effects

Summary of CC Approach

5.1 The principal focus of the CC in this stage is an assessment of potential harm arising from unilateral effects to identify "when a merger enhances the ability of the merged firm to exercise market power independently, without the need to second guess the strategies of other firms in the market"[16].

5.2 The CC proposes to assess potential unilateral effects in local markets through two analyses. The first is based on revenue diversion ratios calculated from the result of NOP surveys involving interviews of approximately 100 people at each of the selected Acquired Stores. The second is to apply a highly simplified and theoretical economic model to the margin data provided by Morrisons and the diversion ratios to show "illustrative price rises" as a result of Somerfield's increase in market share in the local relevant geographic isochrone.

5.3 In addition, the CC undertook a margin concentration analysis, using the margin data provided by Morrisons to see whether there was any relation between those margins achieved and local market shares enjoyed by an Acquired Store and, accordingly, to check the accuracy of the CC's market definition from Stage 1.

5.4 The CC prefers its margin concentration analysis to the price concentration analysis undertaken and presented by Somerfield, because it considers that margins better show the risk of deterioration in any or all of the price, quality, range and service ("PQRS") available from Somerfield if competitive constraints are weakened.

5.5 Both "high margin" and "high diversion ratios" are required before the CC considers that the merger might reduce competition constraints locally leading to unilateral effects. The threshold over which SLC is determined is:

5.5.1 where the revenue diversion ratio is greater than approximately 14% - this threshold is justified by the CC on the basis that as its merger guidelines suggest that mergers which result in a market share of below 25% are less likely to raise competition concerns, a diversion ratio of about 14% seems a reasonable level at which to consider diversion ratios would give rise to competition concerns; and

5.5.2 where the illustrative price rise study for the store shows a price rise of at least 5%.

5.6 The CC identifies eleven "problem" stores that exceed these thresholds. In addition, the CC identifies three stores in Bedlington, Kelso and Littlehampton where the Somerfield owned Proximity Store has been closed since the acquisition and diversion ratios were therefore unavailable. The CC considers that "given that the existing Somerfield stores, now closed, were all located much closer than the nearest one stop shop to the Acquired Stores, [the CC] would expect diversion ratios and potential price rises of the three stores who have exceeded the diversion ratio and illustrative price rise thresholds" set out above.

[16] Paragraph 7.2 of the Provisional Findings

5.7 The Frome, King Street store was excluded from the "problem" store list because of an imminent opening of an Asda store nearby. No other particular characteristics of local markets were deemed sufficient to warrant further exclusions from the list.

5.8 The CC dismisses Somerfield's suggestion that local market shares should be used as a "reality check" against the diversion ratio analysis or that in circumstances where Somerfield's local market share was below a de minimis level, it would not be safe to make a finding of SLC.

5.9 The CC considers that low barriers to entry could not resolve any immediate lessening of competition at mid-range or one-stop stores although it is acknowledged, at paragraph 7.29, that local circumstances vary and barriers to entry may be higher in some local areas than others.

5.10 The CC considers the particular circumstances at Filey mean that it could not rely on new entry for the opening of a new convenience or larger store to resolve any immediate lessening of competition caused by the merger. This was on grounds of a small population and apparently little available retail space. The CC found also that the NOP survey indicated that" a substantial proportion of the Filey convenience store customers use the store for more substantial shopping"[17].

5.11 In the counterfactual, CC finds that if the "problem" stores had not been sold to Somerfield then they would have been sold to other retailers. Accordingly, the proper analysis of SLC was not with reference to the situation had Morrisons retained the stores but in circumstances where those stores had been sold to another grocery retailer.

[17] Paragraph 7.32 of the Provisional Findings

6. Diversion Ratio Analysis

6.1 Somerfield considers that, in principle, the use of diversion ratios as the focus of an assessment of whether SLC may have occurred in any local grocery retailer markets can have real benefits. Unlike the fascia count, which is applied within a fixed isochrone to a limited competitor set, a correct diversion ratio methodology does not disregard the choice of consumers to shop at LADs, Marks & Spencer, Iceland, Symbol groups or specialist shops (in response to a small but significant non-transitory increase in price by the Acquired Store) and it does not disregard those choices where the stores might be outside a defined geographic isochrone.

6.2 In addition, diversion ratios, if applied correctly, will distinguish between the relative "pull" of stores and can, in particular, identify the stronger relative impact an MMGR one-stop store can have in a local market.

6.3 By concentrating upon customers of the Somerfield stores affected, the diversion ratios would also be capable of catching the actual range of shopping missions (main, secondary-top up, convenience, impulse, emergency) undertaken at those stores. This is rather than analysing a single shopping mission (e.g. secondary or top-up shopping) carried out at those stores to the exclusion of all others.

6.4 However, Somerfield is very concerned that the CC is considering a threshold diversion ratio of 14%, in excess of which there would be a presumption of SLC. This threshold is based on a 25% market share at which the CC Guidelines consider potential concerns are raised, but is applied in this case by the CC as a prohibition threshold. In addition the threshold includes no margin for error to take account of legitimate concerns about accuracy and reliability of the results.

The Diversion Ratio Methodology Employed by the CC

The CC's diversion ratios relate to the average customer and not to the marginal customers whose behaviour disciplines Somerfield's PQRS choice.

6.5 The CC calculated the diversion ratios from the replies to the NOP survey. The answer to the question "which store would you have used if this store was unavailable?" coupled with the respondents' spend in the Acquired Store have been used by the CC to compute a revenue weighted diversion ratio. Although Somerfield recognises that the simplicity of this question carries many advantages, it also calls for care in making inferences from it.

6.6 The main problem is that, to be fit for purpose, the diversion ratios need to reveal the behavior of marginal customers and to exclude that of infra-marginal customers, whereas the NOP survey question extracts information on all consumers leaving the Acquired Stores. It is a well established proposition in economics that in a differentiated goods merger analysis, the inframarginal (e.g. brand-loyal) consumers do not play a role in constraining the pre-merger prices, and so their preferences and alternatives should not be used when estimating the diversion ratios[18].

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[18] An ideal survey would overcome this problem by asking two questions to the exit shoppers:

6.7 There are two *a priori* reasons to believe that the NOP survey question might generate results that exaggerate the diversion ratio to the Proximity Store.

6.8 First, given the cost-benefit calculation to the consumer in deciding whether to incur the extra travel costs of going to an OSS store to save money on a shopping basket, Somerfield would expect shoppers who had engaged in high value transactions at the Acquired Store to be more likely to be among the marginal consumers. In that case, a diversion ratio comprising only marginal consumers would have a higher proportion of shoppers who stated an OSS outlet was their next best alternative. This factor applies over and above the value-weighting adjustment that the CC has (rightly) carried out in computing the diversion ratios. Thus, OSS retailers may be under-represented in the CC's diversion ratios, and therefore the Proximity Store may be over-represented.

6.9 Second, some of the customers in the diversion ratio may be there because they have an inherent brand-loyalty to Somerfield. In the present case the Acquired Stores were already operating under the Somerfield brand when the surveys were conducted. This means that customers who are brand-loyal to Somerfield would appear as part of the diversion ratio as calculated through the NOP survey. Had it been possible to conduct the survey when the Acquisition store was owned and operated by Morrisons, these Somerfield-loyal consumers would not have been caught by the survey (to the same extent).

6.10 Somerfield point to the NOP survey result at Kilsyth, which was the only survey where the questions were answered by Safeway rather than Somerfield customers, the fascia not then having changed from Safeway to Somerfield. The diversion ratio to Somerfield is 0% even though the Proximity Store is only 0.63 minutes drivetime away and is the only store in the CC competitor set within 6 minutes of the Acquired Store - the Lidl store (diversion ratio 8%) is about 0.8km away. The Morrisons customer diversion ratio of 34% can be explained[19] by 3 Morrison stores outside the isochrone but all prominently located on routes into Glasgow, including a brand new Morrisons store (c.80,000 sq. ft.) recently opened at Easterhouse, Glasgow.

6.11 In answer to these points, at paragraph 7 of Appendix D (Diversion Ratios) of the Provisional Findings, the CC accepts that the diversion ratios may be different for different groups but dismisses the claim that there is a bias that overstates it. The CC states that "there is no clear reason for diversion ratios to differ systematically between people likely to be more or less price-sensitive." At the footnote to this statement it is claimed that "all customers have a second choice and there is no obvious reason why a more price-sensitive customer's second choice is more likely to be Sainsbury's than is represented by the Sainsbury's diversion ratio in the whole sample".

(a) Would you have shopped elsewhere if the prices in this store had been 5-10% higher? (If not, discard response); and (b) *If so*, where would you have shopped instead? Somerfield acknowledges that in practice there are problems in extracting reliable answers from hypothetical questions about responses to marginal price changes.

[19] It might also be explained by some element of brand loyalty. Although the Acquired Store is trading under the "Safeway" fascia all the own-brand products and carrier bags will be Morrisons. The takeover by Morrisons is well known, so not much should be read into the 1% customer diversion to Safeway.

6.12 This response does not meet the point. Somerfield's argument relates to whether a customer is marginal or not, and not to his/her price-sensitivity. A discussion of price-sensitivity creates obfuscation because other factors may override price-sensitivity in making a consumer infra-marginal or marginal. The CC's point about consumers without cars demonstrates how relative position in terms of marginality can differ from the relative position with respect to price-sensitivity. Contrary to the CC, Somerfield believes that there would be a systematic difference between the customers to which it refers.

6.13 Consider two customers of an Acquired Store. Everything else being equal, the more price-sensitive customer is more likely to move away his/her custom (i.e. behave as a marginal consumer) than the other in response to a price rise. More importantly, for a given set of locations for the customer, the MMGR store and the Proximity Store, the attractiveness of the MMGR store over the Proximity Store increases line with the price-sensitivity of the customer.[20] Conversely, one could argue that for given price levels, the attractiveness of the Proximity Store over the MMGR store would increase in line with the convenience-sensitivity of the customer.[21] However, this is different from the case of price-sensitivity: all else being equal, in response to a price rise a more convenience-sensitive customer is <u>not</u> more likely to move away his/her custom than a less convenience-sensitive one.

6.14 Somerfield's assertion is that higher transaction customers are more likely to move their custom away to an MMGR store in response to a price rise. This is because, at any given level of price-sensitivity, the relative attractiveness of a cheaper but less convenient store increases in line with the amount of groceries bought. First, note that the impact of a 5% price increase on the customer’s decision as to whether to shop at an Acquired Store is greater when the basket to be purchased is larger. Therefore, larger spend customers are more likely to be marginal. Second, such customers are more likely to have an MMGR store as their second best choice because the savings by shopping at the MMGR store rather than at the Proximity store increase in proportion to the transaction size.

6.15 The CC states that Somerfield's arguments on these points are unconvincing. However, instead of arguing why they are unconvincing and seeking to demonstrate that they do not lead to systematic bias the CC points out two instances where it believes that the diversion ratios from the survey understate the true picture. The CC is claiming that the biases about which Somerfield expressed concern may be counteracted by the following factors:

- Customers without a car are more likely to be price-sensitive but less likely to go to an OSS.
- The current diversion ratio underestimates Somerfield market power because brand loyalty is expected to rise amongst Acquired Store customers.

[20] This statement is true whenever the average price level at the MMGR store is lower than that at the Proximity store (which is generically the case).
[21] This statement requires that it is more convenient for the customer to shop at the Proximity Store than to shop at the MMGR store based on his/her transport options.

6.16 Both of these suggestions indicate a misconception by the CC of the marginal customer concept. Taking each of these points in turn:

6.16.1 Does the CC believe that its survey respondents are more likely to be car owners than marginal consumers? If not, the CC's first point above is irrelevant to the question at hand. If the CC believes that there is a bias in its sample which counteracts the bias expected between marginal and average consumers' diversion ratios then it should put forth the reasons for that belief.

6.16.2 The effects of the transaction on Somerfield's pricing will be determined by its effect on the marginal consumers' alternatives. If Somerfield is able to convert marginal consumers to infra-marginal ones by providing a better offer, this is irrelevant for assessing the transaction's potential for an SLC.

Using the NOP survey results requires caution

6.17 Somerfield has urged the CC to be cautious in implementing a decision on ratios obtained from a sample survey because:

6.17.1 The NOP sample sizes at individual stores are quite low – around 100 responses. This makes the results subject to a wide margin for error.

6.17.2 The NOP survey in each store was derived from two weekday slots and one weekend slot randomly chosen. Although this approach represents a serious attempt to replicate the shopping patterns in a store, it inevitably has potential weaknesses. For example, Saturday trading is in general much busier than Sunday trading (and may also include a different mix of OSS and top-up/distress purchase occasions), so NOP's choice of whether the weekend slot for a store was Saturday or Sunday might have a big impact on the diversion ratios. Since stores have different patterns of shoppers on different days and hours, pooling data gathered at random slots may produce a distorted image of the underlying shopping behaviour at these stores.

6.17.3 Different customers may have interpreted the critical question differently. It is possible that some customers declared where they would shop as if they first came to the Acquired Store and then realised that it was unavailable while others might have thought they knew that the store was unavailable before they left their homes;

6.18 Somerfield invited the CC either to build in a margin for reliability in the threshold it adopted and/or where possible to "sense-check" the results that come from the survey against available market evidence (as to the latter, see Section 9)

6.19 The CC responds to this at paragraph 7.7:

"Although, as discussed in Appendix D, revenue diversion ratios are likely to be more variable, not only are the two [revenue and customer] diversion ratios very similar for stores about which we are mainly concerned, but also the customer diversion ratios (for which we have a measure of the statistical significance of the survey results) are significantly above the threshold we use below in identifying competition concerns."

6.20 The first point to make is that the statement is not true. The customer diversion ratios for 2 identified "problem" stores, Poole Bearwood (14.9%) and Whitburn (16.3%), are not significantly above the 14% threshold used.

6.21 Secondly, Somerfield cannot find any logic in the CC's reasoning. Assume, to the contrary of Somerfield's belief, that the CC's claim that the variance of customer diversion ratio for the identified stores is not high enough to cast doubt on whether the real ratios are above the threshold, is correct. The fact that calculated customer diversion ratios are broadly similar to calculated revenue diversion ratios cannot say anything about the potential of the real revenue diversion ratio to be below the threshold (because the latter is likely to have a different distribution from that of the real customer diversion ratio). The customer diversion ratios cannot be used instead for the CC's purposes as they are irrelevant to the predictive price rise formula used in the assessment.

6.22 The statistical measure about the reliability of customer diversion ratios mentioned by the CC appears at paragraph 10 of Appendix D where the CC claims that the underlying distribution for the customer behaviour can be assumed to be Poisson.[22] Approximation by this distribution is convenient (and hence attractive to the CC) because one needs only the mean to understand the distribution (the mean and the variance are the same in this distribution). Therefore, for example, in a case where 16 out of 100 customers say 'Somerfield' the standard deviation will be 4 and with 95% probability the real diversion ratio would lie between 8% and 24%. This assumption allows the CC to say it is rather unlikely that the real customer diversion ratio is below the 14% threshold for most of the eleven identified stores.[23] But the fact that this is the most convenient assumption does not make it correct. Furthermore, this assumption is technically incorrect when the CC is using the variance of customer diversion to infer the variance of the revenue diversion[24].

The theoretic model that forms the basis of the CC's decision relies on strict assumptions that are unlikely to hold.

6.23 The illustrative price rise formulae used rely on four strict assumptions and cannot predict any result for cases where any one of these does not hold:

6.23.1 there is only one Proximity store to the Acquired Store,[25]

6.23.2 the diversion ratios between the two stores are symmetric,

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[22] In statistical theory, Poisson distribution can be used to approximate the Bernoulli distribution of a binomial event when the number of trials is large enough and the success rate is low enough. In contrast, a Poisson distribution cannot be used for a continuous random variable such as the amount of revenue diverted to Somerfield.

[23] Somerfield notes that, taking the CC's assumption at face value, 95% confidence interval would lie entirely above a 14% customer diversion ratio threshold only if at least 24 out of 100 respondents chose Somerfield as the second best. Only six of the eleven identified stores are such.

[24] In contrast to its theoretical applicability to customer diversion ratio variable, a Poisson distribution cannot be used for a continuous random variable such as the amount of revenue diverted to Somerfield.

[25] Only five of the eleven identified Acquired Stores have one Proximity Store.

6.23.3 the revenues of the two stores are the same,[26]

6.23.4 third-party competitive constraints faced by the two stores are the same.[27]

6.24 At paragraph 14 of Appendix D, the CC notes Somerfield's concerns that the underlying assumptions in the derivation of the formula do not hold for the stores where the formula is applied. It is remarkable that the CC is able to dismiss this issue by simply saying that *'the effect of a correct modification[28] could run in either direction, therefore it is reasonable to assume symmetry, in the absence of evidence to the contrary'*.

6.25 On a number of occasions during this Inquiry[29], the CC's logic has been that even if one knows that an assumption does not hold but one cannot second guess how it biases the results, then assuming that it holds is reasonable unless evidence of the bias can be proved. This is unacceptable in sound economic research: formulas are only valid when their assumptions hold, and there can be no justification of their use on the basis that bias could potentially go either way.

6.26 It is not appropriate for a regulator to use a formula without providing any justifications as to why it is applicable and seek to place the burden on the party under investigation to prove that its purely theoretical assumptions do not hold. The burden to show the symmetry or to demonstrate that the real asymmetry would make things worse is on the CC because it is the CC which uses the formula not Somerfield.

The Diversion Ratio Threshold

6.27 The 14% diversion ratio threshold implemented by the CC is extremely low and is over interventionist compared to previous merger policy. There are three main objections to the CC's threshold:

The CC misuses the threshold of 25% at which, under the CC Guidelines, potential concerns are raised by implementing it as the threshold at which SLC is expected.

6.28 The 25% market share threshold in the guidelines is intended to be used as a threshold under which the likelihood of SLC is presumed to be low. Where there is a market share of 25% or above, this is sufficient to raise potential concerns regarding the effect of the merger on competition. However, in the CC's current methodology for this transaction, the 14% diversion ratio works as a prohibition threshold. This is because the indicated price increase formula for isoelastic demand, which the CC uses, would produce a 5% price rise for any margin over 22.6% when coupled with a 14% diversion ratio. To the extent that Somerfield has seen the Morrison/Safeway

[26] In those locations where there is a single Proximity store, the ratio of Proximity store sales to Acquired Store sales are [CONFIDENTIAL] in Whitburn, [CONFIDENTIAL] in Filey, [CONFIDENTIAL] in Newark, [CONFIDENTIAL] in Pocklington and [CONFIDENTIAL] in Peebles.
[27] For example, one of the two Proximity Stores at Paisley is considerably closer to a rival OSS store than the other Somerfield outlets within the catchment.
[28] This is understood to be the result of an analysis including the diversion ratio from the Proximity to the Acquired Store and their relative sizes.
[29] For example, the way the CC seeks to discredit Somerfield's concerns about diversion ratios relating to average customers rather than marginal ones at paragraph 7 of Appendix D and footnotes 60 and 61 at paragraph 5.11 of Appendix B.

margins from the CC's papers, there are no stores with gross margin less than [CONFIDENTIAL][30]. Under these conditions 14% becomes an absolute threshold over which divestment is required. In effect, the CC's approach is equivalent to a per se prohibition on post-merger market shares in excess of 25%. Given the meaning attached to the 25% market share in the CC Guidelines, a methodology which results in using that level as a prohibitive action trigger is unacceptable.

6.29 There is no basis either in UK, EC or US merger policy suggesting that a 25% market share threshold is sufficient to raise a presumption of SLC. Such a low market share is only likely to give rise to difficulties in markets where the market shares of rivals are insufficient to offer adequate competitive constraint in the markets concerned. Having regard to the fact that Somerfield is the fifth largest supermarket chain in the UK and the larger four are represented in or adjacent to the local markets where Somerfield is present, it is obvious that such a situation does not arise in this case.

Taken at face value the CC's logic indicates that 8 to 7 mergers in symmetric conditions should be blocked

6.30 This is a completely new approach in comparison to the CC's past merger policy. Somerfield does not know of any merger blocked in an 8 to 7 situation where the conditions are not extremely asymmetric in favour of the merging parties. In comparison, during the Safeway inquiry where the involved fascias faced similar market conditions, the CC evaluated the proposed mergers by using a 4 to 3 fascia reduction rule in local markets. Somerfield is not inconsistent in raising this argument. Somerfield does not believe that fascia count is the right approach to the current Inquiry, but it would be valid in symmetric conditions. Therefore, both of the CC approaches would be applicable under symmetric conditions. For an asymmetric market, the conflict between the two thresholds is huge.

6.31 At the second hearing it was suggested that the concern in the Safeway inquiry was for co-ordinated effects so the rule developed then is not relevant for the current Inquiry where the concern is for unilateral effects. However, (so far) the CC has not argued why it believes that the concern for unilateral effects arises at lower levels of concentration than the concern for co-ordinated effects. Somerfield's view is that, since co-ordinated effects require the tacit collaboration of a number of competing suppliers, both economic theory and empirical observation of merger control decisions suggest that the concerns of unilateral effects tend to arise at substantially higher levels of market concentration than is the case for co-ordinated effects.[31]

The CC's logic in creating a 14% diversion ratio threshold from a 25% market share threshold is internally inconsistent.

6.32 The CC provides an example at para 7.12 for justifying its diversion ratio threshold. The CC states that a merger between two symmetric firms in an eight firm

[30] One out of the only two stores that have gross margins less than [CONFIDENTIAL] is a net loss maker which makes us believe that gross margins less than that are unlikely to be found amongst Safeway stores.

[31] Our reading of the economic reasoning behind the Safeway analysis is that the coordinated effects concerns were more fully set out in respect of the national effects of the proposed mergers. When it comes to the local market effects, the factors taken into account by the CC appear to us to be at least as well explained by a theory of unilateral effects concern.

undifferentiated product market would create a 25% post-merger market share and would imply a 14.3% diversion ratio.

6.33 A merger between two firms producing homogeneous goods, each having 12.5% of the market, would result in a market share of 25% only if the diversion ratio between the firms is 100% or if the firms behave as if the merger did not occur[32]. In effect, the type of theoretic models used by the CC would predict a 14.3% post-merger share for each of the seven post-merger firms (i.e. market shares would be equally distributed between 7 rather than 8 suppliers). In an undifferentiated market, a firm with twice the market share of another firm will only be observed if the merged firm has lower costs than its rivals or its rivals are capacity constrained. Neither of these scenarios complies with conditions of symmetry.

6.34 In a symmetric undifferentiated market, if the resulting post-merger market share is 25% or more, there must have been at most five firms pre-merger. The symmetric diversion ratio in a five firm market is 25% (i.e. when contemplating a 5 to 4 merger).

6.35 The impact of a low diversion ratio threshold is exacerbated in circumstances of an acknowledged conservative Stage 1 that seeks only to exclude from analysis those Acquired Stores where there could be no prospect of concerns resulting from the merger.

[32] This would require firms to keep their pre-merger strategic variable choices although such choices no longer constitute a market equilibrium in the post-merger environment.

7. Margin Concentration Analysis

7.1 Whereas Somerfield considers the margin-concentration analysis to be, in principle, a valid analysis to have undertaken in order to test whether there is any link between the operating margin of a store and its local market share, Somerfield has concerns that the input data means that extra care should be taken before relying upon the conclusions which, after all, only establish a statistically significant link in rural areas. These concerns are, in particular, that the margins used are Safeway (rather than Somerfield) margins taken during a period of trading uncertainty and the allocation of distribution costs within those margin figures.

7.2 Somerfield has presented evidence that shows that there is a very weak relationship between Somerfield's price levels and concentration. As opposed to those supermarkets that apply single national prices (e.g. Asda, Morrison) with perhaps variations for convenience size stores, (e.g. Tesco, Sainsbury), Somerfield's developed price tiering policy means that a useful insight can be gained from comparing prices with local market shares across Somerfield's estate. The CC has commented on this evidence (see response at paragraph 7.22).

7.3 Instead of pursuing Somerfield's price concentration analysis, the CC has explored an alternative "non-price" theory of competitive harm under which consumers could be given a worse deal through lower quality, range and service ("QRS") in those locations where there appears to be a deficiency of local competition.

7.4 However, the Group has not sought to assess its theory directly by use of any measurable evidence on QRS that could be obtained from Somerfield[33] The only evidence identified by the CC of reduction in QRS by Somerfield is the reduction by one hour of the opening times at one of the stores in Pocklington. This is wholly insufficient evidence upon which to justify an expectation of reduction in QRS to the legal standard.

7.5 In the paper "Somerfield: Statement of Policy on Quality, Range and Service" reproduced at Appendix 4, Somerfield demonstrates that it does not discriminate in its QRS offering between those "monopoly" locations and the rest of its portfolio. The CC therefore has no evidence that Somerfield does in fact reduce service quality when it has a local monopoly, and has not provided any analysis to justify its belief that matters will be different in the identified locations.

7.6 The analysis of risk of increasing price or reducing QRS is in stark contrast to the industry evidence of dramatic improvement of shopping experience. In 2004, 81% of food shoppers considered that their shopping experience had improved over the previous year. In 2003, the figure was 75%[34].

7.7 The IGD Report concludes that the improvements are evident across all elements of shopping experience and that no single theme seemed to dominate:

- 25% of consumers perceived no increase in the price of food

[33] Some examples of which could be labour costs, store refurbishment investments, opening hours and customer satisfaction surveys, as provided by Somerfield, Tab 7 of the First Hearing Materials.
[34] IGD Report - "Grocery Retailing 2004" para 2.4.3

- 20% of consumers more discount stores in the area
- 18% of consumers more supermarkets in the area
- 18% of consumers more special price promotions in store.

Margin Concentration Analysis Input Data & Results

7.8 Previously, Somerfield has noted to the CC that the margins used in its margin concentration analysis do not permit any conclusions as to how the level of concentration affects competitiveness of PQRS offers of grocery retailers. There are three main reasons for this concern:

(i) Variations in margin do not correspond to variations in PQRS offer to consumer

7.9 The margins as used by the CC may reflect both product mix effects and differences in efficiencies of different stores. Even under the same PQRS offer for two stores, one may have a higher margin than the other (i) because its customers buy more fresh produce, or (ii) because its sales per square metre are higher. Such variations are irrelevant for the welfare of the customers of these stores because they face the same PQRS at both locations. However, the CC's analysis treats the situation as if the consumers are getting a worse deal in the higher margin store.

7.10 In response to the first point above, the CC writes that it cannot attach any weight to Somerfield's observation because there is no reason why there should be a systematic bias for customers of higher concentration areas to consume more fresh produce than others (suggesting that on average these effects would cancel out). Furthermore, the CC claims that stores that face less local competition can force their customers to buy more higher margin products by altering their range accordingly. There is no evidence that range is managed in that way. This is another instance that simply because there is no systematic bias, the CC ignores the point completely[35].

7.11 The CC's counter argument for the second point (at a footnote to paragraph 5.11 of Appendix B) is that capacity utilisation may be a choice variable that depends on the local competition faced by the store. Again, the CC has not tested this theory against reality.

(ii) The margins used in the analysis were Safeway's margins.

7.12 In grocery retailing the short-term profit maximising PQRS offer of a retailer is likely to differ from the long-term one. This is because a long-term perspective takes taking into account concerns that do not exist in the short-term. Somerfield submitted to the CC that by using the margins of a grocery retailer which had the intention of selling these stores it was analysing the behaviour of an operator with only short-term interests. This was based on the assumption that the margins were the ones chosen by Morrison after having decided on the sale of the stores.

[35] *See paragraph 6.24*

7.13 At a footnote to paragraph 5.11 of Appendix B, the CC argues that the margins used related to the year ending in April 2004 which was six months before the Somerfield acquisition. Therefore, the CC claims the margins were recorded in a period when the stores were under competitive operation. This information confirms Somerfield's concern that the analysis detects short-term behaviour. According to publicly available information, Morrison's acquisition of these stores from Safeway was completed in March 2004. Therefore, the margins used are not the margins of an operator that decided to sell the stores but they are (mostly) the margins of an operator that has already sold the stores and is running them only until any deal was implemented. This seems a paradigm case where short term behaviour is to be expected.

(iii) Inability to account for distribution costs properly

7.14 It is plausible that remote areas with higher distribution costs may also be areas where concentration is high (i.e. concentration and distribution costs could be related). Therefore, margins which do not account properly for distribution costs can seem to be higher at more concentrated areas even when the retailer provides the same PQRS offer irrespective of the local competition. Since the margins used by the CC allocate distribution costs according to the relative revenues of the stores, the analysis conducted is qualitatively equivalent to one which does not take into account any distribution costs. This is apparent when one writes the margin of a store as derived by Morrisons.

7.15 Let R_i be the revenues, C_i be all the costs except the distribution costs of a given store and let D_T be the total distribution costs and R_T be the total revenues for all stores. Then the margin over direct cost of a store (as calculated by Morrison) is:

$$M_i = \frac{R_i - C_i - \left(R_i / R_T \right) D_T}{R_i} = \frac{R_i - C_i}{R_i} - \frac{D_T}{R_T}.$$

Therefore, the margin over direct cost of each store is the margin of that store without taking into account the distribution costs less a fixed amount (which is same for any store).

7.16 At paragraph 5.11 of Appendix B, the CC asserts that under Somerfield’s claim that the stores in concentrated areas would have higher capacity utilisation (higher sales per square metre), the revenue based allocation of distribution costs may be a reasonable solution to the problem of allocating distribution costs.[36] Somerfield does not understand how this market fact can change the apparent conclusion from the above equation: under the methodology the distribution cost alters all the margins by a fixed amount.

Even at face value the analysis finds an insignificant effect in urban areas and a significant but limited effect in rural areas.

[36] Note that there is no reason why allocating distribution costs relative to revenue would allocate higher costs to higher capacity utilisation stores because relative revenues and relative revenues per square metre are two different variables unless all the stores are the same size.

7.17 The CC should take into account that even taken at face value its own analysis (i) indicates that it is not possible to reject the hypothesis that there is no relation between margins and local concentration for urban stores, and (ii) finds a significant but a very limited relation between margins and local concentration for rural stores.

7.18 The CC's result for the rural stores indicates that a merger from duopoly to monopoly is likely to result in a reduction in PQRS that is much less than the comparable one predicted by the theoretical formula. Considering that the behaviour analysed was one of a short-term operator, one would expect the current merger's effect to be even less. In effect, Somerfield's pricing evidence confirms that both amongst the Acquired Stores as run by Somerfield and amongst Somerfield's whole estate the relation between prices and concentration is much less than the relation predicted by the formula.

7.19 In response to the CC's continued denial of the relevance of Somerfield's pricing evidence, Somerfield suggested that, if it were to continue with its theory about QRS levels, the CC would have to demonstrate why flexing QRS factors with respect to the degree of local competition would be preferable to flexing prices. It would also need to provide evidence to support the hypothesis that such flexing is applied in the grocery retailing sector. In response, the CC provides an analysis based on the relation between the staff costs of the Acquired Stores under their previous ownership and their pre-merger market shares. The CC finds that the stores that command a higher market share tend to have lower staff costs per £1 of sales and concludes that the service offered at such stores is poorer than the service offered at stores with lower market share. Somerfield does not believe that that conclusion can legitimately be drawn.

The CC's service intensity and local competition analysis suffers from ignoring capacity utilisation effects.

7.20 Once again, the CC's analysis clearly suggests that local monopoly stores are more efficient (i.e. they command higher sales per square foot) than others but the CC infers that these stores provide lower service quality. The main problem arises from the fact that the CC uses staff cost per unit of revenue as a measure of service quality.

7.21 The staff cost of a grocery store is a function of its size rather than its revenue. If two stores are the same size then they will have similar labour costs. However, if one of these two is a local monopolist with higher sales per square metre its staff cost per unit of revenue will be much lower. This cannot be considered as proof that the service quality of the monopoly store is lower than the other. It is a measure of efficiency, not service.

The CC's points on Somerfield's pricing evidence

7.22 At paragraph 5.32, the CC rejects Somerfield's price concentration analysis. It considers that, contrary to Somerfield's contention, the relationship between Somerfield's price levels and local fascia count was strong and not very weak because the correlation between the proportion of stores on Somerfield's lowest price tier and the number of competing fascias those stores faced locally was 0.78 for the 97 acquired mid-range stores.[37]

7.23 In its pricing analysis, Somerfield admits that as locations where it is the monopoly provider are more likely to be in rural areas, proportionately higher distribution costs to those stores will mean a higher price tier is more likely in order to achieve minimum store contribution. However, the key point to recognise is that because of competitive constraints, the actual price differential achieved by Somerfield by switching to a higher tier is marginal. If there would be no constraints other than local competition (as assumed by the CC's SLC theory) it is most likely Somerfield would have profited from such marginally higher prices at all of its monopoly locations. The CC's theory falls short of explaining why there are significant number of monopoly stores in the Somerfield estate that are at the lowest price tier. However, such competitive pricing at monopoly locations is fully consistent with objectives of a long-term operator with dynamic concerns.

7.24 Secondly, the CC counters the evidence of average price differentials as it "ignores the ability of the stores facing less competition to stock more expensive items instead of cheaper ones". There is no evidence whatsoever that monopoly or duopoly stores stock goods with higher margins (which is presumably what is meant by "more expensive"). The CC has not sought out this evidence and is thus not entitled to draw this conclusion. It is another example in this Inquiry of ignoring the facts when they confound the theory.

[37] Somerfield does not think that a correlation coefficient which measures whether two series co-move is a good measure for evaluating the strength of a relationship between an explanatory variable and a dependent variable. For example, if the percentage of stores in the lowest price tier decreased by 0.01% for a unit decrease in the number of competing fascia consistently the correlation coeffient would be 1. Somerfield doubts that this would qualify as a strong relationship.

8. Illustrative Price Rise Analysis

8.1 Somerfield has serious concerns about the formula and methodology used to determine "illustrative price rises" as a result of the merger. The model is based on an unjustified assumption that diversion ratios are symmetric between the Acquired and Proximity Stores, even though absolutely no evidence has been collected on the diversion ratios of the latter. Moreover, the CC's decision to use iso-elastic demands rather than linear demands is entirely arbitrary and has a huge impact upon the predicted "illustrative price rises". It also leads to price rise predictions that are patently absurd and unrealistic in some cases, a fact which is seen most starkly in the prediction of a 19-fold post-merger price rise in the Johnstone store. The CC ignores the fact that the predictions of its theoretical model are contradicted by both Somerfield's pricing evidence and the CC's margin concentration analysis on Morrison's data.

It is also disingenuous of the CC to describe these model predictions as "illustrative" only, since they are actually relied upon heavily by the CC in justifying the use of an extraordinarily low threshold for the critical diversion ratio (i.e. the de facto per se prohibition of post merger market shares above 25%).

The difference in the predictions of the two formulae demonstrates the unreliability of the analysis and the lack of robustness in the CC methodology

8.2 The predictive price rise formula for iso-elastic demand (on which the CC based its provisional findings) predicts much higher price rises than the predictive price rise formula for linear demand.[38] This shows how sensitive the CC's methodology is to changes in some of the underlying assumptions.[39]

8.3 There can be no basis to any claim that the underlying demand for groceries at these locations is iso-elastic rather than linear. To reach such a conclusion would require a vast amount of empirical research which would be very difficult to carry out. Most likely, each of these demand functions is as far from the reality as the other. The CC can appreciate that both of these functional forms are used in economic theory mainly due to the simple mathematical derivations they allow for and not because they are supported by empirical findings at large.

8.4 The CC's preference of one formula over the other is purely arbitrary. At paragraph 13 of Appendix D the CC claims that a decreasing price elasticity along a demand curve is a particularly unreasonable assumption for groceries without referring to any particular piece of evidence about the grocery demand. Somerfield strongly disagrees with the case put forth by the CC in favour of an iso-elastic demand. Somerfield also notes that under a demand function such as the one hypothesized by the CC's case (one where price elasticity increases as price decreases), if the demand is differentiable throughout its range (a necessary assumption for the CC's indicative formulas) firms would either be able to make arbitrarily large profits by increasing prices ever higher or they would be pricing at cost (it is not at all surprising that economic theorists have never tried to use such a demand function). Not only are

[38] The ratios of the predictions of the two formulae for the identified stores range from 285% to 5,580%.
[39] In effect, six of the eleven identified stores are below 5% threshold according to the linear demand formula.

both cases distant from any real market evidence, they would also render merger policy unnecessary.

8.5 Somerfield believes that the CC is confusing a continuous aggregate demand curve with separate demand curves for more price-sensitive and less price-sensitive consumers.[40]

The CC ignores the fact that the predictions of its theoretical model are contradicted by both Somerfield's pricing evidence and the CC's margin-concentration analysis based on Morrisons' data.

8.6 One practical way to assess the reasonableness of model assumptions is to sense-check the predictions of the model against viable observations on how the market works before applying it to predict the future. Yet the CC's approach has manifestly failed to do this. If the formula's predictions diverge from market reality for observable periods, then it is likely that its predictions for the future will fail. Somerfield's main concern is that the given formula is derived from unchecked and arbitrary assumptions about key parameters under an assumption of short term profit maximisation for a given market structure while in grocery retailing market players have to take into account a number of dynamic issues such as maintaining a national brand image and threat of local entry.

8.7 The CC has ignored Somerfield's concern that the formula's predictions do not match market reality. The CC has never requested Somerfield, which constitutes an ideal case study due to its flexible pricing policy and diverse estate similar to the Acquired Stores, to provide the data that would allow for a sense-check of its theory. Furthermore, the CC did not pay any attention to the fact that its theoretical predictions do not match the pricing evidence produced by Somerfield. Additionally, the CC neglected the results of its own margin concentration analysis which shows that local duopoly to local monopoly merger would result in a decline in PQRS that is equivalent to a 1.8% price rise. For the same merger, the CC theory predicts a 17% price rise under conservative assumptions of 30% diversion ratio and 25% pre-merger margin.

Somerfield highlights the specific case of the Johnstone store, where the CC model predicts a 19-fold price rise. The model predicts that a 20p tin of tomatoes will go up in price to almost £4 after the merger, even though the store will continue to face competitors nearby.

8.8 The CC states that it does not expect that the formula's predictions to hold one to one. In particular, the CC notes that the formula would predict a price rise for all the stores while it does not expect such an across the board effect in reality. The CC believes that there would not be any SLC if the formula predicts less than a 5% price rise and explains that this is not because a price increase of less than 5% does not qualify as an

[40] The way Somerfield reads the CC case is that at high prices the only buyers are less price-sensitive consumers so increasing prices would not lead to a large loss in demand. However, a price change would not only effect the amounts bought by the current customers (those that buy at the pre-change prices) but would also alter the customer base. Consequently, at such high prices a price cut is likely to bring in more price-sensitive consumers than a price cut at a lower price where these consumers would already be buying. Therefore, a price cut at a high price could lead to a larger increase in demand than one at a lower price and thus demand would be more elastic at higher prices.

SLC, but because of the belief that the factors which the formula does not take into account would not allow for any SLC in those cases. However, the CC does not justify why it believes this would be the case for up to 5% or explain why those other unidentified factors would not intervene above this threshold.

9. **Market Shares in Stage 2 analysis**

9.1 An ideal unilateral effects analysis could be based on diversion ratios alone, dispensing with the need to define the market (and could hence proceed independent of market share considerations).

9.2 However, since there are legitimate concerns about producing diversion ratios from the NOP survey, the market shares would provide a useful sense-check to understand whether customers in those locations have credible and suitable alternatives to switch to in response to a worsening of PQRS.

9.3 If the share calculations show that the Acquired and Proximity Stores account for a high share of the isochrone spending, and that the acquisition creates a substantial increment to that share, this to some extent validates the diversion ratio analysis. It reveals that consumers in that area tend not to use alternative stores, and so may be unlikely to switch demand away.

9.4 But, if the share calculations show that the merging stores together enjoy a small share of grocery spending in an isochrone, that evidence confirms the existence of competing stores, and provides evidence of alternatives and choice. In themselves, these do not prove that the (high) diversion ratios between the merging stores have yielded a misleading story, but unless consumer preferences are very strong the existence of alternative retailers that have attracted a significant share of the spending of households in the proximity does suggest that any risk to consumer welfare arising from the merger must be small.

9.5 For example, the Johnstone store which sits at the top of the CC's list with a diversion ratio of 72% has only [LESS THAN 12%] market share and Somerfield's post-merger market share in that catchment is [CONFIDENTIAL]. This store is defined as an OSS store and it derives more than [CONFIDENTIAL] of its revenues from transactions over [CONFIDENTIAL][41] according to Somerfield's trading data.[42] It is rather curious that 72% of the [LESS THAN 12%] of the catchment's grocery spend see the Proximity store as the next best alternative while [CONFIDENTIAL] of the catchment's grocery spend end up elsewhere. Somerfield would question whether the survey evidence proves that the customers of an Acquired Store face conditions sufficiently different from the rest of the consumers in that catchment. A better explanation is that the evidence is only a confirmation of the rational expectation that in response to the closure of the Acquired Store a Somerfield customer is very likely to go to the Proximity store at 0.67 minutes distance.

9.6 Similar curious results occur elsewhere. The Yarm store has [LESS THAN 12%] market share and Somerfield's post-merger market share within that catchment is [LESS THAN 12%] but the store has a revenue diversion ratio of 22.4%. This store derives [CONFIDENTIAL] of its revenues from transactions over [CONFIDENTIAL]. The South Shields Acquired Store has [LESS THAN 12%]

[41] The CC found that average one stop shopping basket at Somerfield stores included in the NOP survey varied between [CONFIDENTIAL].

[42] This suggests that the market share figures are calculated by application of the relevant denominator for this store.

market share and Somerfield's post-merger market share within that catchment is [LESS THAN 12%] but there is a revenue diversion ratio of 43%.

9.7 The CC's effective reliance on diversion ratios at Stage 2 is partly due to its preference to ignore Somerfield's market shares based on the view that they do not relate to secondary shopping. The CC would seek to exclude main shopping carried out at OSSs from the market share analysis.

9.8 At paragraph 6.20, the CC refer to the 2000 Supermarkets report in which it estimated that 60 to 70 per cent of expenditure in Asda, Morrisons, Safeway, Sainsbury's and Tesco stores was on one-stop shopping. Based on current total grocery market shares of these MMGRs of 73.5%[43] and even without making an adjustment for the increased profile of Tesco and Sainsbury in the convenience sector when compared to 2000, this would suggest that one stop shopping at Asda, Morrisons, Safeway, Sainsbury's and Tesco stores represented between 44% and 51% of the total grocery market. Accordingly, on this analysis the relevant product market identified by the CC in this Inquiry will represent between 49% and 56% of the total grocery retail market.

9.9 Thus, the CC should be very cautious before making a judgement of SLC in circumstances where Somerfield's aggregate local market share post-merger is [LESS THAN 12%]. This is because this would be less than 25% of the relevant product market for this Inquiry and the CC Guidelines make it clear that a merger that results in a market share of less than 25% is less likely to raise competition concerns.

9.10 Somerfield's aggregate local market share post-merger is [LESS THAN 12%] in three "problem" stores: South Shields [CONFIDENTIAL]; Yarm [CONFIDENTIAL] and; Poole Bearwood [CONFIDENTIAL].

9.11 In addition, the CC's objection (with which Somerfield disagrees) to consideration of market shares in relation to mid-range stores (i.e. that the market shares for all groceries include main shopping trips that would not be undertaken at mid-range stores) will not apply to the assessment of market impact of the acquisition at Johnstone. As per the previous paragraph, based on the Somerfield market share data, relied upon by the CC as part of its margin concentration analysis, the acquisition in Johnstone results in a post-merger local market share of only [CONFIDENTIAL]. As per the CC Guidelines referenced above, mergers which result in a market share of below 25 per cent are less likely to raise competition concerns.

[43] TNS Data February 2005

10. **Distance Ratios for closed stores**

10.1 In the absence of diversion ratio analysis for these three stores, the CC has judged the prospective unilateral effects of the merger by comparing the distance between the Acquired Store and the Proximity Store and the Acquired Store and the nearest OSS rival.

10.2 This distance ratio may be defined as follows:

Distance between the Acquired and Proximity Stores
÷
Distance between the Acquired Store and the closest OSS rival

10.3 It does appear extraordinary that Somerfield might be required to divest 3 stores on grounds simply that each is too close to an existing store. It is suggested that a ratio of this kind is likely to work less well than a market share calculation in providing a cross-check against the diversion ratio analysis. This view is based principally on the fact that it constrains the "next best" alternative to be an OSS retailer. OSS retailers have indeed been revealed to be the closest rivals to Somerfield's mid-range stores, but in individual cases it could be convenience stores, LADS, alternative mid-range stores, etc. that provide this constraint as the diversion ratio analysis shows.

10.4 To Somerfield's knowledge, competitive effects in grocery retailing have never before been assessed by measuring distances between stores. It is understood from the second hearing that it was observed by the Group while considering diversion ratios that a high diversion ratio would normally mean a low distance ratio and that higher diversion ratios were almost always found when the distance ratio was less than 40%. Accordingly, when diversion ratios have not been available, the Group has assumed that SLC will occur when the distance ratio is less than 40%.

10.5 However, there are a number of notable exceptions to this observation. The Kilsyth and London Camberwell stores have distance ratios of 9.7% and 10.3% respectively, less than half that of Littlehampton (20.6%)[44] which is classified as a problem by the CC using the distance ratio analysis. Neither Kilsyth nor London Camberwell demonstrated diversion ratios that created a competition concern for the CC. Equally 3 stores have significantly higher distance ratios, Paisley (49.3%), Poole Bearwood (74%) and Yarm (263.4%), yet each produced diversion ratios over the CC threshold.

10.6 Dealing with each of the three in turn and identifying at this stage any other relevant factors:

Bedlington

10.7 There are legitimate concerns over whether the Bedlington town centre will sustain 3 supermarkets (alongside Netto (which commanded a 26% customer diversion ratio) and Somerfield) and a number of convenience stores. See below for trading history of the now closed Proximity Store. Although a number of customers may walk to the

[44] The CC may well have miscalculated the Littlehampton distance ratio. There is a Tesco (25,000 sq ft) located 2.43 minutes from the Acquired Store. At 7.21(c), The CC erroneously state that the nearest OSS is 6 minutes away. There is a Sainsbury OSS 6.08 minutes away.

Acquired Store, many will have access to a car (69% of households) and others to public transport and will be able to visit the Asda (drivetime 3.93 minutes, customer diversion ratio 43%) mentioned in the CC report and another 5 OSS stores within 10 minutes drivetime of the Acquired Store. It is not a requirement that those living in the centre of town are able to walk to at least 3 supermarkets.

10.8 The Proximity Store was closed on 19 January 2005 but a disposal has not yet taken place. The Proximity Store sales area was 6,731 sq ft, the Acquired Store is 11,936 sq. ft. Both stores are on the same street in Bedlington. Pre merger, [CONFIDENTIAL].

10.9 [CONFIDENTIAL]. Even if the Acquired Store had not been purchased it is highly likely, had its performance not improved, that the Proximity Store would have migrated to the closures category at the following quarterly meeting. This meeting pre-dated the acquisition, completed on 24 October 2004, knowledge of which (and the stores involved) was kept to a limited few. The decision to include the Proximity Store in this list was not influenced by the then prospective acquisition.

Kelso - Roxborough Street

10.10 The Proximity Store was trading as a 5,400 sq ft Kwik Save, with sales of [CONFIDENTIAL] per week but on the announcement of Kwik Save's exit from Scotland it was designated for potential conversion to the Somerfield fascia. This had been announced, but before conversion the opportunity to purchase the Kelso Acquired Store arose so Somerfield put the conversion on hold until it knew the future of the catchment.

10.11 This Proximity Store had become marooned as the only trading Kwik Save in Scotland. Somerfield had shut the East Kilbride depot, and were serving this store from Sherburn near Leeds. It soon became obvious to the store's staff that something was awry, and the store sales and profit dropped significantly. Given that the fascia had no future it was a commercial necessity to close the store and this occurred on 25 January 2005. The store has not yet been sold.

10.12 The Acquired Store was a much stronger proposition, with a sales area of 7,400 sq. ft. and reputedly turning over [CONFIDENTIAL] per week (information supplied by Morrison). Recent data reveals the Acquired Store has sales of [CONFIDENTIAL] per week even after the Kwik Save has closed.

10.13 Not contained within the data submitted to the CC is a new Lidl store which opened at Shedden Park Road, Kelso on 9th December 2004 with area of circa 15,000 sq ft gross. The Lidl store is 0.65 mins drivetime from the Acquired Store. It is evidenced in a 14% customer diversion ratio from the NOP survey.

10.14 Pre-merger, Kelso had a Safeway (main shop), a Co-op and a small Kwik Save (discounter). It now has a Somerfield, a Co-op and a much larger discounter. Somerfield suggests that the situation is comparable. This is supported by evidence that sales at the Acquired Store have not increased as a result of the Kwik Save closure.

11. **Low Barriers to Entry at Filey**

11.1 Somerfield has undertaken an investigation of retail space or development space available in Filey.

11.2 Details of available units and sites for possible grocery retail development were sent to the CC under cover of Bill Hull's letter dated 14 July 2005 and are reproduced at Appendix 2.

11.3 Somerfield notes the CC's conclusion that there "seems to be little retail space in the town available for conversion to a new convenience store within a reasonable time frame".

11.4 However, Somerfield believes that it has demonstrated that there are several sites in and around the town centre of Filey that are suitable for conversion to a new convenience store - there are four vacant units. In addition, there are six larger sites which would be suitable for development as convenience or larger grocery stores.

11.5 Somerfield notes the CC's assessment that a "substantial proportion of customers use the store for more substantial shopping missions" but would point out that it is still the case that the majority use the store mainly for convenience or emergency purchases and that this is certainly the case for the day that the interviews were carried out. Somerfield would highlight also that those proportion of customers (43%) that mainly use the Filey Store for main or top-up shopping is significantly lower than the average (67%) across the stores the subject of the NOP survey.

11.6 Somerfield is concerned that barriers to entry in relation to its Filey convenience store have been singled out by the CC as a problem. In the recent OFT assessments of 3 mergers (Tesco/T&S, Tesco/Adminstore and J Sainsbury/Jackson Stores), it was considered that low barriers to entry for stores of 3,000 square foot or less meant that those mergers, involving the acquisition by Tesco and Sainsbury of over 1000 convenience stores, could not amount to a substantial lessening of competition in any of the local markets affected (or operate contrary to the public interest in the case of Tesco/T&S).

11.7 As far as Somerfield is aware, there was no specific investigation by the OFT either of population or community sizes serviced by local grocery outlets in relation to any of these 1000-plus convenience stores nor was there any assessment in relation to planned or potential developments in the catchments surrounding these stores. Somerfield considers it inequitable to receive different treatment in relation to its Filey Acquired Store, particularly in the light of the very significant national market profile of those 2 supermarket chains whose acquisitions have been cleared by the OFT.

11.8 In addition, neither Somerfield nor any of its competitors have been asked about planned or potential developments or land banks in any of the catchments surrounding the Acquired Stores. Nor has there been any assessment of communities served by those Acquired Stores as to whether there is an over or under-capacity of grocery retail servicing those communities. Accordingly, Somerfield suffers the detriment of having to face arguments in relation to Filey that these issues cause a problem where otherwise there would not be, but does not have the prospective benefit of research that might have been discovered as part of this Inquiry that demonstrates that in the catchment of a "problem" Acquired Store, the potential problem may be overcome by low barriers because of under-capacity in that local market, available retail space or imminent or prospective development by a competitor retailer.

11.9 [CONFIDENTIAL].

12. Barriers to Entry in relation to other "problem" store catchments

12.1 Although, the CC considers that low barriers to entry could not resolve any immediate lessening of competition at mid-range or one-stop stores it acknowledged, at paragraph 7.29, that local circumstances vary and barriers to entry may be higher in some local areas than others.

12.2 Accordingly, Somerfield has undertaken planning and survey analysis of a number of the affected isochrones where evidence of imminent or prospective new entry should be taken into consideration by the CC. The full analysis is produced at Appendices 1 and 2. A summary is included below. In this section, Somerfield also includes any other local relevant factors.

Johnstone

12.3 In the Johnstone isochrone there are numerous opportunities for new grocery retail development. Morrisons have submitted a planning application for a supermarket on a vacant site in Burntville (42,500 sq. ft.) 0.65 minutes drivetime from the Acquired Store. A planning application has also been submitted by St Mirren Football Club Limited for a new food store 9.15 minutes drivetime from the Acquired Store. Somerfield believes [CONFIDENTIAL] may be the eventual store operator. The outline application seeks approval for the erection of a Class 1 retail superstore, ancillary car park, landscaping, petrol filling station and ancillary works.

12.4 There are also a number of opportunities to acquire existing vacant units. Somerfield has identified 2 separate ground level vacant units of more than 3,000 sq. ft. that are currently available to let in Renfrew. In addition, the freehold of a 0.61 acre site is available, which could be developed as a supermarket site. Various leases for units ranging in size from 7,627 sq. ft. (gross) to 42,300 sq. ft. (gross) are also available at the Renfrew retail park. The retail park currently has planning consent for bulky goods but, is not letting well. The agents Eric Young & Co. are suggesting that one of the vacant units could be occupied by a food retailer, however this is subject to planning consent for change of use.

South Shields

12.5 There are numerous opportunities to acquire vacant units in the isochrone area. Somerfield has identified 5 units of over 3,000 sq. ft. that are currently available to let, including one unit of 35,791 sq. ft.

Middlesbrough Linthorpe

12.6 Asda has made a planning application to open a 80,000 sq. ft. store just outside the Middlesbrough isochrone, (6.35 minutes drivetime from the Acquired Store). In addition, Asda has obtained planning permission to extend its existing store at Allensway, Thornaby-on-Tees of 44,557 sq ft by 15,000 sq ft The Asda store is 5.4 km from the Acquired Store.

12.7 There are numerous opportunities to acquire vacant units in the catchment area. Somerfield has identified 9 units of over 3,000 sq ft that are currently available to let, including a unit of 30,700 sq ft and a unit of 10,000 sq ft

Pocklington

12.8 A retail space assessment has been sent to the CC and is reproduced at Appendix 4, which demonstrates opportunities available for new entrants in the Pocklington catchment.

12.9 The map shows a number of sites suitable for development in Pocklington. Further information:

12.9.1 East Yorks Motor Services bus depot (green circle 1). The site has been allocated for retail use and is 23,000 sq ft.

12.9.2 East Riding bus depot (yellow circle 4). The site is 1.5 acres and is allocated for retail use.

12.9.3 Pocklington Civic Arts Centre (yellow circle 2). This site includes a vacant retail unit with land to the rear. The site is 15,000 sq ft.

12.9.4 A site that is currently used for a Travis Perkins building materials unit (the planning designation is unknown). However, the site is 15,000 sq ft. and in a very prominent location.

12.10 As noted in the CC's Property Consultants' evidence, supermarkets will target catchments for new entry where there has been a reduction in fascia count from 2 to 1.

Yarm

12.11 Somerfield has identified various grocery retail developments, including land banks, within the Yarm isochrone:

12.11.1 Maritime Road (10 minutes drivetime from the Acquired Store) - Netto has made an application for the construction of a new 16,000 sq ft food store. Permission has been granted and construction has begun.

12.11.2 Carter Steel Site, Yarm Road (4.98 minutes drivetime from the Acquired Store) - Lidl has made an application for a new 17,600 sq ft food store. Permission has been granted.

12.11.3 Whitehouse Farm Shopping Centre, Bishopton Road West (10.46 minutes drivetime from the Acquired Store) - An application has been made for the refurbishment of the former Safeway store, recently purchased by Sainsbury. Permission has been granted.

12.11.4 Pickerings Lifts, Junction of Norton Road and Durham Bypass (14.2 minutes drivetime from the Acquired Store) - A developer led application has been submitted for a 90,000 - 95,000 sq. ft. (gross) retail development including 70,000 - 80,000 sq. ft (gross) convenience floor space. The application remains undetermined.

Paisley

12.12 In the Paisley isochrone there are numerous opportunities for new grocery retail development. Morrisons has received planning consent to erect a Class 1 retail superstore (36,167 sq. ft.) and associated car parking, petrol filling station and car wash facilities at Mill Street/Seedhill Road 1.06 minutes drivetime from the Acquired Store. Somerfield understands that this store is currently under construction.

12.13 A planning application has also been submitted by St Mirren Football Club Limited for a new food store. Somerfield believes [CONFIDENTIAL] may be the eventual store operator. The outline application seeks approval for the erection of a Class 1 retail superstore, ancillary car park, landscaping, petrol filling station and ancillary works, 2.01 minutes drivetime from the Acquired Store. Planning permission has also been granted to MacDonald Estates for a major re-development which includes a new food superstore with ancillary restaurant, offices and storage (63,700 sq ft) 0.31 minutes drivetime from the Acquired Store.

Poole, Bearwood

12.14 Sainsburys has submitted a planning application to extend its existing food store by 6,391 sq ft and Lidl has been granted planning permission to demolish its existing store (with sales floor area of 9,235 sq ft) and replace it with a new store with sales floor area of 11,442 sq ft.

12.15 There is also a vacant unit available to let in the Poole isochrone which is suitable for grocery retailing. The unit is located on a prominent corner site in the main retail area of Winton and has a sales area of approximately 4,129 sq ft.

Newark

12.16 Asda plan to open a new 65,000 sq. ft. store on a redevelopment site on the location of the former Potterdyke car park 3.55 minutes drivetime from the Acquired Store. The site has a boundary to Portland Street, Lombard Street and Pelham Street. Simons of Lincoln, in a joint venture with Asda, have been chosen by the Council to develop the site with the support of the Local Authority. It is understood that initial proposals are for a 65,000 sq ft Asda store together with 20,000 sq ft of other retail. It is understood that Tesco also bid on this site but was unsuccessful.

12.17 Besides the site for Asda's planned new store, Somerfield has identified various other opportunities for grocery retail development in Newark:

Edge of Town Opportunities

12.18 Retail development at Northern Road/Lincoln Road - Proposals for approximately 6,500 sq ft of retail floor space with approximately 22 car spaces. This is a busy route linking the A1 into Newark Town Centre - rents quoted at £13.50 per sq ft.

12.19 Northgate: Adjacent to Northgate Retail Park - There are various sites adjacent to the brewery and Northgate Retail Park that have been cleared and could be made available for retail development subject to planning permission. The site would certainly accommodate a store of at least 15,000 sq ft.

12.20 London Road - This site was sold for redevelopment approximately 2 years ago and currently appears to have a temporary occupier in one half only. The site could be redeveloped to provide approximately 10,000 sq ft of decent quality retail floor space with proper servicing and car parking.

12.21 Queens Road - There is a site opposite the Morrisons' car park on Queens Road which has been cleared. Whilst there is no apparent sign of future redevelopment it would accommodate a 15,000 - 18,000 sq ft food store with car parking.

Town Centre Opportunities

12.22 25 - 25a Cartergate - Situated in the town centre adjacent to Argos, and with servicing, there is approximately 4,500 sq ft of ground floor retail space together with 1,500 sq ft of ancillary accommodation. Whilst there is access to the rear to the car park this may cause operational issues given that this is also the service location. The store presently trades as £5 or Less.com.

12.23 In Somerfield's view it would certainly be possible to find alternative space in and around Newark Town Centre principally along Northgate. In particular, Woolworths is considered by Somerfield as likely to be amenable to a subdivision of their store at Northgate Retail Park following its conversion from Big W.

12.24 There are also a number of opportunities to acquire existing vacant units in the catchment area. Somerfield has identified 2 ground level vacant units of more than 3,000 sq ft that are currently available to let.

Whitburn

12.25 In October 2004 Ecosse Regeneration revealed plans for a £500m Heartlands mixed use regeneration scheme in Whitburn. These plans include 2,000 new homes, a 1.5 million sq. ft. business park and 30,000 sq ft of retail space. Part of this retail space is likely to be available for grocery retailing.

The Counterfactual

12.26 Somerfield has provided a list to the CC of the stores which Morrisons had stated that it had not received an alternative offer to purchase. [CONFIDENTIAL].

12.27 Somerfield has not had sight of Morrisons/Safeway operating margins and does not know what level of contribution the CC is referring to in paragraph 7.43 when it confirms that all but one of the "problem" stores earned a "positive net margin". However, Somerfield doubts that for the [CONFIDENTIAL] stores identified that the contribution would have been sufficient to attract investment from another retailer.

12.28 Other than the [CONFIDENTIAL] stores referred to, Somerfield accepts that alternative purchasers might have been found for the other stores and that, for these stores, it is appropriate to measure SLC with reference to purchase by another grocery retailer rather than ownership being retained by Morrison.