

The counterfactual

Introduction

1. As part our inquiry we consider what we would expect to happen in relation to the provision of football pools games in the UK if the anticipated merger between Sportech and Vernons were not to take place ('the counterfactual')—see paragraphs 6.1 to 6.12. This Appendix provides additional background information on the counterfactual. First we consider the evidence relating to Sportech and then the evidence relating to Vernons.

Sportech

2. In recent years Sportech has undergone a period of major management change and restructuring in order to dispose of certain loss-making businesses. As a result it has become a company primarily focused on its football gaming business (Littlewoods and Zettors Pools) and has stated its commitment to reinvigorate and grow that business (both organically and via the anticipated acquisition of Vernons).
3. In its first hearing, Sportech told us that its strategy was to invest in the business, halt the decline in turnover and grow the business, and it provided us with some details of the ways in which it intends to invest in its pools business in order to modernize its appeal and workings. We do not consider these further.
4. There are, however, four particular issues that we have investigated as part of our inquiry, which will (or may) be a feature of Sportech's football pools business without the merger and which are considered below for any implications they may have in the counterfactual. These are:
 - (a) the future of the Littlewoods collector network;

- (b) the expiry of Sportech's current licence to use the Littlewoods name (and trademarks) in 2010;
- (c) the question of whether Zettlers would be shut down or merged into one pool with Littlewoods; and
- (d) Sportech's recent increase in the entry price of Littlewoods and Zettlers pools.

The Littlewoods collector network

- 5. Vernons closed its collector network in 1998. The Littlewoods collector network accounts for roughly half of Littlewoods' turnover. Consequently any decision to close it (in the same way that Vernons did) could significantly reduce Littlewoods' market share. Sportech has told the CC that it has no intention of closing the Littlewoods collector network.

- 6. Sportech told us that it intended to improve and extend its channels of distribution, taking full advantage of developments in technology in doing so. In particular, it intended to retain and modernize its collector network—in spite of the disadvantages currently associated with it (customers of the collector network are declining at over twice the rate of direct customers). Sportech considered the collector network to be an important attribute that differentiated its pools products from Vernons and from the National Lottery, and in particular allowed it unique access to sell a gambling product to people in their own homes.

Sportech's licence to use the Littlewoods name

- 7. Sportech's licence to use the name Littlewoods and various trademarks, which are owned by Littlewoods Limited (part of the Littlewoods Shop Direct Group), will expire in 2010.¹ There is some uncertainty over whether Sportech might be successful in

¹Littlewoods Limited and Littlewoods Pools do not share common ownership.

renewing the licence to use the Littlewoods name for football pools and also whether Littlewoods Limited could in some way exploit it.

8. In order to address these issues, Sportech is currently researching a new brand name, which it expects to be able to launch in late 2007.² By addressing the issue so far in advance of the deadline, Sportech management consider that they [X] or alternatively will be able to minimize the risk of losing business, if extension or renewal of the licence does not prove possible, by migrating existing customers over an extended time frame.
9. Littlewoods Limited told us that it would be happy to see the proposed merger proceed, and did not anticipate that it would be directly affected to any material extent either way.

The continued existence of Zettors

10. Zettors Pools is currently profitable, although Sportech told us that this was only because it was able to merge almost all the fixed costs of the Zettors business with Littlewoods. Accordingly, the cost savings from closing down the Zettors business altogether are likely to be marginal.³ Sportech told us that with full allocation of costs, Zettors would not be profitable without the Littlewoods infrastructure, and that Zettors would not survive as a stand-alone business.
11. Furthermore, Zettors still has a loyal following of customers (albeit declining). Sportech told us that if the merger went ahead, in the short term, it would probably retain each of the three pools brand names, but would seek to make the product offering more attractive by [X], whilst retaining the different entry price levels and the

²2006 Report and Accounts, p9.

³Sportech has indicated no intention that it will do so to the CC.

prize structure of each brand. We would therefore similarly expect Zettlers to continue as a separate, differentiated brand and product without the merger.

Sportech's decision to increase its pools entry prices

Introduction

12. This section of the appendix considers the history behind Sportech's decision to increase its pools entry prices. In particular, it examines Sportech's stated position that this decision is unrelated to the merger, and considers whether or not it would still have happened without the merger.

The proposed increase in prices

13. Sportech told us that it was currently in the process of seeking to raise the average price per line of Littlewoods and Zettlers by 25 per cent primarily by increasing the price of an 8-from-10 bet (the most popular combination) by 25p (33 per cent) from 75p to £1, thereby matching the price of a lottery ticket. We have been told that the implementation of that process began in mid-May 2007 with direct customers and is expected to be substantially complete by 22 September 2007 when it will be rolled out to the collector network. Smaller percentage increases will be implemented in other products (ie 8-from-11, 8-from-12).
14. Sportech provided us with slides from an internal presentation (prepared for a board meeting on 31 August 2006) entitled 'Sportech/Wembley Merger Models'. Sportech's plan to acquire Vernons was originally code named 'Project Berry' and then subsequently 'Project Wembley'. Under the heading 'Sportech: Key Trading Assumptions' the proposed price increase is discussed in some detail. Sportech told us that it assumed that following the price increase there would be an immediate net decrease in customer numbers of [§<] per cent. Sportech told us that it believed this would be a short-term effect and that it anticipated that an increase

in customer numbers would result in the long term as the product became more attractive.

15. Sportech told us that the price increase would be introduced simultaneously with product enhancements and [REDACTED], but that the principal intention was to increase the prize pool, the jackpot (first dividend) and profitability. The Littlewoods jackpot has been in long-term decline and Sportech management considered that if it were to fall below [REDACTED] the negative impact on the business could be significant. Sportech argued that a sustained increase in the jackpot could be effective in arresting the cycle of decline in Sportech's football gaming business.

16. However, we note that, following the price rise, a net customer loss is still predicted, which indicates that the positive effect of the enhanced prize fund is not expected to outweigh the negative effect of the price rise sufficiently to make the pools more attractive to customers on balance, at least in the short term. This is consistent with survey evidence that customer awareness of prize levels is very low. Sportech has, however, provided us with evidence which it believes demonstrates that in the long term this strategy will attract new customers as a result of the improved product offering.

17. No change in the Littlewoods or Zettlers payout ratios of (20-25) per cent is currently proposed. However, in the presentation mentioned above, a note to a table setting out synergy benefits reads 'Merge price [sic] funds, reduce Wembley to [REDACTED]%. Assuming that 'price' here is a typing error for 'prize', the note implies that Sportech plans to reduce Vernons' payout ratio to [REDACTED] per cent. Sportech told us that Vernons had recently decreased its payout ratio to [REDACTED] per cent, but evidence we have received from Vernons indicates that it should meet its target average payout

ratio for this year, which is set at a level above [redacted] per cent. Vernons told us that it intended to reduce its payout ratio to [redacted] per cent next year.

The timing of the proposed increase in prices

18. We have received contemporary documentary evidence in the off-the-shelf material (and in subsequent submissions) about the timing of Sportech's intention to increase the price of Littlewoods pools, which is summarized below:

- (a) Email correspondence from 11 August 2006 onwards between the Sportech Finance Director and Finance Executive includes a number of versions of a financial model setting out a three-year forward-looking view of Sportech's revenue and profit as well as a ten-year forward-looking view based on an assumption that there would [redacted].⁴ [redacted] The financial model was produced for and in advance of a strategy presentation⁵ and discussion at the board meeting on 31 August 2006.
- (b) Slides from the strategy presentation given to the board of Sportech on 31 August 2006 (and referred to in the board minutes) entitled 'Sportech/Wembley Merger Models' refer to price increases of 25 per cent for Littlewoods on 4 August 2007, for [redacted] and (significantly)⁶ for Vernons 12 months following the acquisition.
- (c) In an email (part of a series) dated 23 November 2006, the Chief Executive of Sportech confirmed that the 2007 price increase was definite and should be included in the 2007 budget. Sportech told us that this email was intended to confirm an instruction to the operational pools team to draw up a budget which reflected the price increase.

⁴We have been told by Sportech that the three-year plan was produced on a notional basis and that the ten-year plan was 'highly speculative'.

⁵The three-year view (although not the ten-year view) was used as part of the strategy presentation.

⁶Sportech told us it did not consider this to be significant in that it would review the position on Vernons prices once it had completed the merger and had more information on Vernons customers.

- (d) A presentation entitled 'Budget Summary 2007' refers to a pools price increase of 25 per cent as one of the 'budget assumptions'. Sportech told us that this was presented to the board in January 2007. Similarly another presentation (also presented to the board in January 2007 according to Sportech) entitled 'Business and Budget Objectives' refers to 'the second price increase in thirteen years'. It is also evident from spreadsheets supporting the budget itself that the [REDACTED].
- (e) Finally Sportech submitted to us a recent sample Pools Direct (subscription) renewal form, including reference to the forthcoming price rise and a number of promotional offers designed to offset its impact. Sportech told us that these forms were currently being sent to customers.

The timing of the decision to acquire Vernons

19. We have also received oral, written and contemporary documentary evidence (primarily board minutes) from both Sportech and Vernons about the process and timing of Sportech's intention to acquire Vernons, which is summarized below:
- (a) According to Sportech board minutes, the opportunity to acquire Vernons was discussed at meetings held with Ladbrokes, under [REDACTED], between [REDACTED] and its acquisition had been considered [REDACTED]. However, subsequent board minutes conclude that [REDACTED] based on due diligence carried out by Sportech. [REDACTED]⁷
- (b) [REDACTED] However, in the second half of 2005 there was a significant change in the management team at Sportech. From late 2005 to mid-2006 a new CEO, Finance Director, Marketing Director and Managing Director of the pools business and Chairman of the board were appointed. Sportech told us that this new management team embarked upon a strategy of eliminating loss-making businesses, reducing debt and concentrating on establishing a strategic and

⁷[REDACTED]

operational direction for the core business of football gaming activities. [REDACTED] Hilton/Ladbrokes were also engaged in the sale of the Hilton hotel business, which occurred in January 2006. According to the minutes of the board meeting of 31 May 2006, the new (current) Chief Executive of Sportech had met with his opposite number at Ladbrokes (confirmed in Ladbrokes' initial submission). At the board meeting of 27 June 2006 one of the directors requested a 'complete view of the Vernons opportunity' and following the strategy presentation at the board meeting on 31 August 2006 the acquisition of Vernons was described as a [REDACTED].

(c) Sportech then [REDACTED].

(d) Following [REDACTED].

20. Sportech told us that the price increase was now under way despite the fact that the merger remained uncertain (dependent principally on the outcome of this inquiry). The implementation of the price increase began in mid-May 2007, with customers in its direct channel being contacted as their 'subscriptions' came up for renewal. By late July some [REDACTED] customers had been informed of the change and plans [REDACTED].

21. Arguably, however, the key date for both strategies is 31 August 2006 since this is when the price increase was presented to the board of Sportech with a model and when the decision to make a new offer for Vernons ([REDACTED]) was taken by the board.

Vernons

Potential owners of Vernons

22. Ladbrokes told us that it considered there to be [REDACTED].

23. Ladbrokes told us that [REDACTED].

24. We cannot rule out the possibility that without the merger Ladbrokes may choose to sell Vernons to a third party (or Ladbrokes itself might be acquired by a third party). However, since any potential purchaser (excluding Sportech) would not be involved in football pools, there would not appear to be any implications for market structure in the counterfactual.

Vernons' strategy without the merger

25. Vernons told us that if the merger did not go ahead [REDACTED]
[REDACTED]
26. Ladbrokes sent us [REDACTED].
27. Ladbrokes considered that the [REDACTED].
28. By way of illustration, if Vernons Pools turnover fell by 10 per cent a year ([REDACTED]), it would take 17 years to reach a turnover of £[REDACTED] (from a projected turnover of £[REDACTED] in 2007). If it fell by 20 per cent a year, it would take eight years.
29. Notwithstanding Ladbrokes' comments, we noted that Zettlers is currently operating profitably (as part of Sportech and dependent on the Littlewoods structure) with a turnover of £[REDACTED] a year, and Brittens Pools, which is independent, told us that it still operated profitably with annual turnover of around £400,000, although we have not seen any financial information relating to it.