Summary

1. On 23 March 2005, we were asked to investigate the acquisition in October 2004 by Somerfield plc (Somerfield) of 115 stores and other assets from Wm Morrisons plc (Morrisons) (see Appendix A). The purchase of almost all the stores has now been completed. The acquisition involved mainly mid-range stores—those of between 280 and 1,400 sq metres (3,000 to 15,000 sq feet). In making the reference to us, the OFT said that it had identified 22 mid-range stores and one one-stop shop (a store of over 1,400 sq metres) which raised possible competition concerns, and also noted one potential problem convenience store (a store of below 280 sq metres) where it was possible that barriers to entry might be sufficiently low to address the competition issue. Our investigation is not confined to the stores identified by the OFT as raising possible competition concerns.

2. The Somerfield group is the fifth largest supermarket group in the UK with annual turnover of approximately £4.7 billion. It has almost 750 mainly mid-range stores under the Somerfield fascia and almost 500 stores under the Kwik Save fascia. Morrisons is the fourth largest grocery retailer in the UK, operating about 500 stores. The stores with which we are concerned were all acquired following its acquisition of Safeway, on which we reported in 2003. Following that report, Morrisons was required, as a condition of the acquisition of Safeway (which had owned 481 stores), to divest 52 Safeway stores. It subsequently decided to dispose of the 115 stores whose acquisition by Somerfield we now have to consider. All of these stores had been acquired from Safeway but only two (at Loftus and Beverley) came within the 52 stores it was required to divest. The sales of the 115 stores for the 12 months to 31 March 2004 were £860 million (including VAT). We have

concluded that the acquisition has resulted in the creation of a relevant merger situation.

3. The focus of the 2003 Safeway inquiry was on larger stores. In contrast, in this inquiry the vast majority of the acquired stores are 'mid-range' stores and Somerfield, in particular, argued that a fresh look should be taken at the methodology previously used. Against this background we examined the methodology used in previous CC inquiries into mid-range stores; and considered the evidence from Somerfield and others on whether and, if so, how mid-range stores might be assessed on a different basis from that used in previous inquiries. We then determined a methodology appropriate to this inquiry.

4. We had no concerns that the merger would adversely affect competition at a national level. At a local level, as is apparent in much of the evidence we received, there is a considerable diversity in the particular characteristics of mid-range stores and the local markets they serve. We therefore adopted a two-stage approach. In Stage 1 we identified relevant product and geographic markets, and a rule that could be applied to identify those possible problem markets in which there may be some initial concern that the transaction may result in a substantial lessening of competition (SLC). We deliberately adopted an inclusive approach to ensure we captured all of the acquired stores where there may be a potential competition problem. In Stage 2 we then carried out a detailed competitive assessment of each of the local markets thus identified.

5. In examining these issues we considered a wide range of evidence including that on the local impact of competitor openings and on the margins of

individual stores and the extent to which higher margins were associated with higher local concentration.

6. In order fully to evaluate local markets, we also commissioned a survey by NOP of customers at 56 of the acquired stores. These surveys provided information not only on the current shopping patterns of consumers, but also how they would react if the acquired store were not available.

7. In Stage 1, we defined the main product market with which we were concerned as the market for secondary shopping, which includes 'top-up' and 'convenience' shopping, as distinct from 'one-stop shopping' with which the 2003 report was primarily concerned. Such secondary shopping is supplementary to the regular main shop carried out by most households, and from stores where accessibility for shoppers is of more concern than the wider range or lower prices available from one-stop shops. But to the extent that one-stop shopping is also carried out at mid-range stores, this was also relevant to our analysis. The evidence we saw suggested that larger stores are effective substitutes for mid-range stores in the secondary shopping market, although mid-range stores are poor substitutes for large stores in the one-stop shopping market. As the effective competitors to the mid-range stores of Somerfield, we took stores of 280 sq metres (3,000 sq feet) and above of Asda, Budgens, Co-op, Morrison/Safeway, Sainsbury's, Tesco and Waitrose, thereby including one-stop shops but excluding convenience stores. We first identified local markets with reference to drive-times of 5 minutes around the acquired stores in urban areas (but taking into account the significant proportion of shoppers who walked to the stores in urban areas, for whom we used an equivalent drive time had they instead driven), and 10 minutes in rural areas. Additionally we examined the effects of the

merger on similar areas around existing and competing stores, around population centres, and also around more closely defined areas where the population of shoppers lives. We identified for further investigation those local areas where the number of such competing fascias would be reduced to three or below as a result of the merger.

8. In Stage 2 of our analysis we sought a measure of the degree to which the existing Somerfield stores and the acquired stores under the ownership of Safeway or Morrisons had been rivals locally prior to the transaction. A good measure of the degree of rivalry is the diversion ratio between them—ie the proportion of revenue from customers who would choose the other store as their second choice, in preference to other local stores. To estimate this effect we used the results of the survey to calculate diversion ratios, which measure the extent to which, if the acquired store were not available, shoppers would divert to an alternative Somerfield or Kwik Save store, or to another store, and the effects on revenue of their doing so. We included diversion to all other stores, not just those within the markets identified at Stage 1: ie we included stores outside the local areas as defined above, other sizes of store and other fascias, enabling us to take local characteristics into account. But we also considered evidence on the gross margin of the stores, the potential for any increase in price or equivalent deterioration in quality, range or service after the merger, and other evidence on the local markets.

9. We identified 14 stores, whose acquisition, in our view, had significantly reduced competition. They included three acquired stores where, following the merger, Somerfield had closed its existing stores, located close to the acquired stores, but where Somerfield still retains its interest in them. We did not feel we could rely upon the prospect of new entry to resolve any lessening

of competition in any of these 14 areas. One of those stores, about which we were concerned, was a convenience store, at Filey; in the particular circumstances of that town, we considered that we could not rely on new entry from the opening of either a new convenience store, or of a larger store.

10. We therefore concluded that the acquisition may be expected to result in an SLC in each of the local markets served by those 14 stores, resulting in higher prices, or reduction in quality, range or service. In addition, we concluded there would be the adverse effects on customers in those markets from a reduction of choice between competing stores, for example between different prices available for particular products, or between different quality or range of goods on offer or service provided. The stores (all mid-range stores except for the convenience store at Filey and one-stop shop at Johnstone) are as follows:

- •Bedlington
- •Filey
- •Johnstone
- •Kelso
- •Littlehampton
- •Middlesbrough Linthorpe
- •Newark
- •Paisley
- •Peebles
- •Pocklington
- •Poole Bearwood
- •South Shields
- •Whitburn (Scotland)

- Yarm

11. We are separately issuing a notice of possible remedies to the SLC and to the adverse effects on customers we have identified.