

Observations regarding the competition assessment of future mergers in the grocery retailing sector

Introduction

1. In Emerging Thinking, we stated that: 'We recognize that the approach used in this investigation to define the market for the retail supply of groceries may also guide future merger activity among grocery retailers' (paragraph 85).
2. Since that time, a number of parties have asked us to provide some guidance on our views of the implications of our analysis, both with respect to market definition and, more generally, for mergers. We also recognize that there is some likelihood of merger activity in the UK grocery retailing sector in the short to medium term, which might involve assessment under the merger control provisions in the Act.
3. The intention behind this appendix is to benefit interested parties by:
 - (a) explaining our view that the parameters of the 'competition test' should not be applied when conducting a competition assessment of mergers under the Act in grocery retailing; and
 - (b) providing views on how the analysis in this report might otherwise bear on the competition assessment of future mergers under the Act.
4. It is important to stress that the contents of this appendix should be read merely as observations. Regard should also be had to recent OFT merger decisions involving grocery retailing.¹ Moreover, merger analysis is necessarily very fact-specific (as the Tesco Slough case clearly demonstrates).² As such, this appendix should in no way be read as fettering the judgement of the OFT and future CC groups in individual cases.

Differences in analysis between mergers and market investigations

5. When considering the implications of the analysis in this report for future mergers qualifying for investigation under the Act, it is also important to remember that there are significant differences between the frameworks for merger inquiries and market investigations. These differences have a significant effect on the analysis undertaken by competition authorities, and they may limit the extent to which findings in this report can be read across to the analysis of mergers.
6. An important basis for the distinction is that, under the Act, merger inquiries and market investigations involve the application of different statutory tests. When assessing a merger, the Act requires the OFT to consider whether it is or may be the

¹Co-operative Group (CWS) Limited/United Co-operatives Limited (23 July 2007); Anticipated acquisition by Tesco Stores Limited of two former Kwik Save Stores (Audley and Dudley) (30 October 2007); Completed acquisition by Tesco plc of five stores (Thurso, Bedlington, Little Lever, Ramsbottom and North Hykeham) from Somerfield plc (5 December 2007); Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson) (11 December 2007).

²In November 2007, the CC published its report into the completed acquisition by Tesco plc of a store operated by Co-operative Group (CGL) Limited in Uxbridge Road, Slough ('Tesco Slough'), in which it found that the acquisition substantially lessened competition in the retail supply of groceries by larger grocery stores in the Slough urban area.

case that, and the CC to decide whether, a transaction has led to a substantial lessening of competition in a relevant market. In contrast, the market investigation regime involves the CC in assessing whether there are features of a relevant market which prevent, restrict or distort competition in connection with the acquisition or supply of goods or services.

7. In addition, merger inquiries are intended to assess (and, if necessary, remedy) the effect of a transaction on competition in affected markets and customers within those markets. A market investigation is tasked with analysing if competition in a market is working effectively (and if it is not, with implementing remedies to address 'features' and thereby increase its effectiveness or prevent detriment to customers). Merger control, meanwhile, cannot be used to solve competition problems that are unrelated to the merger and its impact on competition.

'Competition test' is not an appropriate benchmark for merger review

8. The differences in analysis between mergers and market investigations have important implications for the applicability of the 'competition test' rules to mergers. As part of our remedies package, we have recommended that the OFT should apply a 'bright-line' *competition test* in respect of planning applications for new grocery stores, as a statutory consultee (see Section 11). Applying certain rules (based on the number of fascias within a 10-minute isochrone and a retailer's share of floor space), the OFT would advise a local planning authority on whether a retailer should be allowed to operate a new grocery store on competition grounds. A similar test would be applied by the OFT when deciding whether to order a retailer to release a restrictive covenant or whether to order a retailer not to enforce an exclusivity arrangement.
9. However, for a series of reasons, we do not consider that the parameters for the competition test are an appropriate guide to, or in any way a proxy for, when, under the merger control rules, a transaction should be regarded as leading to a 'substantial lessening of competition':
 - (a) First, the competition test is designed to address the adverse effect on competition arising from the features of the reference market(s) listed in Section 10 of the main report. As noted in paragraph 6, the test to be applied under the Act in the assessment of mergers is quite different, being one of substantial lessening of competition.
 - (b) Second, when considering the calibration of the competition test, we have expressly had regard to the need for more 'lenient' treatment of the construction of new stores compared with an acquisition that eliminates direct competition between two rival enterprises (ie a merger). New store construction involves entry and the creation of extra capacity, which can in turn bring consumer benefits. In our remedies package, control on entry is sought principally because of other factors, such as the planning regime, which act as barriers to entry and render suitable sites (and thus entry possibilities) scarce.
 - (c) Finally, it must be noted that, in the interests of practicability and ease of application for the OFT, we have sought to make the competition test 'bright-line' and clear. In contrast, merger analysis of an individual transaction may often be more extensive and nuanced (although the degree of examination which can be given to the effects of the transaction in any one local market will depend on the number of local markets being reviewed).

Applicability of individual elements of this report to future mergers qualifying for investigation under the Act

10. In our view, the evidence collected and findings made in this report may have relevance to the competition assessment under the Act of future mergers in the UK groceries retailing sector. For example, it may be appropriate for competition authorities to apply the *market definition* (both product and geographic dimensions) discussed in Section 4 of the main report, provided grocery retailers do not significantly reposition their brands. In particular, material changes to the product range of an LAD might result in it being appropriate to consider its inclusion in the larger grocery stores or the mid-sized and larger grocery stores product markets. The market definition adopted in this market investigation is, in many ways, similar to that used in previous inquiries by the CC, including the 2000 investigation, and the Safeway and Somerfield merger inquiries. However, market definition elements emphasized in this report more than in previous reports include:
 - (a) competitive constraints in relation to grocery retailing are asymmetric, as larger grocery stores place a greater constraint on mid-sized grocery stores and convenience stores than vice versa;
 - (b) the lower boundary for larger grocery stores in terms of floorspace may vary between 1,000 and 2,000 sq metres; and
 - (c) local geographic markets should be defined in terms of collections of competing stores, rather than by localities.
11. In our view, the assessment under the Act of mergers in grocery retailing should involve a detailed analysis of the features of individual stores and local topographic features, in order to ascertain more directly the competitive constraints that grocery stores actually impose on each other. In its decision in Co-operative Group (CWS) Limited and United Co-operatives Limited,³ the OFT took account of the extent to which the merging operators' grocery stores acted as a competitive constraint on one another by considering diversion ratio analysis, following the approach adopted by the CC in Somerfield. Tesco Slough emphasized the importance of looking at variations in competitive constraints within local markets for grocery retailing—in that case, a key basis for the CC's decision was the finding that the Uxbridge Road store/site acquired by Tesco was the closest competitor to Tesco's expanded store in Brunel Way.
12. This approach will clearly be feasible where a limited number of geographic markets are affected. In inquiries involving a much larger number of stores, such as the 2000 investigation, the current market investigation or the Safeway merger inquiry, it may be appropriate to apply 'filters', based on approximations of the boundaries of markets, in order to identify those markets which may raise competition concerns. In the present inquiry, filters have been used to identify highly-concentrated local markets (see Section 7 of the main report). Clearly, the precise settings of a filter will depend on the purpose for which it is applied. However, the criteria used in the filters detailed in Section 7 of the main report to identify markets for more in-depth analysis, being drive-time, number of fascias and retailers' share of floorspace, are likely to be appropriate. In a merger situation it may also be appropriate to consider the change in concentration to indicate the change in market power as a result of the merger.

³www.of.gov.uk/shared_of/mergers_ea02/361227/Co-op.pdf (date of decision 23 July 2007).

13. We consider that the report's analysis of *barriers to entry* may also be applicable to competition analysis of future mergers. However, the importance of certain barriers might vary in particular local markets. In particular, we recognize that, where it is feasible, a competition authority might wish to seek evidence from the parties and local planning authorities regarding the availability of alternative sites for grocery stores.⁴

⁴The CC in *Tesco Slough* concluded as follows: 'On the basis of the evidence from Slough Borough Council, we do not expect any sites in Slough that are suitable for the construction of larger grocery stores to become available in the medium term' (paragraph 7.69).