COMPETITION COMMISSION

Somerfield plc and Wm Morrison Supermarkets plc

A report on the acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc

September 2005

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Note by the Competition Commission

The Competition Commission has excluded from this report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002. The omissions are indicated by [✄].

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The acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc

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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 Office of Fair Trading (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 plc (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 (referred to as one-stop shops). 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 World (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 Safeway 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 Stores Limited (Asda), Budgens Stores Limited (Budgens), Co-op, Morrisons/ Safeway, J Sainsbury plc (Sainsbury’s), Tesco plc (Tesco) and Waitrose Limited (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 margins 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. In our Provisional Findings, 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 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 a larger store.

10. Somerfield made a number of comments on those Provisional Findings, which we considered. We did not accept its comments on our general methodology, but its responses did draw our attention to the construction of a new one-stop shop by another retailer in Paisley, which we were satisfied would prevent Somerfield's acquisition of the store in Paisley resulting in an SLC. Its responses also led us to conclude that the acquisition of the closed store at Bedlington would not give rise to an SLC.

11. We therefore concluded that the acquisition may be expected to result in an SLC in each of the local markets served by 12 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 the one-stop shop at Johnstone) are as follows:

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

12. We considered a number of behavioural remedies proposed by Somerfield, but concluded they would not be effective in addressing the SLC and adverse effects identified. We concluded it would be necessary to require Somerfield to divest 12 stores, consisting of seven acquired stores specified in the report, at Filey, Middlesbrough Linthorpe, Newark, Pocklington, Poole Bearwood, South Shields and Whitburn; two existing stores which it has already closed, at Kelso and Littlehampton, and three other stores, at Johnstone, Peebles and Yarm where Somerfield can choose to divest either the acquired or the specified existing store in the initial divestment period. Each divestment must be to a suitable purchaser able to maintain and develop the divested store as a viable and active competitor in the relevant local market and who would not be likely to recreate the expected adverse effects as a result of the divestment; and will be carried out in accordance with the process and timetable set out in our report.

Findings

1. The reference

1.1 On 23 March 2005, the OFT referred to the Competition Commission (CC) a merger which involved the acquisition in October 2004 by Somerfield of 115 stores[1] and other assets from Morrisons (see Appendix A). The purchase of almost all the stores has now been completed.[2] For convenience, we refer to this transaction as 'the acquisition', and to the stores concerned as the 'acquired stores'.

1.2 In making the reference to us, the OFT said that it had identified 22 mid-range stores—those of between 280 and 1,400 sq metres (3,000 to 15,000 sq feet)—and one one-stop shop (ie a store of over 1,400 sq metres) in Johnstone, Scotland, which raised possible competition concerns. The stores identified by the OFT are listed in its decision document, which it published shortly after the reference to us setting out its reasons for referring.[3] The OFT also noted one potential problem convenience store (a store of below 280 sq metres) in Filey, East Yorkshire, 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, and we are obliged to look at all 115 stores.

2. The companies

2.1 The Somerfield group is the fifth largest supermarket group in the UK, with annual turnover of approximately £4.7 billion. For the year ended 30 April 2005 it recorded operating profit of £31 million (after exceptional items).

2.2 In April 2005, Somerfield had 748 stores under the Somerfield fascia[4] (including the acquired stores), 494 Kwik Save stores, 37 forecourts and 29 Aberness stores. Table 1 shows its store numbers, and effects of acquisitions by fascia. The number of its forecourt stores, however, subsequently increased to 177 following its purchase of 118 Texaco forecourt convenience stores from Texaco Limited and 22 forecourt convenience stores from Fuelforce Limited.

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[1]Although the OFT's decision document referred to 114 stores, a further store at Birtley was also part of the transaction we are required to examine (see paragraph 2.9). The stores are listed on our web site: www.competition-commission.co.uk. The acquisition also involved a depot and seven petrol forecourts about which no concerns were raised with us.
[2]Delays in completion were due to the need to obtain landlord or similar third party consents.
[3]There is a link to the OFT decision document on our web site.
[4]A multiple grocery retailing brand.

TABLE 1 **Somerfield: store numbers split by fascia**

	As at 30 April					
	2000	*2001*	*2002*	*2003*	*2004*	*2005*
Somerfield (including Aberness)	550	566	570	571	606	777
Kwik Save	755	734	717	680	634	494
Forecourts (Somerfield)	20	19	19	18	28	37
Other	46	0	0	0	0	0
Total Group	1,371	1,319	1,306	1,269	1,268	1,308

	For the years ended 30 April				
	2001	*2002*	*2003*	*2004*	*2005*
Movement accounted for by:					
Somerfield closures	10	5	8	12	24
Somerfield acquisitions	4	6	4	46	129
Kwik Save closures	1	14	33	35	67
Kwik Save conversion to Somerfield	21	3	4	11	75
Kwik Save acquisitions	1	0	0	0	2

Source: Somerfield.

The average size of the acquired stores—948 sq metres (about 10,200 sq feet)—is somewhat above that of Somerfield's existing stores—771 sq metres (some 8,300 sq feet).

2.3 Somerfield has stated that it aims to operate only stores in the 185 to 1,400 sq metre (2,000 to 15,000 sq feet) range. It said that its Somerfield fascia is being marketed as a national chain of small to medium-sized stores which compete with and complement the chains of both the larger stores and of the limited range discount stores. It focuses on items suitable for top-up and convenience shopping within its smaller stores, while its larger stores offer a more comprehensive range of products.

2.4 Somerfield group's strategy for Kwik Save is to operate stores of 560 to 1,115 sq metres (6,000 to 12,000 sq feet) that are located in urban centres and offer low prices for more budget-conscious shoppers. It is converting Kwik Save stores into the Somerfield fascia in those catchment areas better suited to the Somerfield fascia, and [✂]. Kwik Save stores are now mainly in north-east and north-west England, the Midlands, and North and South Wales and it has closed the Kwik Save fascia in Scotland.

2.5 In February 2005 (following the acquisitions) Somerfield announced a possible cash offer to acquire Somerfield by Baugur Group hf (Baugur), an Icelandic retail and property group which had shortly beforehand acquired the Big Food Group (owners of the Iceland store chain). In March 2005, Somerfield said that it had subsequently received further proposals regarding possible cash offers which it was considering. In April, it confirmed that it was in discussion with a consortium, which comprised Apax Partners Worldwide LLP, Barclays Capital (Barclays), the Tchenguiz Family Trust as advised by R20 Limited (R20) (an investment vehicle owned by Mr Robert Tchenguiz) and Baugur, for a recommended cash offer for the group. During the course of our inquiry, United Co-operatives Ltd also announced that it was exploring the possibility of making an offer for Somerfield, but subsequently said that it had decided not to proceed. In July 2005, it was reported that Baugur would leave the consortium interested in bidding for Somerfield, and it sold its stake to another member of the consortium. Somerfield assured us that none of the potential transactions had any bearing upon this inquiry.

Morrisons

2.6 Morrisons is the fourth largest grocery retailer in the UK, operating about 500 stores, with an annual sales to 30 January 2005 of approximately £12.1 billion (excluding VAT), after the disposal of the acquired stores. The stores acquired by Somerfield were originally acquired by Morrisons as part of their £3.3 billion acquisition of Safeway in March 2004. The CC reported on the proposed acquisition of Safeway by Morrisons and three other bidders in its September 2003 report.[5] We refer to this as the 2003 Safeway report (and where relevant to the 2003 Safeway inquiry). 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 acquired stores, all of which had been acquired from Safeway but only two of which (at Loftus and Beverley) came within the 52 stores it was required to divest.

The merger transaction

2.7 On 25 October 2004 Somerfield, through its subsidiary Somerfield Stores Ltd, agreed unconditionally to acquire the business conducted by Morrisons at 109 leasehold stores, five freehold stores, seven petrol forecourts and the leasehold of a distribution depot at Welwyn Garden City for a cash consideration of £115 million. As part of the transaction and at the same time, Northwharf Investments Limited (Northwharf), a company jointly owned by Barclays and R20, acquired the freeholds/long leaseholds of 51 of the 114 stores and the distribution depot for an aggregate cash consideration of £145 million. Northwharf agreed to lease the properties to Somerfield for 30 years at an initial annual rent of approximately £10 million. Accordingly, total proceeds to be received by Morrisons on completion from either Somerfield or Northwharf were approximately £260 million. This excludes £35 million paid by Somerfield for stock and cash floats.

2.8 The gross assets of the acquired stores (excluding the freehold/long leasehold interests acquired by Northwharf) as at 7 March were £61 million.

2.9 During the course of our inquiry but as part of the acquisition referred to us, Somerfield acquired a further store at Birtley in County Durham.

2.10 The acquired stores were located throughout the UK, but with about two-thirds in Scotland, Yorkshire and the North-East of England.

2.11 Sales of the 115 stores for the 12 months to 31 March 2004 were £860 million (including VAT) (having declined since the acquisition of the stores by Morrisons). Store contribution was £82.5 million (after rent) before the allocation of central overhead and distribution costs, which were of a similar sum,[6] reflecting (as Somerfield told us) the high costs of servicing the small store portfolio.

Rationale for the merger transaction

2.12 At the time of the acquisition, Somerfield said that it believed the acquisition would allow it to grow its estate (and estate density) without a significant increase in borrowings and to capitalize on its proven expertise in operating smaller stores.

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[5]The CC's report on the proposed acquisition by Morrisons and three other bidders for Safeway: *Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc. A report on the mergers in contemplation*, The Stationery Office, Cm 5950, September 2003.
[6]According to Morrisons press release October 2004.

2.13 The stores acquired accounted for about 1 per cent of all groceries sales in the UK (see Table 4), increasing Somerfield's share of local UK grocery sales to about 6 per cent.

2.14 We saw Somerfield papers suggesting that it was considering disposing of almost [✂] of the stores acquired; before the date of the reference to us it closed two of the stores acquired, at Cumnock and Port Glasgow, and seven of its existing stores near to acquired stores: at Bedlington, Blyth, Brechin, Carluke,[7] Dunfermline, Kelso and Littlehampton. Of these, at the date of the reference to us, it no longer had an interest in the stores at Brechin and Cumnock, and in January 2005 had also entered into an agreement to dispose of the store at Carluke to another grocery retailer which it did with our agreement during the course of our inquiry. (We discuss several of these stores further in paragraphs 7.33 to 7.37.)

2.15 Even if, prior to the reference to us, a particular store has been closed and disposed of, it is still open to us to decide that the merger has given rise to an SLC: but its closure would affect any remedy that could be imposed in such a case.

3. Jurisdiction

3.1 In order to decide whether a relevant merger situation has been created under Part 3 of the Enterprise Act 2002 (the Act), we are required to consider, first, whether two or more enterprises have ceased to be distinct within the meaning of the Act and, second, whether either the turnover test in the Act (namely whether the value of the turnover in the UK of the enterprise being taken over exceeds £70 million) or the share of supply test (ie whether the merger creates or enhances a share of supply of more than 25 per cent of goods or services of any description in the UK or any substantial part of the UK) is satisfied. The reference to us was made on 23 March 2005, before the statutory deadline for the making of the reference. As is apparent in paragraph 2.11, the value of turnover of the stores acquired exceeded £70 million. We therefore conclude that a merger situation qualifying for investigation has been created. Somerfield did not contest this.

4. Background

4.1 The CC conducted inquiries into supermarkets in 2000 and 2003. The 2000 Supermarkets inquiry,[8] under the monopoly provisions of the Fair Trading Act, was into the supply in Great Britain of groceries from 'multiple stores'.[9] The report found the market to be generally competitive, but that certain pricing practices (persistent below-cost selling, and what was termed price flexing, namely varying prices in the light of local competitive conditions) were against the public interest, but no recommendations were made to the Secretary of State for remedial action. It also found a number of aspects of relationships with suppliers to be against the public interest, for which it recommended a Code of Practice, which was subsequently introduced. The 2003 Safeway report (referred to in paragraph 2.6) was on the proposed acquisition by Morrisons and three other bidders of Safeway, which operated mainly larger stores—those of 1,400 sq metres (15,000 sq feet) or above, termed 'one-stop shops'.

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[7]The store closed on 5 April 2005, but the decision to do so was taken before the date of the reference, and staff had received notice of termination of employment contracts no less than 30 days before closure.
[8]*Supermarkets: a report on the supply of groceries from multiple stores in the UK*, Cm 4842, The Stationery Office, October 2000. We refer to this as the 2000 Supermarkets report.
[9]Defined as supermarkets with 600 sq metres or more of grocery sales areas, where the space devoted to the retail sale of food and non-alcoholic drinks exceeded 300 sq metres, and which were controlled by a person who controlled ten or more such stores.

4.2 However, a number of aspects of those previous inquiries, particularly on market definition, are relevant to our current inquiry. We discuss these in section 6. 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 (defined in the Safeway inquiry as being of between 280 sq metres (3,000 sq feet) and 1,400 sq metres (15,000 sq feet)); hence the focus of the current inquiry is quite different from that of previous inquiries. We have also considered to what extent circumstances affecting grocery retailing have changed since the previous inquiries.

4.3 Subsequent to the previous CC reports, there has also been consideration by the OFT of other acquisitions of grocery retailers. One of these cases involved a proposed acquisition of some of Somerfield's mid-range stores; the others involved the acquisition of smaller 'convenience stores' (defined in the 2003 Safeway inquiry as being of below 280 sq metres). None of these led to reports by the CC.[10]

4.4 Some of the evidence we received, and some of the press comment we observed, related to issues which went beyond those specific to this particular inquiry. For example, some parties (including the OFT) were concerned that there should be clarity and predictability in the criteria to be used for judging mergers in the grocery retailing sector—namely that there should be objective criteria that could be applied universally to particular cases—sometimes referred to as a 'bright line' approach. However, some of those same parties also suggested some flexibility was often necessary to take local circumstances into account.

4.5 Against this background, we decided to proceed as follows:

(a) we examined the methodology used in previous CC inquiries into mid-range stores (while acknowledging that their principal focus was on larger stores);

(b) we examined the alternative methodology considered (but not adopted) by the OFT in deciding whether to refer the acquired stores to us, including whether the mid-range segment might usefully be subdivided into different size categories;

(c) we considered the evidence from Somerfield and others on whether and how mid-range stores might be assessed on a different basis from that used in previous inquiries;

(d) we determined a methodology appropriate to this inquiry (see section 5); and

(e) we considered the possible lessons learned from this inquiry which might be relevant to future inquiries in the grocery retail sector, by either the OFT or the CC, and to grocery retailers in planning their business.

5. Issues

5.1 In our Issues Statement published on our web site we listed a number of issues concerning the effects of the merger, in particular:

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[10]Proposed acquisition by Tesco plc of T&S Stores plc (OFT advice to the Secretary of State, 9 December 2002); proposed acquisition by J Sainsbury Plc of 171 Somerfield stores from the 'Springwater' Bidding Group (the merger was referred to the CC but abandoned, OFT advice to Secretary of State of 28 July 2003); acquisition by the Co-operative Group of Balfour Convenience Stores Ltd (OFT decision, 23 October 2003); anticipated acquisition by Tesco plc of 45 stores from Adminstore Ltd (OFT decision 5 March 2004); completed acquisition by Musgrave Investments plc of Londis (Holdings) Limited (OFT decision 30 September 2004); completed acquisition by J Sainsbury plc of Jacksons Stores Ltd (OFT decision, 26 October 2004).

(a) the relevant product market, and the size of stores which service it;

(b) the relevant geographical markets, both national and local;

(c) the effect of the merger on competition within those markets. This included in particular:

(i) the criteria to be used in identifying whether the acquisition may give rise to concern, such as a reduced number of competing stores in any particular local market; and

(ii) any other indicators of the effect of the merger on competition, taking into account any relevant local characteristics;

(d) the resulting number and identity of stores whose acquisition gives rise to concern;

(e) barriers to entry to any such markets affected by the merger; and

(f) hence, whether the merger has given rise to or may be expected to give rise to an SLC, or other effects in these markets.

As noted in the Issues Statement, we received little concern about the national effects of the merger; hence we first consider issues relevant to local effects.

Methodology and approach

5.2 As is apparent in much of the evidence we received, and which we refer to below, there is a considerable diversity in the particular characteristics of mid-range stores and the markets they serve. We therefore adopted a two-stage approach to our consideration of the above issues.

5.3 In Stage 1, we identify:

(a) relevant product and geographic markets (see paragraph 5.1(*a)* and *(b)*); and

(b) a rule that can be applied to identify those possible problem local markets in which there may be some initial concern that the transaction might be expected to result in an SLC (as distinct from those which do not appear to be problematic)—see paragraph 5.1*(c)*(i). We have deliberately adopted an inclusive approach to ensure we capture all the acquired stores where there may be an SLC.

5.4 In Stage 2, we then carry out a detailed competitive assessment of each of the local markets identified in Stage 1 in which each relevant store operates to determine whether there is an SLC (see paragraph 5.1*(c)*(ii) to 5*(f)*). In assessing the effect of the acquisition in particular markets, we considered market shares, the extent of competition from inside and outside the markets as defined in Stage 1, the competitive conduct of firms, whether market conditions facilitate unilateral or coordinated effects, and the ease of market entry and expansion.

5.5 In examining these issues we have considered the evidence of Somerfield, other grocery retailers and others who gave us views, including consumers in a number of the areas affected, much of which has been put on our web site. As set out in more detail in Appendix B, we have also undertaken quantitative analyses of a considerable volume of factual information we received. This included:

(a) Evidence provided to us by Somerfield on the local impact of competitor openings. This allowed us in part to analyse the appropriate product market for Somerfield stores, by observing the degree to which different competitors with stores of different sizes at different distances varied in their competitive impact.

(b) The evidence on profit margins of individual stores when they were owned by Morrisons. We analysed the extent to which higher margins were associated with higher local concentration. This analysis also provided evidence on the relevant markets in which the stores operated and an indication of what would be the appropriate measure of concentration within those markets to use in the first stage of our analysis of the competitive effects of the merger.

(c) Other data provided by a number of retailers on the average basket size of shoppers at different size categories of the stores, which is also indicative of the markets in which they operated; data by Somerfield on the geographical areas served by their stores; and data by many operators on recent store openings and their cost.

5.6 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. This related not only to our definition of relevant markets but also to our assessment of the effects of the acquisitions in the local circumstances of each case. It enabled us in particular to identify which stores shoppers considered to be alternatives to Somerfield, and hence the competitive constraints on Somerfield from all stores irrespective of whether or not they were included in the market definition in Stage 1 of the analysis, thereby enabling us to take into account the particular characteristics of each local area.

6. Stage 1: identification of possible problem local markets

The relevant market(s)

6.1 As noted in our merger guidelines,[11] one tool that we have regard to in defining relevant markets is the 'SSNIP test' (also known as the hypothetical monopolist test). This test entails asking, for any group of products that might be defined as a relevant market, whether it would be profitable for a hypothetical monopoly supplier of those products to introduce a small but significant non-transitory increase in price (SSNIP). If such a price increase were profitable and could be sustained, then that group of products could be regarded as being monopolizable, and would therefore be considered a separate market. The SSNIP test applies to both product and geographical markets. The SSNIP test would include not only the scope to increase prices profitably, but also to reduce the quality, range and service provided in a store—price, quality, range and service (referred to by one retailer as PQRS, by which we also abbreviate price, quality, range and service below) being among the main ways in which stores compete once location is fixed. We refer to the hypothetical monopolist test rather than the SSNIP test, from this point forward, to emphasize that it is not through price alone that competition occurs.

6.2 In this case, as noted above, we used the tool of market definition to assist us to identify those local markets in which we believed an SLC might occur as a result of this transaction. We then investigated in more detail whether the acquisition has given rise to an SLC, or may be expected to do so, in each of the local markets so

[11] *Merger References: Competition Commission Guidelines*, CC2, June 2003.

identified. In general, therefore, any possible competitors that we judged *not* to be in the same market as the acquired stores would nonetheless be taken into account in Stage 2 in assessing competitive effects. For example, we did not consider stores below 280 sq metres (3,000 sq feet) to be in the same market in Stage 1, but our assessment of competitive constraints upon the acquired stores in Stage 2 included the combined effects of all such stores nearby. Similarly, any competitive constraints provided by stores outside the boundaries of our proposed geographic markets were also included.

6.3 Thus, exclusion of particular types of competitor from the market definition should not result in our incorrectly identifying in Stage 2 any local markets as giving rise to an SLC but enables us to identify those markets in which no problems would occur. However, were we to include in the market stores that do *not* provide effective competition to Somerfield, we could incorrectly conclude that a local market was unproblematic, and thus not investigate in detail, when we should have done so. Thus, it seemed appropriate to base market definition on an inclusive approach to ensure that we considered all local markets in which the acquisitions could affect competition, particularly as regards the inclusion or otherwise of possible competitors.

6.4 As our Guidelines note, market definition is not an end in itself, but rather a framework within which to analyse the effects of a merger on competition. The definition of a market is a useful tool in assessing such effects, nothing more. To the extent that we erred on the side of caution in assessing the relevant markets, therefore, we would accept that in some cases an application of the hypothetical monopolist test could have resulted in a wider market than we have used for this purpose.

The relevant product market definition

The 2000 Supermarkets report

6.5 In its 2000 Supermarkets report, the CC distinguished (paragraphs 2.26 and 2.30 of that report) between shopping for the bulk of a household's weekly grocery needs, carried out in a single trip and under one roof, and which it termed 'one-stop shopping'; and other forms of shopping which it characterized as 'secondary' shopping and which typically involved the use of other types of grocery stores, a different product mix and a lower average basket size. One-stop shopping, it suggested, required a range of products, for which it suggested a minimum size of store of some 1,400 sq metres would be required; a dedicated car park would also typically be provided. The CC acknowledged, however, that any such threshold had some element of arbitrariness about it, and that there would be some variation about the level at which a store could be regarded as suitable for one-stop shopping.

The 2003 Safeway report

6.6 Similarly, in the 2003 Safeway report, the CC took the view that one-stop shopping in grocery stores of 1,400 sq metres (15,000 sq feet) and above was a relevant market for the purpose of that inquiry, because most consumers visited such stores to carry out their main weekly shop. At the first stage of analysis of the local effects of the 2003 mergers, stores of 1,400 sq metres (or not less than 75 per cent of the area of the Safeway store under consideration) or larger belonging to one of Asda, Budgens, E H Booths & Co Limited (Booths), the Co-operatives (referred to as the Co-op), Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose were taken as being effective competitors to Safeway and to one another.

6.7 The 2003 Safeway report regarded the market for one-stop shopping as essentially local, as had the 2000 Supermarkets report, because most consumers were prepared to travel only a limited distance for their main grocery shop. There was also a national dimension to such competition. That is to say, key decisions affecting the operation of stores and other aspects of their business were taken centrally, and competition in local markets would to a significant extent reflect factors present at the broader national level; such factors included the costs of groceries purchased from suppliers, the costs of operating the business, the promotion of the stores' brand and the overall strength of competition operating through local markets.

6.8 In the 2003 Safeway report, the CC also considered the effect of the mergers on convenience stores, which were defined as stores below 280 sq metres (3,000 sq feet); and on stores between 280 and 1,400 sq metres (15,000 sq feet), which provided for 'secondary', or 'top-up', shopping (and which we refer to as mid-range stores). The Safeway report recognized that some one-stop shopping also took place in stores smaller than 1,400 sq metres and that very large one-stop shops down to very small convenience stores all competed to some extent for customers' secondary shopping needs. At the first stage of analysing the local effects of the possible mergers involving mid-range stores, ie stores smaller than one-stop shops, the CC decided that any store above 75 per cent of the size of the smallest Safeway store should be considered, and that all one-stop shops should also be considered; it also identified the effective competitors for the smaller store analysis as all fascias identified in paragraph 6.6 as effective competitors for the one-stop shop analysis, plus Iceland.

6.9 The Safeway report suggested that there was likely to be a scale moving from stores closer to 1,400 sq metres (for which the issues would be similar to one-stop shops) to smaller stores (for which the issues would be more similar to the convenience sector). In the case of the stores we are currently investigating, the OFT considered a further subdivision of mid-range stores into those that were 'closer to convenience' (280 to 650 sq metres (3,000 to 7,000 sq feet)), 'mid-range' (using this expression in a new and more restricted sense, namely 650 to 1,020 sq metres (7,000 to 11,000 sq feet)) and 'closer to one-stop shop' (1,020 to 1,400 sq metres (11,000 to 15,000 sq feet)), with smaller shops likely to have smaller catchment areas and possibly face different competitors.

Evidence in the current inquiry

6.10 In our Issues Statement, we set out a number of issues related to market definition:

(a) Whether (and, if so, to what extent) one-stop shops, mid-range stores and convenience stores can be regarded as being in separate markets through serving different purposes for shoppers or separate segments of one grocery retailing market; but we also subsequently considered to what extent different types of shopping (sometimes referred to as 'shopping mission') can be regarded as separate markets.

(b) Whether within mid-range stores there should be further subdivisions (which we discuss under geographical markets below).

(c) What particular fascias can be regarded as competing with Somerfield (we refer to such fascias as comprising the 'competitor set'—see paragraph 6.41).

(d) Whether account should be taken of the particular circumstances of stores in different localities and, if so, which circumstances and how they should be taken into account.

(e) Whether there has been any change in consumer behaviour since the Safeway report which may affect our assessment.

However, we acknowledge that even if we were to conclude that these categories of store—one-stop shops, mid-range stores and convenience stores—were in separate markets or were in separate segments of the same market, we would still need to consider the overlap and competitive constraints between them, in particular the competitive constraints upon stores in a mid-range size band imposed by larger and smaller stores.

6.11 A number of parties that have expressed an interest in the current inquiry have pointed out to us that, as noted in paragraph 4.2, the focus of the Safeway report was on one-stop shops, and that the CC did not reach a conclusion on defining the market in which mid-range stores operated. One hundred of the acquired stores in the current inquiry are 'mid-range' stores of between 280 and 1,400 sq metres (12 were one-stop shops of above 1,400 sq metres and three were convenience stores of below 280 sq metres). Somerfield, in particular, argued that the present acquisition was entirely different from the Safeway merger, not only in involving primarily mid-range stores, but also in that it was on a much smaller scale, and involved the fifth largest chain, rather than the four largest supermarket chains in the UK. Hence, it did not consider that the Safeway methodology, formulated in an entirely different context, should be mechanically transposed and applied to evaluate this case: rather, a fresh look should be taken. In particular, it said that the case for arguing that mid-range stores comprised a distinct market segment was much more difficult than for one-stop shops.

6.12 As is apparent from the evidence on our web site, we received a wide range of views on appropriate market definition:

(a) Asda, for example, said that, for a customer wanting to do a one-stop shop, the main mission was to obtain a full shop in one visit at a good price. Location and convenience were less important for this purpose than price, range and quality. Only larger stores could operate a one-stop shop, for which a definition of some 1,400 sq metres was quite reasonable. In the mid-range and convenience sector, the main mission was secondary shopping and top-up shopping, and convenience was the key driver: it was therefore still a separate and distinct market from one-stop shopping. Although there was a degree of linkage between the markets, and some customers did find it convenient to do secondary or one-stop shopping at Asda, the operators of one-stop shopping competed among themselves, and the primary competitors of convenience and neighbourhood shops, including mid-range stores, were other convenience and neighbourhood shops.

(b) The Co-operative Group (CWS) Limited (Co-operative Group) expressed reservations regarding the division of the market into rigid segments. It regarded one-stop shopping as a single market which could be serviced only by stores of at least 1,020 sq metres (11,000 sq feet), but with the exception of most rural parts of Great Britain where its stores below that level met heavy basket requirements. It said that it was difficult to segment stores between 280 sq metres (3,000 sq feet), the threshold for convenience stores, and 1,020 sq metres (11,000 sq feet) because of the fluidity and substitutability of products in the market. One-stop shops competed with stores in the same segment, and constrained the competitive activity of smaller stores; smaller stores could exert some upward pressure but not on the same scale.

(c) Morrisons' view was that there was effectively one market for food retailing, regardless of store size, and distinctions were becoming blurred because of changing customer behaviour and lifestyles. The costs of smaller stores were higher, so it was necessary to charge somewhat higher prices for goods sold in smaller stores, and customers were generally prepared to pay a small premium for convenience when making small purchases. But one-stop shops constrained to some degree the smaller stores on price and non-price aspects of their offer, although in general the smaller stores did not constrain the one-stop shop.

(d) Netto Foodstores Limited (Netto) said that stores below 280 sq metres may be perceived as a slightly different market; but there was no reason to segment the market above that level.

(e) Sainsbury's said that there were two markets, for convenience and one-stop shopping, but the dividing line between them was blurred and depended on the local situation; a flexible approach was necessary. Stores of above 1,400 sq metres (15,000 sq feet) operated primarily as one-stop shops. Stores of below 465 to 560 sq metres (5,000 to 6,000 sq feet) were invariably convenience stores. As to stores larger than this, if there was no other one-stop shop in the local area, they might act as a default one-stop shop, with a correspondingly wider catchment area; conversely, if there was significant one-stop shopping competition available locally, they were more likely to cater for convenience shopping. In commenting on the provisional findings, it reiterated its view that there was a continuum linking stores of 280 to 1,400 sq metres, with stores being classified as either convenience or one-stop shop based on the availability of parking and local characteristics; and that the 280 sq metre threshold for convenience stores was arbitrary and unwarranted.

(f) Tesco argued that market definition should relate to customer behaviour rather than store size. While it could understand the logic of a conclusion that there were distinct markets for one-stop shopping and convenience shopping, it did not think there was a distinct market for mid-range stores. Mid-range stores acted as a competitive constraint on one-stop shops, but not as great as that exerted downwards by one-stop shops on smaller stores.

(g) Waitrose said that the one-stop shop sector was still a separate market sector. 1,400 sq metres (15,000 sq feet) was a relevant lower limit for one-stop shops, stores smaller than that generally being used for top-up shopping. A one-stop shop exercised a competitive constraint on mid-range stores, but mid-range stores did not significantly constrain one-stop shops.

6.13 Somerfield said that local markets may be defined by broad categories of shopping trip, by reference to broad categories of stores, and by reference to a geographical area based on the distance at which the average consumer was likely to travel to undertake different types of shopping. But such segmentation was only appropriate as a first step in the analysis: it could not be applied in a precise or formalistic way since there was a significant cross-over both in terms of shopping types and store destination which inevitably blurred the definition of local markets. It regarded this cross-over as particularly important with respect to mid-range stores, which competed both with the large one-stop shop outlets of the major multiple grocery retailers and with the many smaller players in the convenience sector. Mid-range stores had higher capital and distribution costs, and prices in those stores had to be slightly more expensive than in one-stop stores to reflect those higher costs. But such price differences could not be beyond a certain level since there was only a slight premium chargeable for convenience and there was no scope to raise price beyond that premium. [✂]

6.14 Somerfield agreed that a one-stop or main shopping trip could be identified as a distinct segment. However, baskets worth £30 or more (which it regarded as indicative of one-stop shop baskets) accounted for over [✂] of the turnover of Somerfield stores over 929 sq metres (10,000 sq feet), and for which therefore it would compete with larger stores. It was much more difficult to draw the distinction between convenience and secondary shopping because there was substantial substitutability between convenience and secondary shopping trips, particularly in terms of the type of store—convenience, mid-range or one-stop shop—which the consumer might use for each. It therefore regarded the correct product market for the purpose of assessing the merger as all grocery retail sales, whether at convenience stores, one-stop shops or mid-range stores.

6.15 Somerfield and the other retailers from whom we heard generally argued against the OFT's suggestion for distinguishing between different sizes of mid-range stores: we discuss this in the context of geographical markets below.

6.16 Somerfield also argued that the competitor set for mid-range stores (see paragraphs 6.6 and 6.10*(c)*) should include not only those put forward by the CC in its previous report, but also the limited assortment discounters (LADs), namely Aldi Stores Ltd (Aldi), Lidl UK GmbH (Lidl) and Netto; symbol groups (such as Spar UK Ltd (Spar) and Londis): and Marks & Spencer plc (Marks & Spencer). It pointed, inter alia, to the [✂], the proportion of its shoppers who also shopped at LADs' stores, the overlap in products stocked, the good quality of their products, the growth plans of the LADs, and what it saw as the illogicality of treating Kwik Save but not the LADs as an effective competitor to the stores acquired from Morrisons. As evidenced from the views on our web site, a number of other retailers (eg Asda, the Co-operative Group, Morrisons, Netto, Sainsbury's and Tesco) also argued that all such operators should be regarded as competitors to mid-range stores, although Waitrose argued they should be excluded because of their narrow product range, as too, it argued, should Marks & Spencer because it was predominantly a retailer of own-label fresh foods.

6.17 Although some parties said that there had been a gradual trend to more secondary and convenience shopping over time, and greater participation by operators of one-stop shops in the convenience sector, these changes were generally not regarded as affecting the market definition used in previous reports.

Assessment

Types of shopping

6.18 In assessing the relevant product markets, we considered the extent to which we could distinguish types of shopping; types of shop (including their relative size); and the extent to which different types of shop cater for different types of shopping.

6.19 The 2000 Supermarkets report showed that the majority of shoppers carried out a main weekly shop. That report also found that the main factors influencing their choice of store for main grocery shopping was the ability to get most of the weekly shopping done under the one roof. Hence, as noted in paragraph 6.5, the report concluded that because of the product range and depth required to provide a one-stop shop, a minimum store size of 1,400 sq metres was a reasonable threshold for defining the market. The evidence we received from retailers in the current inquiry, summarized in paragraph 6.12, similarly showed that main shopping generally requires a wide range of goods at relatively low prices, for which consumers, particularly if travelling by car, will often be prepared to travel further, but which they may also carry out at stores of below 1,400 sq metres, depending on the local circumstances.

6.20 The 2000 Supermarkets report showed most consumers also carried out secondary (or top-up) shopping—namely, buying a few items to ‘top up’ or complement other purchases and for which a greater variety of shops were used. Whereas Tesco and Asda were the main fascias used for one-stop shopping, Somerfield/Kwik Save and Co-op were found in that inquiry to be the most frequently mentioned supermarkets for top-up shopping. The evidence to the current inquiry from retailers, summarized in paragraph 6.12, also suggested that secondary shopping has a greater requirement for a shop to be in an accessible location, typically in a town centre, with less weight given to price or range of goods than for their main weekly shop. Our survey of the acquired stores confirmed that secondary shopping was the main type of shopping carried out in mid-range stores.

6.21 The 2003 Safeway report also referred to convenience shopping, namely shopping for a few grocery items that typically takes place close to a consumer’s home or workplace. Such shopping is often carried out as ‘distress’ purchases, ie those being required urgently for consumption within 24 hours, from smaller, neighbourhood stores with more limited range but often with longer opening hours (to benefit from extended Sunday opening hours in England and Wales, convenience stores have to be below 280 sq metres). However, from the evidence in this inquiry we found it difficult to see a clear dividing line between top-up shopping, some of which is also for use on the same day, and convenience shopping. We therefore regard secondary shopping as comprising a range of shopping, including both top-up and convenience shopping, albeit, as discussed below, different types of store may provide for somewhat different proportions between the two.

6.22 We noted in paragraph 6.17 that there had been a gradual trend towards more use of secondary shopping and also that some of the major grocery retailers have expanded into the convenience sector. But we saw nothing to suggest that such changes should affect market definition in the context of this inquiry. Nor, as many to whom we spoke agreed, did the increasing use of the Internet and home delivery of shopping affect our analysis of the market, given that it still accounts for only a few per cent of grocery sales.

6.23 Within a wider grocery retailing market, therefore, we regard the two different types of shopping—one-stop shopping and other secondary shopping, including top-up and convenience shopping—as separate sectors of that market, given the different requirements of consumers associated with each. That is, a hypothetical monopolist of just one such type of shopping would be able profitably to increase price and/or worsen quality, range or service. But we recognize that, although all stores (or almost all) can supply both types of shopping, they can do so to varying extents, as to some extent different types of store also provide for a different balance between top-up and convenience shopping. In Stage 2 of our analysis, we take into account both secondary shopping and one-stop shopping.

Competition between supermarkets

6.24 We now consider which type of store can be regarded as catering for particular types of shopping: we subsequently discuss what fascias, particularly within the mid-range category of stores, can, for the purposes of Stage 1 of our analysis, be regarded as offering an effective competitive constraint to Somerfield.

Competition between different types of supermarket

6.25 As we discuss further in Appendix C, as part of a questionnaire we sent to Somerfield and other grocery retailers, as well as in third party hearings, we asked retailers who they perceived to be their main competitors. In general, the results supported the view that operators of one-stop shops compete with each other, but do not perceive other retailers as competitors, while operators of smaller shops perceive one-stop shops as competitors. The results also supported the view, which was put to us in hearings, that retailers compete across a number of criteria including PQRS and accessibility.

6.26 We have noted in Appendix C a number of differences in characteristics between mid-range stores and one-stop shops, implying that stores in these categories exhibit differences in the extent to which they serve one-stop shopping and secondary shopping (including top-up and convenience shopping) markets. We also noted estimates in our 2000 Supermarkets report[12] that 60 to 70 per cent of expenditure in Asda, Morrisons, Safeway, Sainsbury's and Tesco stores was on one-stop shopping. In comparison, Somerfield in our current inquiry estimated that only about [✂] of its own sales even in its stores over 929 sq metres (10,000 sq feet) was on main shopping (ie one-stop shopping). The NOP survey we commissioned showed that only 11 per cent of customers (but accounting for some [✂] per cent of revenue) were using the acquired stores surveyed for their main shop, although this was slightly higher in the largest stores (13 per cent of customers and [✂] per cent of revenue in stores of 1,020 to 1,400 sq metres (11,000 to 15,000 sq feet)). The balance of 89 per cent of customers were engaged in secondary shopping of different kinds. Thus, 47 per cent of customers (accounting for [✂] per cent of revenue) were using the stores as a planned top-up shop between main shops. 7 per cent of customers (accounting for [✂] per cent of revenue) were buying something to eat, drink or smoke straight away; and 25 per cent (accounting for [✂] per cent of revenue) were buying items urgently needed.[13]

6.27 We have also noted in Appendix C, from responses to our retailer questionnaire, other differences in price and non-price factors between such categories of store. In particular, transaction size, a main indicator of the extent of one-stop shopping, changes positively both with store size, and also with the range of goods offered (which in turn is dependent on the store fascia as well as size). That is, size is a guide to whether a store primarily serves the one-stop or secondary markets, but some fascias—including Somerfield—are likely to focus on secondary shopping even more than would be expected based on the size of their stores alone.

6.28 We have also noted above the comments of a number of retailers as to the different factors influencing consumers' use of different stores. We have noted above that we were told that for one-stop shops, price, range and quality are more important for customers than accessibility. In contrast, 89 per cent of respondents to our survey of Somerfield's mid-range acquired stores[14] said that they used that store because it was easy either to get to or was in a convenient location or was close to work or home (77 per cent quoting this as the most important reason), but only 11 per cent because of price, 10 per cent because of special offers, and between 7 and 10 per cent quoting aspects of range, quality or service. (9 per cent also referred to good parking as a main reason for using the store, but only 2 per cent gave parking as the most important reason.)

[12]These figures relate to the fascias as a whole: but one-stop shops accounted for the bulk of such sales.
[13]The balance being accounted for by 'buying a treat', 'buying a one-off item' and 'other'.
[14]Two of the stores surveyed were still trading as Safeway, another was a one-stop shop, and another a convenience store, but this does not affect these figures.

6.29 We regard the main relevant product market for this inquiry as secondary shopping. A number of factors all suggest that Somerfield's mid-range stores and the acquired stores primarily compete in this market:

(a) Average transaction size of Somerfield's mid-range stores is below £[✂], in comparison with the transaction size of £30 and above which Somerfield suggested was indicative of one-stop shopping.

(b) The NOP survey of acquired stores showed that main shopping accounted for less than [✂] of their revenue.

(c) The average basket size of main shopping was about £[✂] in those stores, compared with an average basket size of top-up shopping of £[✂], and of other shopping of £[✂], and an average basket size as a whole of £[✂].

(d) As noted in paragraph 2.3, Somerfield's strategy for its mid-range stores is to complement the chains of the larger stores; [✂].

But we recognize that all Somerfield's stores—to a greater or lesser extent—also meet other shopping requirements, as confirmed by the results of our NOP survey.

6.30 One-stop shops also evidently compete in the secondary shopping market too, through two mechanisms. First, as was apparent at the time of the 2000 report, and confirmed in evidence to this inquiry, some secondary and convenience shopping is carried out at one-stop shops which provide facilities (such as stocking convenience lines near the entrance, and express check-outs with limited maximum basket sizes) specifically for such shopping. Secondly, an additional potential consumer response to an increase in price (or worsening of quality, range or service) at stores focused on secondary shopping, apart from carrying out secondary shopping at a one-stop shop, is to increase the size of the one-stop shopping trip, reducing the need for secondary shopping, in effect substituting one-stop shopping for secondary shopping.

6.31 Our NOP survey of acquired stores provided further confirmation that one-stop shops do compete for secondary shopping. It showed that, if an acquired Somerfield store was unavailable, 37 per cent of shoppers would instead use a large out-of-town supermarket; 33 per cent a same size supermarket; 9 per cent a smaller convenience store; and 9 per cent another store (13 per cent did not know or would not have shopped). Similarly 26 per cent of survey respondents said that they would have bought more groceries at the shoppers' alternative store had the acquired Somerfield store been unavailable, showing that there is a degree of substitutability between main and secondary shopping. As regards competing fascias, had the acquired store not been available 12 per cent would have used another Somerfield store (of whom 2 per cent would have used Kwik Save).[15] Although that figure of 12 per cent is greater than might be expected from its national market share of all grocery retailing, it suggests that larger stores are the main competitors to the mid-range stores acquired by Somerfield which we surveyed.

6.32 Consistent with this, as discussed further in Appendix B, in our assessment of the effect of the opening of new competitor stores on existing Somerfield stores (to which we referred in paragraph 5.5*(a)*) we found that the most significant impact on existing Somerfield stores was from the opening of larger shops competing mainly in the one-stop shopping market.

[15] As noted in paragraph 2.14, in a number of the cases surveyed the existing Somerfield store had been shut (including in one case—Littlehampton—the closest of two nearby stores); but this would not significantly affect this average figure.

6.33 In our view, therefore, one-stop shops can be regarded as offering effective competition to mid-range stores not only for one-stop shopping which constitutes the majority of the business of one-stop shops and a limited part of the business of mid-range stores; but also for secondary shopping which constitutes the largest category of business of the mid-range stores. We regard it, therefore, as valid to consider all stores of 280 sq metres (3,000 sq feet) and above as being competitors in the same market for secondary shopping.

6.34 This implies, as noted by a number of retailers in evidence to us, that there is an asymmetry of competition between stores of different sizes. Hence, a hypothetical monopoly operator of mid-range stores would not be able profitably to sustain a price rise (or equivalent reduction in quality, range or service), due to the loss of business to one-stop shops; but competition from mid-range stores to one-stop shops would not be sufficient to prevent a hypothetical monopoly operator of one-stop shops from profitably sustaining a price rise. This arises because larger stores are effective substitutes for mid-range stores in the secondary shopping market, but mid-range stores are poor substitutes for large stores in the one-stop shopping market.

6.35 Similarly we do not regard convenience stores as offering effective competition to mid-range stores:

(a) As shown in Appendix C, convenience stores offer a still narrower range of products.

(b) The average basket size of convenience stores (£5 or below, as shown in Appendix C) is significantly below that of mid-range stores (for example, the £[✂] shown in our survey of acquired stores), and with a larger proportion of shopping accounted for by impulse and distress purchases (almost half, on the basis of one study we saw,[16] compared with about one-quarter in the acquired stores we surveyed—see paragraph 6.26).

(c) As we note in Appendix C, the symbol groups Londis and Spar tend to be seen by few supermarkets as competitors, [✂].

(d) From the NOP survey, convenience stores (including the symbol groups), corner shops and petrol forecourts[17] were only mentioned by 16 per cent of survey respondents as an alternative, should the acquired store be unavailable; significantly less than a large out-of-town supermarket or same-size supermarket.

(e) It was evident from most of the consumer evidence we received and put on our web site that convenience stores were not regarded as adequate alternatives to the existing Somerfield or acquired Morrisons stores.

Everyone except Sainsbury's agreed that 280 sq metres (3,000 sq feet) was the appropriate threshold for convenience stores. It was Somerfield's position that due to the Sunday trading laws in England and Wales (which permit all-day Sunday trading for stores up to 280 sq metres (3,000 sq feet)), 280 sq metres (3,000 sq feet) has been used as an easily identifiable threshold for convenience stores. As pointed out to us by the planning consultants to whom we spoke, however, there are no hard and fast rules as to what constitutes a mid-range and convenience store, but a spectrum of different sizes.

[16] IGD Convenience Retailing 2003.
[17] Only 1 per cent of respondents mentioned petrol forecourts, confirming that the petrol forecourts acquired as part of the transaction were unlikely to affect the mid-range stores operated by Somerfield, or vice versa, or be a source of concern.

6.36 We therefore concluded that convenience stores do not, by and large, offer effective competition in the secondary shopping market, against stores of more than 280 sq metres (3,000 sq feet). We cannot therefore include them in the same market. But, as with competition offered by one-stop shops to mid-range stores, mid-range stores would be expected to exert competitive pressure on convenience stores. Despite this, however, any competitive constraints provided by convenience stores on mid-range stores were taken into account in the subsequent detailed competitive assessment in Stage 2 of our analysis (as set out in paragraph 5.4).

6.37 Secondary shopping therefore accounts for the majority of shopping in convenience shops, with significant impulse and distress purchases; but very limited one-stop shopping. Similarly, secondary shopping is the largest category of shopping carried out at mid-range shops, with limited one-stop shopping particularly if there is a nearby one-stop shop. In contrast, one-stop shopping accounts for most shopping at one-stop shops, but with some secondary shopping. The extent to which different types of shop serve different types of shopping can be summarized as follows:

TABLE 2 **Types of shopping and types of shop**

		Type of shop		
		Convenience shop	*Mid-range Shop*	*One-stop shop*
Type of shopping mission	*Secondary shopping (including top-up and convenience)*	Secondary shopping is the majority of shopping in such stores, with significant impulse/distress purchase	Secondary shopping is the largest category of shopping in such stores, more top-up than impulse/distress	Some secondary shopping in such stores, but limited by location, layout, queues etc
	One-stop shopping	Very limited	Limited, particularly if one-stop shop nearby	One-stop shopping is the majority of shopping in such stores

Source: CC study.

6.38 Our NOP survey also suggested that specialist shops should not be regarded as part of the competitor set. Only 1 per cent of respondents said that, if the Somerfield store were not available, they would instead use several shops for different groceries, for example butchers, bakers or greengrocers.

6.39 We therefore regard secondary shopping as a relevant product market for the purposes of Stage 1 of our analysis. Only stores larger than 280 sq metres (3,000 sq feet), excluding therefore convenience and specialist shops, but including the one-stop shops, offer effective competition to mid-range stores within this market.

6.40 However, there remains the question of which sellers of food and household goods could be considered to operate as competitive constraints upon Somerfield’s businesses in this market, as we now discuss.

Competing fascias

6.41 At Stage 1 of our analysis, we need to identify those fascias that significantly constrain the Somerfield stores—which we refer to as the competitor set. As noted above, for the purposes of Stage 1 of our analysis, we aim to identify those areas in which possible problems may occur by restricting the competitor set to effective competitors; but other fascias may also provide a more limited degree of competition, or effective competition in a limited number of areas, which we take into account in Stage 2 of our analysis.

6.42 As we have noted above, the Safeway report defined the list of effective competitors for mid-range stores as the same as the competitors for one-stop shops (specifically Asda, Booths, Budgens, Co-op, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose[18]) together with Iceland.[19] We considered the arguments of Somerfield and a number of other retailers to which we referred above that the potential competitors for mid-range stores should also include Aldi, Lidl, Marks & Spencer, and Netto (we have considered above whether convenience stores (including those forming part of buying groups such as Londis and Spar) or specialist stores should also be included, as Somerfield and others argued).

6.43 As we note in Appendix C, the LADs offer less than 20 per cent of the range of most other retailers. [✂] also sell predominately own-brand items. We also note the following evidence which suggests that the LADs cannot be regarded as being in the competitor set.

(a) From our competitor impact assessment in Appendix B for both Somerfield and Kwik Save, the competitor fascias that appeared to have the biggest impact on sales when they opened in the area were Morrisons, Safeway (before it was bought by Morrisons), Tesco and Asda. The impact on sales of the opening of a LAD was significantly smaller (although we only had one instance of the opening of a Netto store)—generally less than [✂] the effect of the opening of the major retailers. This implies that the LADs are generally less close competitors for Somerfield and Kwik Save.[20]

(b) We note in Appendix C that LADs tend not to see others as competitors or be seen by others as among their main competitors.

(c) From the NOP survey, we note that the three LADs together were only mentioned by 5 per cent of respondents as alternatives had the acquired store not been available. Aldi was mentioned by 1 per cent of respondents at stores in areas where it was present, and by over 5 per cent in only one area. There were two areas where Aldi was mentioned by less than 5 per cent of respondents even where an Aldi store was closer to the Somerfield store than the nearest one-stop shop (Saltcoats and South Shields). Netto on the other hand was seen as an alternative by 4 per cent of respondents in the more limited number of areas where it was present. This included over 20 per cent of respondents seeing it as the alternative store in three areas (Bedlington, Birtley and Doncaster), where it was located very close (within 1-minute's drive time) to the acquired store and at some distance from any other stores (there is no other mid-range or larger store within 3 minutes' drive time of any of these three acquired stores). Lidl was mentioned by less than 1 per cent of respondents at stores in areas where it was present, and by over 5 per cent in three areas.[21] There are therefore a few areas where the LADs do seem effective competitors, particularly Netto, but there are many others where this is not the case: given the conservative approach we have adopted to ensure identification of problem

[18]Safeway report, paragraph 5.238.
[19]Safeway report, paragraph 5.262.
[20]The impact on sales of a new store opening was generally greater for Somerfield stores than for Kwik Save stores, by [✂] percentage points, on average, and the relative effects of different competitor fascias and other factors also varied depending on whether the store was a Somerfield or a Kiwk Save.
[21]Including a maximum of 16 per cent in Kelso where, however, the existing Somerfield store had shut.

areas, this would not seem sufficient reason to include them in the competitor set in Stage 1 of our analysis.

(d) We also noted from a Mintel report[22] that only 14 per cent of adults aged 15+ use a discount format store (here meaning Kwik Save and the three LADs) at least once a week, with another 14 per cent using such stores between once a week and once a month. In contrast, a majority of adults shop at one of the main chains at least once a week.

Somerfield pointed out that, under our competitive impact assessment, the impact of a new [✂] opening was similar to that of [✂]. This we accept. But the NOP survey showed that significantly more shoppers (9 per cent) would switch to [✂], should an acquired store cease to be available, than to a [✂]. We do not therefore regard it as illogical to exclude [✂] from the analysis, while including [✂].

6.44 In support of its view that the LADs should be regarded as part of the competitor set, Tesco provided figures (based on its analysis of TNS Superpanel data for the year ended 24 April 2005) showing a high proportion of what it called ‘cross-shopping’ by its customers, ie a high proportion of Tesco customers also shop at other supermarket chains, ranging from 62 per cent of its shoppers who also shop at Asda to 9 per cent of its shoppers who also shop at Netto, with the proportion shopping at other retailers at intermediate levels, eg Somerfield and Kwik Save (45 per cent), Marks & Spencer (44 per cent), Lidl (27 per cent), Aldi (20 per cent) and Waitrose (17 per cent). Tesco suggested that these figures showed that its customers consider Marks & Spencer and the LADs to be similar to the retailers proposed by us for the mid-range competitor set. (Somerfield showed us similar figures). However, in our view, the Tesco figures do not support the suggestion which Tesco makes. The fact that, for example, 45 per cent of Tesco shoppers also shop at Somerfield or Kwik Save does not necessarily mean that those shoppers regard Somerfield or Kwik Save as a competitor to Tesco. From these figures alone it is impossible to determine which stores shoppers regard as relevant alternatives. In any case, the figures do not distinguish between different sizes of store or different types of shopping (or shopping mission); the use of other stores is therefore as likely to be complementary to use of Tesco, for secondary shopping in addition to the main shop at Tesco, as to be competitive with it. We also note that the Mintel report[23] gives a slightly different impression: ‘The most widely used other sources of shopping by those shopping regularly at Tesco are Iceland (29 per cent), the Co-op (26 per cent) and Marks & Spencer (25 per cent)’—but even the use of those shops could, in our view, be complementary from the shoppers’ perspective to the use of Tesco, not necessarily a competitive alternative to it.

6.45 We noted above Somerfield’s argument that it would be inconsistent to regard the LADs as not being part of the competitor set, while regarding Kwik Save as competing with the stores acquired. Kwik Save offers a much wider range of goods—about four-times more stock-keeping units (SKUs)—than the LADs. We note in our competitor impact assessment that the impact of the opening of a one-stop shop on Kwik Save is less than on Somerfield. But we have also noted Somerfield’s conversion of many Kwik Save stores to the Somerfield fascia: hence there are supply-side reasons to regard Kwik Save stores as at least potentially equivalent to Somerfield stores. The NOP survey also, however, showed 4 per cent of respondents regarded Kwik Save as an alternative in areas where it was present; but one area (South Shields) where a very significant proportion of users of the acquired store—almost half—would have used a Kwik Save store had the acquired store

[22]Customer Loyalty and Discounting in Retailing, December 2004, p93.
[23]See previous footnote, page 87.

ceased to be available, and another (Middlesbrough Linthorpe) where about one-third would have done so.[24] This suggests to us that Kwik Save stores can generally be regarded as more in competition with the acquired stores than are the LADs.

6.46 Our analysis also suggests Marks & Spencer cannot be seen in the competitor set:

(a) From our competitor impact assessment, the estimated effect on Somerfield and Kwik Save sales of Marks & Spencer and Marks & Spencer Simply Food openings was found to be much less than Tesco's.

(b) Marks & Spencer's grocery products are all own-brand.

(c) Marks & Spencer [✂].

(d) From the NOP survey Marks & Spencer was only mentioned as an alternative by about 1 per cent of respondents at stores in areas where it was present; the largest proportion of respondents naming it as an alternative was 8 per cent and it was never in the top four alternatives.

6.47 We also considered whether Iceland should be included in the competitor set:

(a) We noted that Iceland stocks a much higher proportion of frozen foods than other grocery retailers.

(b) It was mentioned in the NOP survey as an alternative to Somerfield by only 2 per cent of respondents even in areas where it was present. Only in eight cases (including three in London and four in Scotland) was it mentioned by more than 5 per cent of respondents (with a maximum of 15 per cent mentioning it as an alternative). This is despite its location in some cases very close to the Somerfield store surveyed.

(c) There was no evidence of the opening of a new Iceland store significantly reducing sales at a Somerfield store (although there were very few instances of such openings).

This suggests in our view that Iceland should be excluded from the competitor set given the inclusive approach we have adopted to Stage 1 of our analysis, to ensure we have identified all potential problem areas.

6.48 We therefore concluded that the LADs, Iceland and Marks & Spencer should be excluded from the competitor set for the purposes of our Stage 1 analysis. Nonetheless, any competitive constraints provided by such stores were taken into account in the subsequent detailed assessment in Stage 2 of our analysis of the effects of the acquisition in each of the potential problem areas identified (as set out in paragraph 5.4).

Conclusions on product market

6.49 In our view, therefore, for the purpose of our Stage 1 analysis, grocery stores above 280 sq metres (3,000 sq feet) primarily compete in a market for secondary shopping. This market is distinct from one-stop shopping, given its different requirements—with an emphasis on accessibility rather than price. However, the larger one-stop shops

[24] In the first of these two cases, there is a Kwik Save store located very close to the acquired store: but there are also some Somerfield stores located close to acquired stores, where, if the acquired store was no longer available, a much smaller proportion of respondents than in these two cases would use the alternative Somerfield store.

compete in this market too, both directly in that secondary shopping can be carried out in one-stop shops and through possible substitution from secondary to one-stop shopping through increasing the transaction size of the one-stop shopping trip. Hence we regard all stores of over 280 sq metres (3,000 sq feet) within the competitor set identified—ie excluding Iceland, Marks & Spencer, the LADs and the symbol stores—as competing in a market for secondary shopping.

6.50 However, to the extent that one-stop shopping is also carried out at mid-range stores, this is also relevant to Stage 2 of our analysis of the effects of the merger. Moreover, any competitors 'excluded' from the market definition in Stage 1 of our analysis are nonetheless also included among the potential competitive constraints in Stage 2 of our analysis when assessing 'potential problem areas' in detail.

Relevant geographical markets

6.51 As noted in paragraph 6.7, the Safeway 2003 report regarded the one-stop shopping market, with which it was primarily concerned, as essentially local, but with a national dimension to competition. We noted in the Issues Statement the importance of delineation of local areas, both in assessing local overlap between existing Somerfield stores (which include its Kwik Save fascia) and the acquired stores, and in assessing the extent of competition from other grocery retailers in such areas. More specifically:

(a) In the case of one-stop shops, the Safeway report delineated local areas for analysis by drawing 10- to 15-minute drive-times around each individual store, to create a set of 'isochrones' (ie lines joining points of equal travel time), approximating to the area within which customers generating most of the revenue of that store would live and shop. Drive-times of 10 minutes were used for urban areas (defined as areas with a minimum population of 10,000) and 15 minutes for rural areas.

(b) For mid-range stores, the CC applied a 5-minute isochrone in urban areas and a 10-minute isochrone in rural areas. However, it recognized that this approach might not accurately reflect the actual attraction of the smallest and largest stores in this category. The largest stores in this category might be expected to attract customers from wider drive-times and hence an analysis on 5- and 10-minute isochrones would underestimate the area over which such a store competes, or offers effective choice. Conversely, a store closer in size to convenience stores might be expected to attract customers primarily on foot, such that a drive-time analysis might represent an unrealistically large catchment area.

(c) Following the Safeway report, in subsequent cases reviewed by the OFT, the OFT considered a catchment area of up to 1 mile for convenience stores.

6.52 We noted in paragraph 6.9 the OFT's consideration in its decision document for this reference of a further subdivision of mid-range stores into three size categories. For those categories, it considered using the following local areas:

(a) a 1-mile radius for those stores in the 'closer to convenience store' range;

(b) a 5- or 10-minute isochrone (depending on whether in rural or urban areas) for those stores in mid-range; and

(c) a 10- or 15-minute isochrone (depending on whether in rural or urban areas) for those stores in the 'closer to one-stop store' range.

Of the 22 problem mid-range stores listed by the OFT as of concern using the CC's isochrone and fascia-count methodology, only 15 were considered to be a concern under both the CC's methodology and that of the OFT. Seven that were of concern using the CC's isochrone and fascia-count methodology were not a problem using the OFT's methodology, but there were a number of other stores which were problematic only on the OFT's proposed methodology. The OFT noted that the vast majority of third parties that it consulted had substantial reservations about such a methodology.

6.53 Among the issues we considered were:

(a) whether the approach outlined in paragraph 6.51 to assessing the local areas served by the stores acquired is appropriate;

(b) in particular, in the case of the mid-range stores, whether different criteria such as those outlined in paragraph 6.52 should be used for different sizes of mid-range store;

(c) the extent to which we should consider the sensitivity of the analysis both of local overlaps and of other sources of competition within such areas to somewhat different assumptions as to appropriate local catchment areas—to take into account, for example, stores that may lie just outside the local areas on the basis of the criteria referred to in paragraph 6.51;

(d) whether it would be practical or preferable to assess the extent of competition between stores with reference to isochrones centred not on each store but based on the main workplace and domestic population centres those stores serve;

(e) whether allowance should be made store-by-store for any other factors relevant to particular local areas, including the extent to which shoppers walk or travel by bus to and from particular stores (as distinct from driving); and

(f) whether any sensible alternative methodology for identifying relevant geographical markets can be devised, but recognizing the desirability of criteria which ensure clarity and consistency across all stores.

6.54 Views of retailers to whom we spoke about analysis of local markets are on our web site, and may be summarized as follows:

(a) Asda, for example, said that it made considerable use of drive-time isochrones because they explained customer trade areas very well, though it had concerns about application of the one-stop shop methodology by the OFT, in particular whether the methodology was transparent and replicable. It continued to believe that store-based isochrones accurately described a particular store's catchment area and had a number of issues concerning the use of population-based isochrones. For example, the origin point of the isochrone based on a postcode could be quite arbitrary and not at all related to a real market, and even within the relatively small area of a postcode, the origin point could have quite a large effect on the output. But the extent of relevant local markets for mid-range stores would vary to some extent according to the proposition of the operator.

(b) The Co-operative Group believed population-based isochrones should be used because the distance a customer was prepared to travel for groceries was the

key factor. In general, it accepted the distances and drive-times used in the Safeway report, but these may be longer in rural areas. An ‘edge of isochrones’ rule (relevant to the issue mentioned in paragraph 6.53*(c)*) was legitimate.

(c) Morrisons said that smaller stores were more heterogeneous than the one-stop shops and should be looked at individually.

(d) Netto said that each location was different, and the methodology used in the Safeway report should be flexed in relation to the location of each store; its customers were generally located within 5 to 10 minutes’ drive-time.

(e) Sainsbury’s said it accepted that drive-time analysis was a reasonable basis for one-stop shops; for convenience stores a radius approach might be more appropriate. The OFT’s suggestion of a 1-mile radius for stores of between 280 and 650 sq metres (3,000 and 7,000 sq feet) was consistent with its own assumption of catchment areas for convenience stores. For stores of between 650 and 1,020 sq metres (7,000 and 11,000 sq feet), the categorization and hence the analysis would depend on local factors, including the local nature of competition. Changing from a store-centred drive-time test to a population-centred test would in its view add a degree of complication, work and uncertainty to the analysis that would not be justified by the additional benefit, or provide the certainty both buyers and sellers were looking for.

(f) Tesco said that mid-range stores should be considered in broad terms rather than creating any additional categories. It did not consider using population-based isochrones was a particularly good way of analysing consumer behaviour.

(g) Waitrose believed the mid-range sector was somewhat more complex than for one-stop shops, and had some sympathy for the OFT’s attempt to subdivide the category.

6.55 Somerfield said that the use of isochrones may be appropriate for an initial appraisal, but they should not be applied rigidly. To do so would fail to allow for the presence of competing stores, particularly one-stop shops outside the selected isochrones: there were substantial competitor stores within a drive-time of a matter of minutes or even seconds beyond those assumed in the Safeway report. Isochrones should therefore be applied with sufficient flexibility to ensure that local market conditions are taken into account.

Relevant local markets for mid-range stores

6.56 We first considered the basis of the isochrones adopted in the 2000 Supermarkets report and the 2003 Safeway report—namely of 10 minutes’ drive-time for one-stop shops in urban areas and 15 minutes in rural areas. In the 2003 Safeway report:

(a) Our predecessors were told that consultants employed by Morrisons in connection with its planning applications for new stores assumed that 80 to 90 per cent of a store’s turnover would be derived from within a 10-minute isochrone.

(b) Asda said that 81 per cent of its sales in urban areas were derived from within a 10-minute drive-time of the store, whilst its rural stores derived 83 per cent of their sales from within a 15-minute drive-time.

(c) Sainsbury's said that its urban stores obtained 75 per cent of their trade from customers travelling less than 10 minutes and that rural stores obtained 80 per cent of their trade from customers travelling less than 15 minutes.

(d) Tesco showed that, on average, 70 per cent of the revenue of its one-stop shops came from customers who travelled less than 10 minutes and 80 per cent came from customers who travelled less than 15 minutes to get to the store.

A survey for the 2000 Supermarkets inquiry showed that 65 per cent of consumers travelled 10 minutes or less to do their shopping and 91 per cent travelled 15 minutes or less. The survey also indicated different urban and rural drive-times. The 2000 Supermarkets report also reviewed information on the distribution of trade by travel time. It stated:

> There is clearly some variability around the average, but the general picture is one where the majority of customers or trade for stores in non-rural areas is seen to be coming from within a 10-minute isochrone, and between 80 and 90 per cent from within a 15-minute isochrone. In rural areas the mean proportion of trade from within these isochrones tends to be less, though it is still high.

Using these results and the evidence above, the 2003 report concluded that 10-minute isochrones were appropriate for one-stop shops in urban areas and 15-minute isochrones for one-stop shops in rural areas.

6.57 Although use of a travel time based on that of 80 per cent of a store's revenue is to some extent arbitrary, as is evident from the previous paragraph it is now widely used by the industry; it is clear from the above that this was an approach also adopted by companies for their own purposes in 2003, and they still appear to do so; it would seem to us equally valid for all sizes of store; and the evidence we saw confirmed that approach remains useful. Somerfield agreed that the isochrones for mid-range stores as defined by the CC in its 2003 report included some 80 to 90 per cent of its individual stores' business. Together with population recentring, which we describe in paragraph 6.70, we believe that this approach allows us to capture all possible problem areas.

6.58 As also discussed in Appendix B, we considered a number of ways to derive the size of catchment area in which 80 per cent of revenue would be generated for the acquired stores.

6.59 The NOP survey showed an average time to travel to the surveyed acquired stores of 8.6 minutes, and an average distance of 1.4 miles (with which the postcode details given to us by respondents were broadly consistent). But we also noted from the survey, as shown in Table 3, considerable variation between those who travel by car (48 per cent of the total) and those who walk (41 per cent of the total, but accounting for a much lower percentage of revenue, the bulk of the remainder using buses), and between urban and rural areas.

TABLE 3 **Distance and travel time to store**

	Urban		*Rural*		*Total*	
	Drivers	*Walkers*	*Drivers*	*Walkers*	*All drivers*	*All walkers*
% shoppers in urban/rural/all areas who drive or walk (%)	42	43	60	35	48	41
Average distance (miles)	1.7	0.6	2.4	0.5	2.0	0.6
Average travel time (mins)	7.0	9.3	7.4	8.2	7.2	9.0
% taking 10 minutes or less to travel to store	90	77	87	83	89	78

Source: CC study from NOP survey.

6.60 Given the significant percentage of shoppers who walk particularly to the urban stores, catchment areas cannot be based on drive-times alone. But the isochrones we use are based on drive-times, so it is necessary to convert the shorter distances over which shoppers travel who walk to the store into equivalent drive-times that would apply in each area had they driven in order to capture the areas in which about 80 per cent of the stores' revenue is derived. This we have done.

6.61 In rural areas where a large majority of shoppers drive to the stores, over 80 per cent of revenues are generated by shoppers within a 10-minute isochrone. In all urban areas surveyed, we estimate that over 70 per cent (and in over one-third of urban areas surveyed over 80 per cent) of revenues are generated by shoppers travelling the equivalent of 5 minutes' drive-time or less to a store, with over 90 per cent being generated within 10 minutes.

6.62 But there is also considerable variation in travel times between individual stores within urban or rural areas. This results in particular from the considerable variation in the percentage of revenue from shoppers who drive to a store (from as little as 2 per cent to as much as 96 per cent) as well as in the distances travelled, and the isochrones expressed in terms of equivalent drive-time will also vary between stores. In the context of a market definition relevant to Stage 1 of the approach we set out in paragraph 5.3, we believe it important that the criterion be set at a relatively narrow level which allows potential problem stores to be identified and then examined in more detail in Stage 2. Use of wider isochrones in urban areas would much reduce the number of stores from further analysis and exclude several where the NOP survey showed competition from stores other than Somerfield was relatively weak.[25] Hence a 5-minute isochrone for urban areas and 10-minute isochrone for rural areas, in our view, represent appropriate travel times to the stores we are considering for Stage 1 of our analysis. But we then allow in Stage 2 for the wider geographical markets of stores in some local areas.

6.63 In addition we examined data from Somerfield. As discussed in Appendix B, analysis of travel-time data for about 12,000 of its customers with Saver Cards, for 11 of the problem stores identified by the OFT, appeared supportive of the drive-times used by the CC for its mid-range isochrones (ie 5 minutes in urban areas and 10 minutes in rural areas). The vast majority of urban customers travelled less than 5 minutes and 74 per cent of rural customers less than 10 minutes to the stores.

[25]There are seven mid-range urban stores where we conclude below that the merger will result in an SLC taking into account a range of considerations including survey evidence of the extent to which shoppers at the individual acquired stores regard other Somerfield stores as alternatives to the acquired stores. Of these, six are identified by the 5-minute isochrone test, and none of them would be identified by a 10-minute isochrone test. (One was identified with reference to population-based isochrones, discussed in paragraph 6.70 et seq.)

6.64 We also considered whether there should be a further delineation of the geographic market, by size of store, within the mid-range category. The NOP survey showed a limited increase in the average basket size, the larger the acquired store: namely £[✂] in stores of between 280 and 650 sq metres (3,000 and 7,000 sq feet); £[✂] in those of between 650 and 1,020 sq metres (7,000 and 11,000 sq feet); and £[✂] in stores of over 1,020 sq metres (11,000 sq feet), slightly less than the basket size in the 650 to 1,020 sq metre category. Such a positive relationship between size of store and average transaction, at least between stores of below and above 650 sq metres, could be consistent with there being different mid-range segments. But the average basket size for the two largest of the three categories of mid-range stores was still substantially below that which would be regarded as consistent with one-stop shopping. For example, it was only around [✂] the £30 threshold suggested by Somerfield as clearly indicating the lower limit of a one-stop shopping mission, see paragraph 6.14. Analysis in Appendix B of sales revenue for different sizes of Somerfield store also suggests there is not sufficient variation in basket values by size of store to justify there being the three mid-range segments suggested by the OFT.

6.65 Other evidence in the NOP survey was also not consistent with use of the three OFT mid-range segments. Travel times and distance travelled to stores do not appear to vary by size as much as would be consistent with the OFT approach. Although respondents' views vary widely as to the substitute stores they would use were the stores acquired by Somerfield not available, the variation is store-specific and not related to size.

6.66 We, therefore, find the 5-minute drive-time isochrone for urban mid-range stores and 10-minute drive-time for rural mid-range stores reasonable in defining local markets for Stage 1 of our analysis, to identify markets for further competitive assessment. For one-stop shops and convenience stores, we saw no reason in Stage 1 of our analysis to change the approach of the 2003 report set out in paragraph 6.51*(a)* and *(c)*.

6.67 We commissioned GeoBusiness Solutions Ltd (GeoBusiness) to validate the data supplied by Somerfield (and also to undertake alternative methods of recentring, which we discuss below); a non-confidential version of its report is on our web site. Using updated population data which had not been available to Somerfield, GeoBusiness identified a number of stores, which had previously been treated as rural, which should be reclassified as urban, and a smaller number of stores, which had previously been treated as urban, which should be reclassified as rural. We adopted GeoBusiness's analysis. This increased by three the number of stores identified as of potential concern; one store was no longer of concern; but four became of concern as a result of these adjustments. (Otherwise, GeoBusiness suggested only minor amendments to the Somerfield data.)

Alternative isochrone methodology

6.68 We raised in the Issues Statement whether there were alternative methods to store-based isochrones to assess the impact of supermarket acquisitions. Store-based isochrones represent a reasonable approximation of the main catchment area of the stores affected by the merger. In the 2003 Safeway report, the CC considered the implications of isochrones based not only on the shops to be acquired but also on the existing stores of the bidders in the affected areas and on other competing stores in the areas—an exercise GeoBusiness also undertook for us in this case.

6.69 But, as noted by the Co-operative Group in the evidence to which we refer above, the alternative stores available for consumers depend on where they start or finish their journey to and from the store—in particular, their home or place of work. A household, for example, may be located in the catchment areas of a number of stores, although those stores may each be located beyond each other's catchment areas. An assessment of the extent to which a merger affects the competition available to shoppers would preferably, therefore, be based on isochrones centred not on individual stores, but on the origins or destinations of the users—in particular their homes.

6.70 In the 2003 Safeway report, the CC also considered the implication of isochrones based on centres of population in the areas affected. In the current inquiry, we commissioned GeoBusiness to apply 'population recentring'—ie (for mid-range stores) determining all competitor stores that were within 5 or 10 minutes' drive-time from any relevant population centre that lies within the 5- or 10-minute isochrone of the acquired store (relevant population centres are based on Office of Deputy Prime Minister (ODPM) settlement boundaries for England and Wales and Developed Land Use Area (DLUA) boundaries for Scotland, in each case with a population of at least 5,000). Secondly, GeoBusiness applied more detailed census output area recentring—determining all competitor stores that are within 5 (urban) or 10 (rural) minutes' drive-time of all census output areas that lie within 5 or 10 minutes from the acquired store. (It applied 10- or 15-minute isochrones for one-stop shops and 1 mile for convenience stores at each stage, although, of those stores of concern to OFT, only Johnstone and Filey respectively fell into these categories.) In each case, the fascia reduction rule (see paragraph 6.75) was applied to determine whether the acquired store was a problem.[26]

6.71 The census output area recentring allowed us to identify further areas that may be of concern and for which, as with the other elements of Stage 1 of our approach, further analysis of competitor effects, including the results of surveys of acquired stores, should then be undertaken in the second stage of our approach. We therefore regard recentring as supplementary to, not as an alternative to, the use of store-based isochrones set out above. The GeoBusiness analysis identified 67 stores which had at least one output area where there was a potential problem. For 33 of the 67 stores, the potential problem would be limited to less than 25 per cent of the population in the relevant catchment area; and for 17 of those 33 stores less than 10 per cent (ie a very small percentage) of the population in the store's catchment area.

6.72 While the GeoBusiness analyses were being undertaken and given the need to meet the statutory timescale for our inquiry, we undertook a second tranche of surveys based on sensitivity analysis of store-based isochrones. For this purpose, we examined the implications of alternative 10-minute drive-time isochrones for urban as well as rural areas; of 10-minute isochrones in urban areas combined with 15 minutes in rural areas; of the alternative drive times for different size categories of store mentioned by the OFT; and possible measures of concentration (see paragraph 6.85). As a result, we undertook more surveys than would have been necessary on the basis of the GeoBusiness analysis alone had the results been available earlier than was practicable. As it turned out, GeoBusiness identified only a further two more stores that merited additional surveys, which we subsequently carried out.[27]

[26] Since the GeoBusiness exercise was undertaken while we were still considering which competitor set was appropriate, Iceland was included in the competitive set in its analysis.
[27] These two surveys having been undertaken at a late stage, only shortly before our provisional findings were completed, the figures we quote for the results of the survey generally exclude them.

Variation between local markets

6.73 We referred in our Issues Statement (reproduced in paragraph 6.53*(e)*) to whether allowance should be made for local factors. The NOP survey showed significant variation in the characteristics of local markets, for example:

(a) The proportion of shoppers using the acquired stores for main shopping varied between zero and 35 per cent, which could only in part be explained by variation in size of store. Other variations shown by the survey included the average value of the basket of shopping purchased in the stores (between £[✂] and £[✂]).

(b) The percentage of revenue from shoppers driving to the stores ranged from [✂] to [✂] per cent, which was only partly explained by whether the store was urban ([✂] per cent from shoppers who drove to the store) or rural (on average [✂] per cent from shoppers who drove to the store).

(c) The average distance travelled to stores varied between 0.5 and 4 miles, which was also only partly explained by whether the store was urban (1.3 miles on average) or rural (1.7 miles on average).

(d) As well as variations in current catchment areas of the stores, a significant proportion of shoppers also said that, in the event of the acquired store not being available, they would use stores which we found were sometimes outside the previously assumed catchment area or definition of competitor sets.

6.74 As is evident above, not only Somerfield but also a number of other retailers acknowledged the greater diversity in mid-range stores and the markets in which they operated than in the one-stop stores on which the 2003 Safeway report focused. As we discussed in paragraph 6.2, we regard market definition in this case as useful in Stage 1 of our analysis primarily to identify possible problem stores, for which the broader patterns of use of mid-range stores are relevant, rather than adopting different market definitions for different local areas. Furthermore, the purpose of market definition—providing a framework within which competitive effects can be assessed—is better served by a common definition (as recognized in paragraph 6.53*(f)*), rather than one that varies for each location. But such local factors are relevant in Stage 2 of our analysis in considering the effects on competition in the local areas identified, which we do below, including the extent to which shoppers may consider alternatives outside the local markets as defined above, such as any that may be just outside the boundary of the isochrones used in the first stage of our analysis (the issue raised in paragraph 6.53*(c)*).

Use of fascia counts in identifying problem local markets

6.75 We referred above to the isochrone methodology used in the 2003 Safeway report. Also relevant in that report is the methodology to assess the effect of the merger on competition within these isochrones. The Safeway report evaluated this in two stages. First, it regarded a reduction in the number of competing fascias to four or fewer as having the potential to affect competition adversely, and secondly concluded that a reduction to three or fewer fascias was sufficient to affect competition adversely; the latter criterion was used by the OFT in deriving the list of 23 stores giving rise to concern referred to above.

6.76 We considered whether the criteria for the reduction in the number of fascias may be less relevant in this inquiry or whether account should also be taken of other indicators of the strength of competition, such as relative size or turnover of stores, their national or local market shares, or any other measure of the attractiveness of an individual fascia.

6.77 We have noted above that the focus of the 2003 Safeway report was on one-stop shops. It was suggested to us that the fascia reduction criteria in that report were in part based on consideration of the national coordinated effects of that merger which may not apply in this case; but we also needed to consider whether coordinated effects could arise in certain local markets in the circumstances of this case, for example on local promotions or on product ranges stocked in some stores.

6.78 Among the views received and included on our web site:

(a) The Co-operative Group said that it had serious reservations about fascia counting, which reflected reduction in choice but not necessarily the competitive dynamics in the market. It said that it would be better to analyse sales for each fascia rather than to give each an equal weighting, though the presumption that all local markets should, following any acquisition, enjoy at least three surviving fascia ought to remain.

(b) Morrisons said that the four to three fascia reduction rule was reasonable, provided sufficient account was taken of local circumstances.

(c) Netto thought the fascia rule did not take account of competition, which depended on competitiveness of the fascia.

(d) Sainsbury's said it accepted the four to three fascia reduction rule used in the 2003 Safeway report, although it was quite restrictive. It would be difficult to apply more sophisticated criteria that sought to measure the relative strength of competitors, because local circumstances were so variable and strength of competition was influenced by a wide range of factors.

(e) Tesco considered the four to three threshold should be used more as an indicator of potential concern rather than of actual concern.

(f) Waitrose thought the fascia test was still valid, although market shares, based on turnover, might also be taken into account.

6.79 Somerfield argued that the fascia count did not take the quality of a fascia or the size of a store's turnover into account, and was therefore biased against operators of multiple smaller stores. The size and strength of a fascia and its location, to which grocery market power related, were all important, though still only imperfect proxies for market power. It believed a market share criterion was relevant, even if not confined to share of top-up purchases alone. First, top-up purchases could be made at a one-stop shop, but secondly the [✂] per cent of sales at the mid-range stores that were accounted for by one-stop shopping was itself sufficient to be a competitive constraint.

6.80 Somerfield therefore put to us some detailed figures of the effects of the acquisition on share of total grocery purchases in the catchment areas of each of the acquired stores. On one approach, it identified only seven stores (Carluke, Kelso, Peebles, Pocklington, Ponteland, Brechin and Filey) where its market share would exceed 40 per cent as a result of a merger. But in certain cases these market shares, in its view, were overstated, since it believed the catchment areas assumed were too narrow in those localities. On a second approach, only three of the seven cases—Kelso, Peebles and Pocklington—would give rise to a market share of over 40 per cent. (It had offered to the OFT to divest those three stores.)

Assessment

6.81 The importance of accessibility in use of mid-range stores indicates that a fascia count could be a relevant criterion in identifying problem areas for further analysis. However, as noted above, the NOP survey showed that, if the acquired store ceased to be available, only 12 per cent of shoppers at the acquired stores as a whole would use the alternative Somerfield/Kwik Save stores instead (but with a significant variation by location), although (given the fascia reduction rule adopted) Somerfield would account for at least one in three fascias in each of those areas. The main alternatives, had the acquired stores not been available, would be Asda and Tesco. The NOP survey suggests to us that larger stores do have a bigger impact, and that simple fascia reduction does not capture the full competitive effect of the merger.

6.82 The survey also, however, showed considerable variability in the alternative stores that would be used. Over 25 per cent of customers would use alternative Somerfield stores in six localities: Johnstone (59 per cent), Frome (30 per cent), Peebles (46 per cent), Pocklington (37 per cent), South Shields (a Kwik Save store at 41 per cent) and Yarm (29 per cent). But in some other locations, no customers of the acquired stores would switch to an existing Somerfield store.

6.83 Other analysis we undertook also suggested that a simple fascia reduction may not capture the full competitive effect of a merger. We have noted above that the competitor impact assessment suggested that the opening of larger stores had a bigger impact on Somerfield than the opening of a smaller store. The results of our margin:concentration ratio analysis, however, were consistent with the use either of a fascia count or use of a market share being appropriate, as a positive relationship between margin and concentration in rural areas was found when concentration was measured either by market share or by a fascia count.

6.84 Nonetheless, although the fascia count may appear insufficient as the sole screening device, we are also doubtful about the basis of the market shares as proposed by Somerfield. These related to all grocery purchases by consumers resident in the catchment areas of the stores concerned, and primarily reflect the very high percentage of one-stop shop purchases at the larger one-stop shop stores used. As we have noted above, mid-range stores primarily provide for secondary shopping—convenience and top-up shopping—for which the market share of mid-range stores is likely to be significantly greater, even allowing for the use of one-stop shops for such purposes. Nor, in our view, do overall market share figures always reflect the state of competition between supermarkets, given the differentiation between stores in the PQRS they offer or features of location (including, for example, whether the store sells petrol) which will affect competition between them. For example, some consumers may have a strong preference for stores offering lower prices, more limited range and, possibly, lower quality or service and not regard a store offering higher prices, greater range and higher quality of service as an acceptable alternative, even if it is adjacent to a store with lower PQRS, or vice versa. Similarly, some consumers (for example those who walk) may strongly prefer stores located nearer to where they live or work than is assumed in the catchment areas we have adopted above. In that situation, adding together the market shares of the stores concerned is unlikely to be a good representation of the market power which the stores have in relation to those customers. There are also a number of measurement difficulties in deriving estimates of local market shares.

6.85 We also examined the implications of adopting an HHI concentration ratio criterion,[28] in addition to the fascia reduction rule. For this purpose we adopted an HHI either of 1,800, subject to a minimum increment of 100, or of 2,000 subject to a minimum increment of 50 (although such an HHI would be relatively low, equivalent to five to six equally-sized retailers in any area). We also examined the implications of a market share test, namely whether there was a pre-merger market share of 25 per cent, which would be increased by 5 per cent or more as a result of the acquisition. For both these purposes, we used Somerfield's data on all retailers' floor space, although the floor space is used for one-stop shopping as well as secondary shopping, for non-grocery sales, and for sales both within and beyond the appropriate catchment area of the acquired shop. It would not be feasible to produce any significantly more accurate estimates of the effect of the merger on the shares of the markets with which we are primarily concerned: namely of secondary shopping within each of the affected isochrones. We did, however, use the HHI criteria to identify further stores to survey pending receipt of the GeoBusiness analysis of population-centred isochrones.

6.86 In our view, therefore, the fascia reduction rule as used in the 2003 Safeway report is the best available indicator of where the acquisition may give rise to competition concerns in Stage 1 of our analysis. We accept in the context of the stores we are examining that fascia count is not enough on its own to indicate an SLC. Hence, in order to identify where a possible SLC could arise in Stage 2 of our analysis, we consider the effect of the acquisition on each of these potential problem areas taking into account the local circumstances of each, including the extent to which the catchment areas of particular local stores may differ.

Conclusions at Stage 1 on identification of possible problem local markets

6.87 For the acquired stores between 280 and 1,400 sq metres (3,000 and 15,000 sq feet), we have therefore defined local markets, and a rule that can be applied in order to identify in which of those local markets the transaction might result in an SLC, on the following basis:

(a) A relevant product market as the market for secondary shopping (including top-up and convenience shopping) which is serviced by stores over 280 sq metres (3,000 sq feet) and by the following fascias: Asda, Budgens, Co-op, Somerfield/Kwik Save, Morrisons/Safeway, Sainsbury's, Tesco and Waitrose. (We found that Booths, also included in the competitor set in the 2003 Safeway report, was not present in any of the local areas we considered.)

(b) A relevant geographic market delineated by isochrones of 5-minute drive-times in urban areas or 10 minutes in rural areas.

(c) A 4 to 3 fascia reduction rule in order to identify local markets where acquisitions might be expected to result in an SLC.

(d) In addition to considering primary isochrones (ie isochrones centred on each acquired store), isochrones centred on all other stores above 280 sq metres (3,000 sq feet) located within the primary isochrone, both those operated by Somerfield and those operated by members of the competitor set, and on relevant population centres located within the primary isochrone (including very disaggregated census output areas).

[28]The Herfindahl-Hirschman Index, referred to in paragraph 3.10 of CC2.

For one-stop shops, and convenience stores, we saw no reason in Stage 1 of our analysis to change the approach following the 2003 Safeway report set out in paragraph 6.51*(a)* and *(c)* above and adoption of the 4 to 3 fascia reduction rule, the potential problem stores being confirmed by GeoBusiness's analysis of alternative isochrone methodology. As with the mid-range stores we then considered in Stage 2 the circumstances of the local areas affected.

6.88 Of the 115 stores acquired, by applying the product and geographic market criteria and the fascia reduction rule set out above, we initially identified 33 possible problem stores; the adjustments to the data suggested by GeoBusiness increased this number to 36. We conducted 56 surveys taking into account the sensitivity analyses to which we refer in paragraph 6.72, in parallel with GeoBusiness undertaking its exercise (the questionnaire used for the survey is on our web site). The GeoBusiness census output area recentring analysis identified, in addition to those 36 stores, a further four stores where more than 25 per cent of the population in the isochrone around the acquired store would be affected by such a fascia reduction, and a further eight stores where between 10 and 25 per cent of the population would be affected. By undertaking the two further surveys at Newark and Prestwick, we surveyed all acquired stores where over 10 per cent of the population would be affected, excluding only one where it was clear no problem could be expected.[29]

Somerfield's comments on Stage 1

6.89 Somerfield made a number of comments on our provisional findings, non-confidential versions of which have been placed on our web site. Its three 'key points' were:

(a) that, based on the analysis set out, the CC was unable to establish an SLC to the statutory standard in respect of any of the markets affected by the transaction;

(b) that, while in principle the approach to Stage 2 methodology was capable of identifying markets in which there may be valid concerns about an SLC, the CC should recognize the inherent limitations in the data available to it, and apply it with greater circumspection than we had done; and

(c) various additional points relating to individual stores.

We discuss Somerfield's comments on these key points in paragraphs 7.20 to 7.32.

6.90 Somerfield also criticized a number of aspects of the Stage 1 analysis, including the market definition and the identification of the competitor set. In particular:

(a) Somerfield argued that we had made a fundamental conceptual error in identifying a market for 'secondary shopping', because a separate product market was not offered in any store. Given the evidence that one-stop shops provide the primary competitive constraint on Somerfield, the product market should, it said, have been defined as 'grocery shopping at stores above 3,000 square feet'. Furthermore, it did not understand how the product market as we defined it could be reconciled with the results of our margin:concentration analysis which were calculated in relation to all grocery shopping.

[29]The acquired store being very close to a one-stop shop and another mid-range store and at some distance from the nearest existing Somerfield store.

(b) It also argued that it was misleading to claim our market definition, by only being applied at Stage 1, did not affect the final results of the inquiry, because our reluctance to take account of its market share data was on the basis that the data did not relate to secondary shopping.

(c) Somerfield argued that our exclusion of some competitors from the market relied on a misinterpretation of facts and our own analysis. Market definition, it said, was concerned with the 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 finding that a store opening by one of the excluded competitors was significantly less than that of Tesco or Asda could not be used to conclude that the excluded retailer exerted no influence. The impact analysis could not shed any light on the own-price elasticity of demand of any candidate product group; but even if it was capable of doing so, the threshold for exclusion should be set at an absolute level, for which a second cross-comparison, from NOP survey results, could not be used.

(d) It objected to our different treatment of Kwik Save stores from those of the LADs due to supply-side substitution. It argued that it was too hypothetical to argue that the stores could subsequently have been converted to Somerfield fascias, which would have required specific investments. Nor did it believe the evidence from the survey could be used to justify a different approach to Kwik Save from the LADs, given the high diversion ratios in three cases to Netto.

(e) It also suggested that our exclusion of the LADs from the competitor set represented a barrier to their expansion (a point also made to us by the LADs in commenting on the provisional findings), since they would be restricted from purchasing any stores whose divestment may be required following any grocery retailer mergers. We discuss this in the context of remedies below.

(f) Somerfield objected to the conservative approach we adopted in Stage 1 of our analysis, including our use of population recentring, which led to as many as 67 stores failing the fascia reduction tests, and which in its view reflected the way in which the recentring tests discriminated against Somerfield's proportionately higher number of stores in its portfolio compared to its competitors. (Other grocery retailers, in commenting on the provisional findings, also criticized aspects of the Stage 1 and Stage 2 rules, including the use of census output area recentring, which they said would be time-consuming and add more complexity to the appraisal of any future acquisitions of mid-range stores.)

6.91 In our view, the above points raised by Somerfield are taken into account in Stage 2 of our analysis which allows for sources of competition, whether they be from within or beyond the markets identified at Stage 1. More specifically on each of the specific points raised by Somerfield:

(a) On market definition (see paragraph 6.90*(a)*), we regard the requirements of different types of shopping for different attributes of PQRS and location as also being relevant to market definition. Somerfield's own strategy of focusing on mid-range stores and on items suitable for particular sizes of store [✂], itself confirms the differentiation of PQRS between different types of store, including to some extent the product range on offer in such stores. As we note above, however, since we also in Stage 2 take account of competition from all competitors, whatever the type of shopping or type of shop, Somerfield's point is not relevant to our final analysis. Our margin:concentration analysis is consistent with both the market definition used by ourselves, and that of Somerfield.

(b) Our concern about Somerfield's market share data (see paragraph 6.90*(b)*) was not just based on our view on market definition; as noted in paragraphs 6.84 and 7.30, the market share data also fails to take into account the differentiation between stores in the PQRS they offer and features of location which are also important in assessing competition. For the same reasons, changes in market share may also not be useful in assessing changes in competition.

(c) Somerfield's criticism that our approach does not shed any light on own-price elasticity of demand (see paragraph 6.90*(c)*) is also taken into account in Stage 2 of the analysis, since product own-price elasticity of demand is among the many factors underlying the diversion ratios and illustrative price increases derived from those ratios and from the stores' margins (and which we discuss in paragraphs 7.4 et seq and Appendix D). The implications of alternative thresholds for exclusions from the market definition are also taken into account in Stage 2, by allowing for all possible sources of competition.

(d) We regard the treatment of Kwik Save (see paragraph 6.90*(d)*) as justified both by supply-side substitutability and by the significant proportion of customers who regarded Kwik Save as an alternative to the acquired stores in some areas. We have acknowledged the high proportion of customers who regarded Netto as an alternative for three acquired stores (for none of which we subsequently identified an SLC) but we noted in paragraph 6.43*(c)* that in each case this appears to reflect Netto as being by far the nearest alternative by location to the acquired store. In any event, the addition of Netto alone would not affect the inclusion of any of the stores where we identify an SLC in Stage 2 of our analysis. Aside from Netto, a much more limited proportion of customers would regard the other LADs as an alternative to the acquired stores than would regard Kwik Save as an alternative to them. Given the fascia rule adopted in Stage 1 of our analysis—a reduction to three fascias or below as indicating a possible competition concern—it is important that those three fascias be effective competitors to the acquired stores; to include less effective competitors might require use of a higher threshold for number of fascias below which an acquisition would give rise to concern.

(e) On the conservative approach we adopted to the Stage 1 analysis (see paragraph 6.90*(f)*), the figure of 67 stores failing the fascia reduction test represents the total number of stores in which population recentring showed even a very limited reduction of competition for shoppers within the isochrone of the acquired store. In practice, there were no stores which were of concern in Stage 2 in which population recentring showed an effect on less than 10 of the population of the primary isochrone. There was one store (Paisley) which would have been of concern following Stage 2 of our analysis, had it not been for a new development in that area, in which population recentring showed an effect on between 10 and 25 per cent of the population of the primary isochrone.[30] The stores finally identified as giving rise to an SLC were all within the more limited number of stores (34) where 25 per cent or more of the population of the primary isochrone would be affected by the acquisition.

(f) On the more general concerns about the use of census output area recentring (to which we also referred in paragraph 6.90*(f)*), this was (as shown in Table 2

[30]In the case of the Paisley store, we recognized in our final conclusion that development of a new one-stop shop by another retailer would prevent any SLC resulting from the acquisition.

of Appendix E), important in identifying one of the 12 stores where we concluded the acquisition would result in an SLC. In that case (Poole Bearwood), the acquired and existing stores were more than 5 minutes' drive-time apart, the appropriate isochrone for that urban area, but the affected population is likely to be resident between those stores and within 5 minutes' drive-time of both. It would also have been relevant in the case of Paisley.

7. Stage 2: Assessment of local effects

7.1 Having identified local areas in which there may be a potential competition problem, we now turn to Stage 2 of our methodology, namely to assess the effect of these acquisitions, separately, upon each of the local markets identified as of possible concern.

7.2 The principal focus in our assessment was the potential harm arising from unilateral (or non-coordinated) effects. As our Guidelines note:

> Non-coordinated effects, which are sometimes also called unilateral effects, occur 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. … other firms in the market might nonetheless also benefit from such a situation.

7.3 As we previously discussed, and as we also discuss in Appendix D, the formal pricing policy applied by Somerfield in its supermarkets is only one of the dimensions upon which it competes. In principle, there could be a deterioration in any or all of the PQRS available from Somerfield if competitive constraints are weakened. Competition is the main constraint preventing firms from worsening their offer in one or all of these dimensions, whether deliberately in order to drive margins up or simply as a result of letting standards slip in the face of weak competition. Accordingly, regardless of Somerfield's pricing or quality policies, there would be concerns about an adverse effect on consumers were there to be an SLC as a result of this transaction.

7.4 As we discuss further in Appendix D, we have therefore sought a measure of the degree to which Somerfield and Safeway/Morrisons had been rivals locally prior to the transaction. A good measure of the degree of rivalry between two firms A and B is the *diversion ratio* between them, namely the extent to which customers would choose firm B (as opposed to firms C, D and so on) as their second choice (the customer diversion ratio), and the proportion of the stores' revenue from those customers (the revenue diversion ratio). The diversion ratio from the acquired Safeway/Morrisons store to the existing local Somerfield/Kwik Save stores would therefore measure the degree to which Safeway/Morrisons and Somerfield were locally competitors.

7.5 The diversion ratio alone will not be sufficient to measure the degree to which the merger might locally reduce competitive constraints leading to unilateral effects. As noted in Appendix D, higher margins, implying a lower residual elasticity of demand for the merging stores, would result in larger incentives to increase prices (or otherwise worsen PQRS) post-merger, for given diversion ratios. (We saw no evidence to suggest that the merger would result in any offsetting changes to enhance competition in the local areas affected by the merger, but did take into account developments by other grocery retailers in two areas—see paragraph 7.17.) As set out in Appendix D, illustrative 'post-merger price rises' can be calculated on the basis of the diversion ratio and the margin. We did not seek to use the formulae directly to predict post-merger price rises, because our concerns are more widely with a deterioration in PQRS over time, as a result of reduced competitive constraints, rather than just an increase in price. However, we did regard that approach as providing important guidance on how to combine margin and diversion ratio data to evaluate the relative lessening of competitive constraints in different stores.

7.6 Neither high diversion ratios nor high margins in isolation need indicate that a merger has potential anticompetitive effects. Rather, it is the combination of a high diversion ratio and high margins (with other qualitative factors relevant to a highly complex market—see paragraph 7.16) that can indicate a loss of competition: where margins are high, firms face little competitive constraint; and where diversion ratios are high, an acquiring firm may be removing what little competitive constraint it faces. The value in the illustrative price rise is in combining diversion ratios and margins in one measure.

7.7 We noted in paragraph 5.6 that we commissioned NOP to conduct surveys at 56 stores, most of which were identified as potential problems by the Stage 1 rule.[31] NOP asked customers in the problem areas identified which stores they would use (including those not within the market definition we have adopted above) in the extreme event that the acquired Somerfield stores had not been available. Using that data, we estimated customer diversion ratios as the percentage of customers of the acquired store which consider the alternative to that store to be another Somerfield or Kwik Save store. But a more appropriate measure than the customer diversion ratio is the revenue diversion ratio, since firms will be more concerned about loss of revenue than of customers; we therefore calculated revenue diversion ratios, weighting the diversion choices of respondents by the value of their shopping, again using the NOP survey data. Although, as discussed in Appendix D, revenue diversion ratios are likely to be more variable, not only are the two 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 statistically significantly above the threshold we use below in identifying competition concerns for all but two of the stores.

7.8 In some cases, where Somerfield had acquired more than one store in a local area, the diversion ratios derived from our survey (which did not ask customers to which stores they would divert) could reflect diversion from one acquired store to another, rather than from an acquired store to an existing Somerfield store. In order to estimate the diversion ratio between the acquired store and the existing Somerfield store(s) alone, we adjusted the diversion ratios in those cases on the basis of relative drive-times to the nearby Somerfield stores, store sizes, and revenues. (As a result, the diversion ratios for some stores fell below the level which, as we discuss in paragraph 7.12, would cause us concern.)

7.9 The analysis we have conducted provides a relative measure of the lessening of competition arising from the merger: a ranking of the degree to which different acquired stores were likely to result in an SLC. We had to determine a threshold level above which we would choose to regard this as an SLC.

7.10 As we discussed, the diversion ratios themselves can be seen as measures of closeness of competition between acquired and existing stores. The illustrative price rises, to which we referred in paragraph 7.5, represent the adverse effects which any

[31] As noted in paragraph 6.72, not all surveyed stores are identified by the Stage 1 rule. This is because the surveys were commissioned before an element of the Stage 1 analysis was completed.

reduction in this closeness of competition might have.[32] We thought it important to have regard both to the adverse effect and to the diversion ratio itself (partly because margins—the other component in calculating the illustrative price rises—could change).

7.11 We therefore considered stores in which the illustrative price rise was at 5 per cent or more (the CC defines a 5 per cent price rise to be 'small but significant' when defining markets and this therefore seemed a useful benchmark for this purpose). We then considered whether the diversion ratios alone for the stores identified as a problem on this measure also seemed high enough—in isolation—to give us cause for concern.

7.12 Diversion ratios are useful when market shares are unreliable as measures of market power (when the products in question are highly differentiated). In a market for undifferentiated products, they would simply be proportional to market shares. Somerfield put it to us that we should 'reality check' the threshold we were applying to determine an SLC, against market share thresholds typically used by competition authorities when considering undifferentiated markets. In such an undifferentiated market, two firms each, for example, with 12.5 per cent (ie one-eighth) of the total market would have diversion ratios to one another of 14.3 per cent (ie, one-seventh). Since the merger of two such firms would result in a market share of 25 per cent, and since our Merger Guidelines suggest that mergers which result in a market share of below 25 per cent are less likely to raise competition concerns, a diversion ratio of 14.3 per cent seemed a reasonable level at which to consider diversion ratios that would give rise to competition concerns. We therefore examined whether those stores identified as giving rise to an SLC on the basis of a 5 per cent 'illustrative price rise' (as described in paragraph 7.5) had revenue diversion ratios in excess of 14.3 per cent.[33]

7.13 We note that there are a small number of cases where the diversion ratio from the Acquired Store to a remaining Morrisons store (or stores) exceeds the diversion ratio from the Acquired Store to the existing Somerfield store. Somerfield suggested to us that this might imply predicted price decreases after the merger, because any price increase following the transfer of stores from Morrisons to Somerfield should be based on the difference between the diversion ratios for the pre- and post-merger owners of the Acquired Stores. In this regard, however, we consider the relevant comparison to be with the counterfactual (ie, the likely ownership of the stores had they not been acquired by Somerfield, an issue we also discuss in paragraph 7.56 et seq), not the pre-merger situation. We are satisfied that there were other bids for these stores; hence the counterfactual is that Morrisons would have disposed of them to another grocery retailer. The diversion ratio to any remaining Morrisons store is therefore irrelevant.

7.14 As noted in paragraph 6.79, Somerfield suggested that market share would be a more appropriate measure for assessing market power and we considered the information on market shares it provided. But we noted in paragraph 6.84 our reservations about the basis of the market share figures estimated by Somerfield, which primarily reflect the very high percentage of one-stop shopping carried out at

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[32]These resulted from the application of formulae combining diversion ratios and data on margins, and should not be taken as price predictions—both because the formulae themselves are simple representations of a highly complex market, and because our concern is with PQRS, not just measurable price.

[33]We note that the analytical process described above will always produce a positive predicted price rise, for any merger in which the diversion ratio exceeds zero and firms are making positive margins. In practice, some mergers clearly do not result in an SLC. It seems to us likely that, in this inquiry, where the diversion ratio is low and the illustrative price increase is low (because margins are low), there is no SLC: that any lessening of competition is non-existent or insubstantial. We would expect no (or at least no substantial) price rises or reductions in PQRS where this is so. It should not be assumed that the 'predicted price rises', below 5 per cent, in these cases represent real price rises that are in some way 'acceptable' to the CC.

one-stop shops. Overall market shares will also not reflect differentiation between stores in the PQRS they offer, or features of location which will influence the diversion ratio. Market shares would, in our view, only be the more appropriate measure if market share happened to coincide with diversion ratio: the diversion ratio is a far better measure of the extent of competition.

7.15 Somerfield also suggested that when market share is small, any lessening of competition is de minimis since only a small percentage of the market is affected. Again we do not agree: a significant diversion ratio between two stores suggests that loss of competition between them would give scope for significant deterioration in PQRS and detrimental effects on their customers.

7.16 But we also considered other evidence received from Somerfield and third parties. The local competitive conditions for each acquired store were considered individually, in particular, the physical proximity of the stores relative to all other stores in the relevant areas; the characteristics of consumers at the stores (including the percentage who walked, drove or used public transport to travel to them) and information from the survey on where they started their journey and journey time data. We also considered evidence provided by Somerfield on each store about which we were concerned. But generally we saw nothing to suggest further local factors that would call into question the conclusions derived from the diversion ratios from our survey and their implications for the effect of the acquisition on competition. (We also reviewed whether similar concerns could arise on the existing Somerfield stores, but the evidence we saw did not suggest this was the case.)

7.17 We noted in our provisional findings, however, one case—Frome—where the expected opening of a new Asda one-stop shop in the near future, less than 3 minutes' drive-time away from the acquired store, is likely in our view to reduce the diversion ratio from above to below the threshold we have set out above. Subsequent to the provisional findings, Somerfield also drew our attention to the construction by Morrisons of a new one-stop shop in Paisley, within about one minute's drive-time of the acquired store, and closer to the acquired store than either of two existing Somerfield stores. We are satisfied that when this store is opened, which is expected very soon, it will also reduce the diversion ratio from above to below the threshold we have set out above.

7.18 We identified ten stores which, as shown in Appendix E, all had revenue-weighted diversion ratios of 14.3 per cent or above and an illustrative price increase—or equivalent reduction in quality, range or service as a result of the merger—of at least 5 per cent. The ten stores whose acquisition is therefore in our view likely on that basis to give rise to the prospect of an SLC (ie, an expectation of an SLC, but subject to our consideration below of entry and of the counterfactual) are as follows:

- Filey
- Johnstone
- Middlesbrough Linthorpe
- Newark
- Peebles
- Pocklington

- Poole Bearwood
- South Shields
- Whitburn (Scotland)
- Yarm

Eight of the above stores are mid-range stores, Johnstone is a one-stop shop and Filey a convenience store.

Somerfield comments

7.19 We referred in paragraph 6.89 to Somerfield's three key points on our provisional findings, that were relevant to Stage 2 of our analysis. Among its detailed arguments on these points were that:

(a) The statement in our provisional findings that the acquisition would be likely to give rise to the 'prospect' of an SLC was insufficient to establish an expectation of an SLC.

(b) The 14.3 per cent diversion ratio, being consistent with a merger resulting in a 25 per cent market share, was far too low a threshold to identify an SLC: a merger with such a low level of concentration and such a large number of competitors would never, it argued, be prohibited. In its view such a threshold should probably be between 25 and 33 per cent.

(c) The 14.3 per cent diversion ratio threshold also failed to allow for the uncertainty in the results of the surveys, or our analysis of them.

(d) A diversion ratio derived from a survey following the merger may be too high, since the survey would reflect loyalty of new customers to Somerfield.

(e) There was no reason for our having adopted an isoelastic rather than linear demand in estimating the scope for price increases; and the formula we adopted consequently predicted price increases, of over 1,000 per cent in the case of the Johnstone store, that could not possibly be sustained.

(f) In undertaking our margin:concentration analysis, we had used gross margin data from when the stores were operated by Safeway and/or Morrisons, which may then have been pursuing shorter-term objectives of maximizing profitability than would currently be the case.

(g) The illustrative price rises put forward as a possible result of the merger were inconsistent with its own existing pricing policy; and similarly any suggested deterioration in quality, range and service as a result of the merger was also inconsistent with the policies it adopted towards quality, range and service, irrespective of the competitive position of its stores. The illustrative price rises were also inconsistent with our analysis of the relationship between margins and concentration, which showed that the effect of higher degrees of concentration was much more limited.

(h) We had ignored its market share data on the grounds that this data did not relate to secondary shopping; but, since secondary shopping could amount to about one-half of the total grocery retail market, its estimated shares of the total

grocery retailing market in several of the areas we identified of below 12 per cent would imply shares of below 25 per cent even of secondary shopping.

(i) On specific stores, there were a number of developments by other retailers being planned (eg of a one-stop shop in Newark), planning applications being submitted (eg for a one-stop shop in Johnstone) or planning permission being granted (eg for a LAD in Yarm), as well as vacant existing retail units or sites in other areas.

We discuss some of its more technical arguments in Appendix D and its more general arguments in the following paragraphs.

7.20 On whether we had insufficient expectation of an SLC (see paragraph 7.19*(a)*), as we have noted in finalizing our report in paragraph 7.18, we used the term ‘prospect’ in this part of the report in the sense of ‘prospective’,[34] because our conclusions remain subject to our consideration of entry and of the counterfactual (namely, what would have been the case in the absence of the merger). On the basis of our Stage 2 analysis, we have formed an expectation of an SLC, subject only to our consideration of these two issues.

7.21 We do not accept that a diversion ratio of 14.3 per cent is too low (see paragraph 7.19*(b)*), particularly in the context of a differentiated product market, in which the degree of competition cannot be inferred from the overall market shares or a simple number of competitors. The appropriate ratio also has to be seen in the context of a very wide market definition in Stage 2 of our analysis; where there is a more narrowly defined market, it is reasonable for us to be more relaxed about a 25 per cent market share given the extent of competition from outside the market. In this case, however, in Stage 2 of our analysis, we are including the competitive effects of all other grocery retailers, as revealed in the diversion ratios from our survey. The diversion ratios allow not only for retailers such as convenience stores, corner shops or specialist shops beyond the competitive set we have used but also for retailers beyond the isochrones we have used in Stage 1; they also allow for respondents who would spend more by shopping instead at one-stop shops, probably by increasing their main shop, and on the other hand those who would not shop at all. This is, for example, a much wider range of competitive alternatives than was appropriate in the 2003 Safeway report. In the current context, if competitive conditions are such that a 25 per cent market share led to a price increase of 5 per cent or above, then a 25 per cent market share would be sufficient for an SLC; our calculations of illustrative price increases show that this is the case.

7.22 Some further indication that 14.3 per cent is a reasonable threshold above which to be concerned is shown by the revenue diversion ratio in Pocklington being only 28.4 per cent. This is despite Pocklington being a market where, following the acquisition, Somerfield is the only grocery retailer with shops of over 280 sq metres (3,000 sq feet) within 10 minutes’ drive-time, and the only alternative grocery stores within the competitive set we have identified are over 20 minutes’ drive-time away. The very strong market position of Somerfield in that case is confirmed by the number of letters we received about the loss of competition in that town. Concerns about the effects of the merger from some areas where we have not established the prospect of an SLC (eg Leeds Chapel Allerton) may on the other hand suggest the possibility that the diversion ratio we have used is too high, although on balance we do not think that is the case.

[34] We note dictionary definitions of the word prospect include ‘expectation’.

7.23 On whether we have failed to allow for the uncertainty in our results (see paragraph 7.19*(c)*), although there is a margin of error around the diversion ratios we have derived, we see no reason to regard them as biased, or any reason why we are more likely to have overstated than understated the effects of the merger.

7.24 On whether the survey may be influenced by any loyalty to Somerfield that has been established since the merger (see paragraph 7.19*(d)*), given that our survey showed that convenience, rather than quality, range or service, is the main reason customers used the stores, we regard this as unlikely to be the case. Although we acknowledge a degree of uncertainty in the diversion ratios derived, we again see no reason to regard the diversion ratios as biased for this reason.

7.25 Acquisition of any particular store with a revenue diversion ratio of above the 14.3 per cent threshold we have adopted is therefore in our view more likely than not to result in an SLC.

7.26 On our assumption of isoelastic rather than linear demand (see paragraph 7.19*(e)*), isoelastic demand—ie a constant elasticity of demand at different prices—is as we discuss in Appendix D a realistic assumption: an alternative assumption of linear demand implies elasticity rising as prices increase, which is implausible. As to the very high illustrative price increases implied by such a formula, we acknowledge that the formula we have used is only valid for constant degrees of competition, and that for very large price rises the degree of competition will not be constant. Hence, we accept that the formula is likely to overstate the upper limit of the range of illustrative price increases. But such bias should not, in our view, apply at the lower level of illustrative price increases, of around the 5 per cent threshold we have adopted. These figures remain, moreover, illustrative, because they encompass not only price increases, but equivalent deterioration in quality, range or service.

7.27 As to our use of gross margins of the stores when owned by Safeway or Morrisons (see paragraph 7.19*(f)*), Somerfield did not offer any evidence of subsequent lower margins. Indeed, margins may be expected to be higher in those cases in which it had subsequently closed one of the stores acquired.

7.28 We also reject Somerfield's arguments that our estimate of the effects of the acquisitions of the above stores on PQRS were inconsistent with evidence of Somerfield's policy and approach to operating its stores (see paragraph 7.19*(g)*). Although it acknowledged some evidence of somewhat higher price tiers being charged in stores with higher market shares, it argued that any such effect was very limited, and likely to reflect other factors such as higher costs in rural areas; it also showed us details of bonus schemes for its managers based in part on achieving high service levels irrespective of local competition. But we noted profitability and cost control were also taken into account in bonuses, aspects of performance where advantage could be taken of any strong market position in a particular area. Somerfield itself acknowledged that decisions on store redevelopment took local competition into account.

7.29 Our analysis in Appendix B, moreover, suggests a positive relationship between Somerfield's margins and concentration at least in rural areas. We do not accept, as Somerfield argued, that our margin:concentration analysis, in suggesting a relatively limited increase in margins associated with higher degrees of concentration, can be regarded as inconsistent with the illustrative price increases of above 5 per cent: that analysis relates to the effect of concentration on margins, not prices. Other analysis in Appendix B, indeed, also suggests a positive relationship between prices and concentration, such that a 10 per cent increase in market share corresponds to higher prices of between [✂] and [✂] per cent. But more generally, other retailers to whom we spoke referred to PQRS as being the means by which grocery retailers compete: in our view, the weaker that competition, the less the incentive to maintain PQRS. As a result of the acquisition in the areas about which we are concerned, Somerfield would have both the incentive and the means to bring about a significant deterioration in PQRS, and, even though that may not be its present policy or intention, we would expect that, consciously or otherwise, to occur.

7.30 On Somerfield's arguments that we should also have regard to its market share data (see paragraph 7.19*(h)*), there are more fundamental reasons why changes in market shares calculated on any basis are not helpful in assessing market power arising from a merger in a market with differentiated products. Somerfield might have a low market share of groceries sold within an isochrone post-merger, but nonetheless possess market power as a result of the detailed differentiation of stores by quality, range, service and—above all—location and convenience given the importance of accessibility for users, be they pedestrians, car drivers or public transport users. (We noted in paragraph 6.91*(b)* the importance of such factors in market definition.) For the same reason, Somerfield may lack market power, even if its market share were high post-merger. This complex situation is summarized by the diversion ratio.

7.31 As to Somerfield's arguments on specific stores (see paragraph 7.19*(i)*), we have accepted, subsequent to our provisional findings, that the expected opening by a competitor of a new one-stop shop in Paisley is likely to reduce the diversion ratios to below the threshold we have adopted. However, we rejected Somerfield's arguments about similar developments affecting other stores. As confirmed by other retailers to whom we spoke, these developments are uncertain, and, even if they proceed, any resulting new stores are unlikely to open within the timescale (of up to about two years) we would regard as necessary to prevent the acquisition resulting in an SLC. We also noted that the schemes initially mentioned by Somerfield in Yarm were for two LADs within a 10-minute isochrone rather than the 5 minutes appropriate for that urban area; the impact of developments by those LADs is itself highly uncertain. As we more generally discuss in paragraphs 7.39 et seq, we cannot therefore rely on new entry, including use of any existing retail units for grocery sales, to resolve any immediate lessening of competition.

7.32 We do not therefore accept Somerfield's arguments against our expectation that the acquisition of the ten stores listed in paragraph 7.18 would result in an SLC.

Closed stores

7.33 We also noted in paragraph 2.14 that a number of acquired stores or existing Somerfield stores located near to them had been shut following the acquisition; we noted the merger could still have given rise to an SLC, but that closure of the store would affect any remedy. In some of these cases, we carried out surveys of the acquired stores which only therefore showed the extent, if any, to which customers would divert to more distant and therefore less convenient Somerfield stores, to which diversion ratios would be lower; in other cases (notably where the acquired store had been closed), no survey could be carried out. Hence, diversion ratios could not usefully be calculated for those stores on the basis of the survey.

7.34 In three of those cases, the existing and acquired stores were located close to each other, and Somerfield no longer has an interest in those stores:

(a) At Brechin, Somerfield told us that the lease on its existing store had expired; it had no rights to renew; and the landlord did not wish the store to remain in the grocery business. Closure therefore was outside its control.

(b) At Cumnock, the closure of the acquired store was also outside Somerfield's control, the break clause having been exercised by Morrisons prior to the acquisition of the store.

(c) At Carluke, Somerfield had entered into an agreement in January 2005 to dispose of its existing store to another grocery retailer (an LAD), which it did with our consent (given the nature of that prior agreement) during the reference.

We are satisfied that, in the first two of these cases, closure would have occurred without the acquisition, while the third was disposed to another grocery retailer with our consent.

7.35 In three other cases (all mid-range stores), the existing and acquired stores were located close to each other, and, although one of the stores was shut, Somerfield has retained its interest in it:

(a) At Bedlington, Somerfield told us that the existing store, now shut, had been loss-making, but still with the possibility of it being turned around. We noted the existing and acquired stores were 0.03 minutes' drive-time away; and there is only one one-stop shop within the 5-minute isochrone, 3.9 minutes' drive-time away. 39 per cent of respondents to our survey walked to that store, and are likely to be reluctant to travel to the one-stop shop.

(b) At Kelso, Somerfield told us that its existing store was under the Kwik Save fascia, which it had decided to withdraw from Scotland. It would have converted the store to the Somerfield fascia had it not been for the Morrisons acquisition; but with the closure of the Kwik Save depot in Scotland, and a decline in its turnover, the store had become unviable. We noted that the stores were 0.8 minutes away; there is only one other fascia within 10 minutes' drive-time and the nearest one-stop shop is 18 minutes away. Subsequently in commenting on our provisional findings, Somerfield pointed to the opening of a new LAD store in Kelso, previously omitted from its data: we considered the implications of the opening of that store, but it is unlikely in our view to have reduced the revenue diversion ratio to below the threshold we have adopted.

(c) At Littlehampton, the nearest existing Somerfield store to the acquired store which we surveyed (0.5 minutes' drive-time away) has been shut. The nearest one-stop shop was two minutes' drive-time away (but we noted that almost two-thirds of respondents walked to the acquired store.) The survey still showed a revenue diversion ratio of 8 per cent to another Somerfield store (2.3 minutes' drive-time away) and we would expect the diversion ratio including the former, nearer store to have been significantly higher.

7.36 Each of those three cases—Bedlington, Kelso and Littlehampton—initially gave rise to concern. From the survey evidence of other stores, there are two main factors that suggest that diversion ratios to an existing Somerfield store are likely to be high: if the acquired store is closer to an existing Somerfield store than to a one-stop shop; and if there are a number of existing Somerfield stores close to the acquired store. As we acknowledged in the provisional findings there were, however, exceptions to this, and Somerfield drew our attention to two cases in which this did not apply: but it does apply in a large majority of the ten cases listed in paragraph 7.18. We also, however, derived a formula set out in the annex to Appendix D that explained much of the variation in diversion ratios for other stores (although we found no single formula that was fully able to explain them). Applying that formula to the three closed stores confirmed that the diversion ratio in two of these cases—Kelso and Littlehampton—would be likely to exceed the 14.3 per cent threshold adopted.[35] But, taking into account comments by Somerfield, and having extended the analysis to incorporate a larger number of stores, it became apparent after completion of our provisional findings that the diversion ratio for the third store—Bedlington—would be somewhat below the 14.3 per cent threshold.

7.37 Taking into account, therefore, not only that the existing Somerfield stores, now closed, were all located much closer than the nearest one-stop shop to the acquired stores, but also the formula we derived for the diversion ratios of other stores, we would expect diversion ratios and potential price rises of Kelso and Littlehampton to have exceeded the thresholds set out in paragraph 7.12. The acquisition of these two stores is also therefore likely to give rise to the prospect of an SLC, ie an expectation of an SLC, subject to our consideration of entry and the counterfactual.

7.38 Including therefore the localities where the acquired or proximity store has been closed, the acquisition of 12 stores would in our view give rise to the prospect of an SLC: namely those listed in paragraphs 7.18 and 7.37. However, reaching our conclusions as to whether the acquisition may be expected to result in an SLC in these areas also depends on whether there are prospects for entry should there be any deterioration in PQRS at the Somerfield stores following the merger, which we now discuss, and on the counterfactual (see paragraphs 7.56 to 7.60).

Barriers to entry

7.39 As noted in the Issues Statement, the OFT's decision document referred to previous cases in which barriers to entry in one-stop shopping were regarded as high. Economies of scale—in particular favourable buying terms for large incumbent supermarkets—distribution efficiencies and planning restrictions may be instrumental in restricting entry. Hence new entry was not considered by the OFT to be a countervailing factor in the one-stop shop segment. The decision document also noted that the convenience store segment had traditionally been dynamic, with a high proportion of independent ownership and rapid turnover of businesses; and that in terms of local planning regulations, once A1 planning permission[36] had been given for any form of retail property, it was possible to use such a property as a convenience store. It also referred to evidence from some large grocery retailers in the Safeway report that barriers to entry for convenience stores were low, but that some smaller grocery retailers had since argued that this sector was becoming increasingly difficult to enter for individual independent retailers, mainly owing to the disparity in buying terms between grocery retailers. The decision document also suggested that the extent to which barriers to entry exist for mid-range stores would depend on how far along the continuum of store size a particular store was placed, but that for the potential problem stores in this segment (all but two of which were over 650 sq metres (7,000 sq feet)), barriers to entry were unlikely to be low enough to alleviate competition concerns.

7.40 We therefore considered:

(a) the barriers to entry relevant to the areas affected by Somerfield's acquisition of mid-range stores, including whether entry barriers may increase with store size

[35]We also used this formula in concluding that the opening of the two new stores by other retailers, in Frome and Paisley, was likely to reduce the diversion ratio to below the threshold set out.

[36]A1 planning permission includes shops, retail warehouses, hairdressers, undertakers, travel agencies, post offices and dry cleaners.

either proportionally or step-wise in the three mid-range size segments identified by the OFT;

(b) whether barriers to entry are likely to be high in the area affected by Somerfield's acquisition of the one one-stop store which the OFT identified as a possible problem;

(c) whether, on the other hand, barriers to entry can be regarded as low in the area affected by Somerfield's acquisition of a convenience store which the OFT identified as a possible problem;

(d) whether any such barriers also vary between new-build sites and conversions of existing stores; and

(e) the implications of PPS6, the most recent relevant planning policy document in England and current equivalent documents in Scotland and Wales; and of the need in some cases to undertake associated developments to obtain planning agreement and the cost of doing so. Generally, however, PPS6 was thought not to have had a significant impact.

7.41 Among the evidence received:

(a) Asda said that whilst the barriers were not likely to be insignificant, it was likely to be easier for mid-range and convenience stores to obtain planning consent than for one-stop shops. This was because they were more likely to be located in town and district centres and meet requirements of planning guidelines for town centre developments.

(b) The Co-operative Group said that planning restrictions were a major barrier and increased with store size but entry was also deterred by problems of landbank assembly by major retailers, the scale of existing players, and the maturity of the market. Barriers to entry in mid-range and convenience sectors had been raised by acquisitions of Tesco and Sainsbury's in those sectors and resulting increases in rents. (Some other retailers expressed similar concerns.)

(c) Sainsbury's said that there were few barriers to entry in stores up to 1,400 sq metres (15,000 sq feet) as there were a large number of premises on the market and it was rarely difficult to obtain planning permission for change of use. It was more difficult to get planning permission for large out-of-town supermarkets.

(d) Tesco said that it was easier to obtain sites for mid-range stores than for one-stop shops. There were plenty of mid-range sites on the high street, although many of them were leasehold and rents could be high. It was somewhat more difficult to obtain planning permission for a mid-range store in a suburban area than in the high street. Despite the fact that barriers to entry in the mid-range store sector were relatively low, it could sometimes be harder to obtain planning permission for a new build store.

(e) Another retailer said that other than for convenience stores, barriers to entry were high, including for mid-range stores given only limited site availability, and planning challenges.

7.42 Somerfield argued that barriers to entry for mid-range and convenience stores were low. Among its arguments were that space was generally available in primary and secondary shopping areas; that planning permission should not normally be a problem; that there had been a considerable number of mid-range stores newly built or newly acquired since 2003; and that, even though independents may be dissuaded from entry in smaller towns where two competitors were already present, this would not stop the entry of more powerful operators*.*

7.43 We also sought advice on planning requirements for new stores from two property consultants, a summary of whose evidence is on our web site. Among the points they made to us was that the difficulty in obtaining planning consent increases with the size of the store, whether it is a new building or not, and its location. But there is no clear dividing line (such as below or above 280 sq metres (3,000 sq feet)) as to what size of new store would or would not give rise to planning problems; ease of entry would also depend on local circumstances, including availability of sites, and even if there is no requirement for planning consent may typically take about two years.

Assessment

7.44 Appendix F summarizes evidence from retail operators including Somerfield and Local Planning Authorities (LPAs) with reference to recent store growth, new store development and development barriers including planning. Among the points noted are:

(a) Additions to the number of stores by the main retailers since the Safeway merger have been dominated by acquisitions of stores in the convenience sector. These acquisitions are for the most part acquisitions of grocery chains, and are therefore not considered entry.

(b) The retailers in the competitor set as defined by the CC in Stage 1 of the analysis have added 135 new mid-range stores since 2003 (24 of these are new build). Of these Somerfield has added 82 stores which account for more than one-half of the store additions in this segment; only two of these are new build. None of the major one-stop shop operators (Asda, Morrisons, Sainsbury's, Tesco and Waitrose) currently seems to be adding any significant number of mid-range stores.[37] This appears to be due to constraints on site availability, or perceived profitability.

(c) Many retail operators and LPAs believe that opening new stores is easier in town centres due to easier planning consents, and with smaller stores due to planning issues and site availability, though it is by no means certain.

(d) Other factors such as the increasing level of rents, site availability and cost constrain acquisitions of stores at town centre locations.

(e) The timescale from identification of a site to opening depends on a number of factors and can be as much as six years in exceptional circumstances, if planning consents or complex site acquisition are required. New builds take significantly longer for planning consents than acquisitions, though the planning process is the same for a new build as for a 'change of use' consent: all retailers have indicated that obtaining planning permission can take a significant amount of time.

7.45 Somerfield put to us that entry into the mid-range was relatively easy as many stores are available. It particularly mentioned current opportunities for entry into the mid-

[37]A number of the stores that Sainsbury's acquired in the mid-range seem to have been a by-product of one of its convenience store acquisitions.

range given disposals by Iceland, Littlewoods and Woolworths. It also asserted that there were many opportunities to build new mid-range stores across the UK. However, while we note Somerfield's points, we have had evidence which implies that while entry may be possible in many areas, local circumstances vary and barriers to entry may be higher in some local areas than others.

7.46 On the basis of the above evidence, we concluded that we cannot rely on new entry to resolve any immediate lessening of competition as regards the mid-range stores and one-stop shop identified in paragraphs 7.18 and 7.37. The availability of appropriate space is likely to be limited in most areas, whether because physical space is unavailable or because of planning restrictions. The process of entry—involving site acquisition, planning approval and fit-out (or construction)—of a new supermarket can often take two years or more. Overall, therefore, the time required for new entry makes it unlikely that entry can be expected to act to constrain or reverse any deterioration in PQRS in the affected areas within a reasonable time. Furthermore, it has been suggested that the risks associated with such entry might be further increased if an incumbent supermarket chain with a strong market position could threaten to react and render entry unprofitable and that even the smaller supermarket chains might find it profitable to deter potential entry in this manner in some locations in which they have a strong position.

7.47 The presence of significant barriers to entry seems to be confirmed by the relatively low level of entry of mid-range and larger supermarkets in recent years.[38] The four largest retailers seem to have had little interest in opening new mid-range stores.

7.48 We did not, in general, assess barriers to entry for stores below the 280 sq metre (3,000 sq feet) threshold, as we had concluded that such stores do not exert an effective pricing constraint upon mid-range (or larger) supermarkets. However, one of the stores identified in paragraph 7.18 (Filey) is in this smaller size range (a 'convenience store' if that category is defined solely by store size, although we note that our survey indicated that a substantial proportion of its customers use the store for more substantial shopping missions). In the particular circumstances of this case we also believe we cannot rely on new entry from the opening of a new convenience or larger store in Filey, a town with a population of only some 7,000 and at some distance from equivalent or larger centres of population. Although the local plan refers to Filey having a shortage of supermarket space, there has previously been little significant development in Filey. There seems to be little retail space in the town available for conversion to a new convenience store within a reasonable time frame; available sites, of which Somerfield gave us details, all had disadvantages, eg they were all small, or without parking or loading facilities at busy times. Furthermore [✂] intends to develop a store larger than [✂], the prospect of which itself might deter new entry.[39]

Comments of Somerfield

7.49 Commenting on the provisional findings, Somerfield argued that it was inequitable that we should adopt a different approach to that in the previous three OFT assessments of mergers involving the acquisition of convenience stores by national supermarket chains larger than itself, in which there had been no specific investigations of the areas serviced by those stores or planned or potential developments in their catchment areas. But we noted that the OFT's assessment of

[38]There has been more substantial acquisition activity—but this is not entry as we use the term here, unless the acquired store was previously not selling groceries.
[39]We note that Morrisons did receive bids for the acquired store in Filey, suggesting that there would have been an alternative to Somerfield in Filey absent the merger, despite the possible new build.

those cases and its conclusions on them were based on the circumstances of the relevant localities. For example, the decision statement on the acquisition by Sainsbury's of Jackson Stores noted that no third parties raised specific issues about barriers to entry in any of the overlap areas; hence it concluded that 'in relation to the relevant localities in this case, actual and potential entry is currently capable of exerting an important competitive constraint'. Our conclusions in respect of the convenience store at Filey are also based on the specific context of that locality.

The effect of the acquisition on competition, and other possible adverse effects

7.50 As is evident from our web site, we have received considerable concern about the effects of the acquisition in a number of the areas listed above, particularly from Pocklington in Yorkshire, but also for example from Filey in Yorkshire, and from Johnstone, Kelso and Peebles in Scotland.[40]

7.51 Somerfield argued that to establish an SLC requires us to establish competitive harm. It said that there were already many instances where it was the sole trader in a locality, but it still only used one of its more generally applied price bands rather than the highest used elsewhere; to do otherwise would damage its brand and attract entry. Even where there would be a reduction in choice as a result of the merger, this did not necessarily represent a reduction in competition. Indeed Somerfield stated that in Pocklington about which we received many complaints, even though more prices had fallen than increased, customers were going elsewhere to competitor stores located both within and outside the isochrone.

7.52 We did not accept this argument. Somerfield does have a policy of local price flexing, which would allow such higher prices. Moreover, as we noted above, our concern is with the potential worsening of price, quality, range and service as a result of weakened competitive constraints arising from local mergers. For example, we received complaints of shorter opening hours at one of the stores identified following the acquisition which would be consistent with such an effect, although Somerfield told us that this was because the store had been very poorly used at times. There is a straightforward economic logic to the notion that an SLC will lead to adverse effects for customers. As we have noted in paragraph 7.29 other retailers to whom we spoke referred to PQRS as being the means by which grocery retailers competed: in our view, the weaker that competition, the less the incentive to maintain PQRS. As a result of the acquisition in the areas about which we are concerned, Somerfield would have both the incentive and the means to bring about deterioration in PQRS, and, even though that may not be its present policy or intention, we would expect that, consciously or otherwise, to occur. Furthermore, our margin:concentration analysis seemed to indicate that this logic is confirmed in this case: rural areas with less competition exhibited higher margins, whether as a result of higher prices or lower costs possibly associated with a reduction in range, quality or service. We therefore treat these local mergers as the CC treats any merger—with the presumption that a loss of rivalry results in adverse effects for consumers unless presented with strong evidence to the contrary.

7.53 In paragraph 7.38, we identified 12 localities where, in our view, competition has been significantly reduced as a result of the acquisition; and we concluded in paragraphs 7.46 and 7.48 that the prospect of entry cannot be relied on to offset

[40] In the first stage of our inquiry we also received letters expressing concern from a number of areas, including Carluke, Dunfermline, Kilsyth, Leeds (concerning the Chapel Allerton store) and London Whitecross Street, where we did not find the merger would affect competition. Comments on our provisional findings included further expressions of concern about the Chapel Allerton and London Whitecross Street stores.

such a loss of competition. That loss of competition would therefore allow Somerfield to charge higher prices (including fewer local promotions), or reduce its quality, range or service compared with that available in other stores through unilateral (also called non-coordinated) effects.

7.54 Such loss of competition is sufficient in our view to constitute an SLC in each of a small number of locations. We also note that the total population of the 12 areas affected by the acquisition of the 12 stores listed above is significant—some 230,000.[41]

7.55 We also considered whether the merger could give rise to possible local coordinated effects. The merger would result in two retailers accounting for the bulk of grocery outlets in some local areas, increasing the possibility of coordination between them: but there was insufficient evidence to establish any expectations that coordinated effect would occur.

The counterfactual

7.56 In order to assess the effects of the acquisition on the relevant markets, we consider the alternatives for Morrisons had these stores not been sold to Somerfield, including whether they might have been sold to one or more other grocery retailers, or to parties not involved in grocery retail.

7.57 A number of companies were invited by Morrisons to bid for the stores. All of these companies had previously expressed interest to Morrisons in acquiring at least some of them. There were 11 expressions of interest from the invitation. Some of the potential purchasers were not interested in the smallest stores, and others were interested only in certain regions. Somerfield was the only company willing to buy all the stores available and accept the possibility that the acquisition might be referred to the CC in doing so.

7.58 It was suggested in some material we saw that some of the stores may not have been saleable separately due to factors such as store condition, remoteness, and the possibility of overlaps with other potential acquirers. We noted in paragraph 2.14 Somerfield's consideration of disposing of a number of stores, when as a result of the acquisition it was now operating two stores in close proximity to each other, and its subsequent closure of some stores close to the acquired stores. But that does not necessarily mean that another grocery retailer could not operate them profitably.

7.59 All but three of the 12 stores listed were bid for by other grocery retailers. But the bidding process was effectively cut short when Somerfield offered to buy the stores as a whole. Negotiations with other bidders were not pursued, which could have resulted in different packages of stores being acquired by other grocery retailers. Morrisons suggested that, if the sale to Somerfield had not gone ahead, it would probably still have been able to sell all the stores, possibly including sale of any residual stores to symbol groups.

7.60 All but two of these 12 stores earned a positive net margin when operated by Morrisons: but other bids were made for those two stores. This confirms our view that all of the acquired stores about which we are concerned would have been profitable under different management and as part of other grocery groups, and in time all

[41]This being the population affected by the merger in those census output areas identified by GeoBusiness. The total population in the isochrones of the 12 stores is almost 340,000.

could have been sold to other grocery groups. Hence the SLC we identified in paragraph 7.54 would not have occurred without the merger.

8. Conclusions on effect of local competition

8.1 We conclude that the acquisition may be expected to result in an SLC in each of the local markets served by the ten stores listed in paragraph 7.18, plus the two stores listed in paragraph 7.37. That loss of competition would therefore result in higher prices (including fewer local promotions), or reduction in quality, range or service compared with that available in other stores through unilateral (non-coordinated) effects.

8.2 But in addition, customers in those 12 areas no longer benefit from being able to choose between the formerly competing stores, for example between different prices available for particular products; between different quality or range of goods on offer or service provided; or, should one of the stores be shut, between more or less accessible locations for at least some of its existing shoppers. Indeed, Somerfield's consideration of shutting either the acquired or existing store in [✂][42] of the areas we have identified, in addition to the two existing stores already shut, is likely to be to the detriment of shoppers currently using that store since it is the most convenient available to them.

8.3 As a result of any such loss of competition, the acquisition may therefore also be expected to have the adverse effects on consumers in those areas, of higher prices (including local promotional activities) to consumers, of reduced range of products available to shoppers; of loss of choice not only of products, but also of retail outlets available to shoppers; and of poorer service to shoppers.

9. The effect on national competition

9.1 Although individual stores serve local areas, the OFT's decision document noted the view in the CC's Safeway report that key decisions affecting the operation of stores and other aspects of businesses are taken centrally by the largest companies in the supermarket sector. It referred to one third party raising concerns about Somerfield's post-acquisition national share of mid-range stores.

9.2 As we noted in our Issues Statement, the OFT suggested that competition issues could not arise solely from having high shares in the mid-range segment. It suggested that, given the asymmetry in competition between large stores and smaller stores, Somerfield's mid-range stores would continue to face competition from large stores post-acquisition; similarly, in terms of buyer power, all grocery retailers appeared to procure centrally and in any event not separately for stores of different sizes, so a high proportion of stores of a certain size range was less significant than a high proportion of market share in total grocery retailing. At the national level, Somerfield's share of all grocery sales—which might be indicative of any buyer power—remained fairly modest, with the increment arising from this acquisition being less than 1 per cent.

9.3 Although little concern was expressed to us about the national effect of the acquisition, we nonetheless considered whether there is any reason to be concerned about:

[42] [✂]

(a) any possible unilateral horizontal effects from the increase in Somerfield's national market share in all grocery retailing as a result of the acquisition or, to the extent that mid-range stores may constitute a separate segment that is relatively unconstrained by one-stop shopping, in the mid-range segment;

(b) any possible unilateral vertical effects of the merger, possibly through enhanced buyer power; or

(c) any possible coordinated horizontal effects resulting from the increase in Somerfield's national market share.

We also considered whether the acquisition could be regarded as bringing about a reduction in concentration at a national level by strengthening Somerfield's position as one of the leading national grocery retailers.

Assessment

9.4 Any assessment of the unilateral or coordinated effects of a merger depends on concentration in the market and how that is affected by the merger. Since this transaction involves the acquisition of a number of stores from Morrisons and not its whole portfolio, the effects on national concentration are considerably different from those had the two companies merged. Both Morrisons and Somerfield continue to operate independently following the transaction and changes in market shares attributable to this acquisition appear to make the national market less concentrated.

9.5 The following table shows the national grocery market shares of the top nine retailers for the four weeks to the end of March 2005. Since this is a completed acquisition, we are able to use actual market share data. HHI levels (a measure of concentration) and the approximate merger increment are also included in the table.

TABLE 4 **Shares of retail grocery market**

		per cent
	Share of traditional grocery market	
	Four weeks ending March 2005	*Four weeks ending March 2005 (if no merger)*
Tesco	29.5	29.5
Sainsbury's	17.3	17.3
Asda	15.5	15.5
Morrisons Group	13.0	14.0
Safeway fascia	4.2	5.2
Morrisons fascia	8.8	8.8
Somerfield/Kwik Save	5.9	4.9
Waitrose	4.0	4.0
Iceland	2.1	2.1
Others (includes Co-op, Lidl, Aldi and Netto)	12.5	12.5
HHI of top nine retailers	1,634	1,650
Change due to decrease in Morrisons share	–27	
Change due to increase in Somerfield share	11	
Merger increment	–16	

Source: Morrisons (data obtained from TNS) and CC analysis.

9.6 The table shows that the actual changes in HHI resulting from changes in Morrisons' and Somerfield's market shares amount to a decrease of 16. This implies that the national market has become less concentrated as a result of the merger although this effect arises only from an increase in the symmetry with which market shares are distributed; there is no change in the number of players.[43] It is also clear from the table that Somerfield is the fifth largest national player with a current market share of about 5.9 per cent.

National unilateral effects

9.7 Unilateral effects occur when a merger enhances the ability of the merged firm to exercise market power independently, without the need to take into account the strategies of other firms in the market. Among other things, an SLC through unilateral effects is more likely, the greater the increment to concentration arising from the merger and the larger the market share of the merging firms. But we have noted that concentration has fallen as a result of the merger. Somerfield's national market share remains limited. There are a number of strong competitors to Somerfield at the national level, including all the national players above Somerfield in Table 4 as well as some smaller retailers.

9.8 We conclude that national unilateral effects will not occur as a result of this merger.

Buyer power

9.9 There was concern in both the 2003 Safeway report and the 2000 Supermarkets report that concentration in the one-stop shopping market could lead those retailers with high market shares to exercise their buyer power in a manner which could lead to detrimental effects such as reductions in the availability, diversity or quality of products available to consumers.

9.10 Somerfield told us that it intended that the merger would enhance its buyer power. Such an effect, in our view, given the relatively limited increase in national market share that would result, is unlikely to have any detrimental effect on suppliers or on competition more generally: Somerfield's market share remains too low for it to be covered by the Code of Practice which applies only from an 8 per cent market share upwards. Given indeed that the proportionate increase in Somerfield's market share is greater than the proportionate decrease in Morrisons' market share, any effect on buyer power and competition may, on balance, be positive.

National coordinated effects

9.11 We have considered whether the potential for coordinated effects increases as a result of a merger.

Assessment

9.12 In the 2003 Safeway report, the inquiry found that the merger increment to the market concentration was large enough under each of the proposed acquisitions to affect the likelihood of coordinated effects. It also found that that the conditions necessary for coordinated effects existed in the one-stop shopping market.

9.13 However, in this case, the number of firms in the market remains the same. Somerfield's market share is enhanced, but if this were to create a more effective fifth

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[43]Any market with an HHI of more than 1,000 is considered concentrated according to CC guidelines.

national player, it is likely to diminish, rather than enhance, the likelihood of co-ordinated effects. If the potential set of coordinating firms is considered to be the four largest supermarkets, any enhanced concentration arises solely from a reduction in the market share of the smallest. It is in principle possible that this could so weaken Morrisons that it ceases to be an effective national competitor, creating the possibility of coordination between the three biggest firms. We are satisfied that the loss of Morrisons' market share is too small for this to result from this transaction and that the slight reduction in Morrisons' size does not make coordinated outcomes between the four largest companies more likely either. Given, therefore, the small change in market shares as a result of the merger and the fact that the number of players in the market remains the same, there do not appear to be any issues of national co-ordinated effects in this inquiry.

10. Conclusions

10.1 We have therefore concluded that:

(a) the acquisition may be expected to result in an SLC in each of the local markets served by the 12 stores referred to in paragraphs 7.18 and 7.37; and

(b) the acquisition may be expected to have the adverse effects on consumers in those markets of higher prices, and reduced range of products, loss of choice, and poorer service referred to in paragraph 8.3.

11. Remedies

11.1 We are therefore required to consider whether action should be taken for the purpose of remedying, mitigating or preventing the SLC or any adverse effects which may be expected to result from such an SLC, having regard to the effect of any action on any relevant customer benefits (as defined in the Act) in relation to the merger.

11.2 Somerfield, while not accepting our conclusion that the acquisition may be expected to give rise to an SLC, proposed behavioural remedies as an alternative to divestment, namely:

(a) to undertake not to vary the price tiering in respect of the problem stores without consulting the OFT and to ensure all acquired stores 'have equal access to sales promotions having regard to their size and characteristics in common with other Somerfield stores';

(b) to undertake to apply its existing rules setting out uniform standards with regard to quality, range and service to the acquired stores as they applied to the rest of its estate; and

(c) where its existing store or stores was a Kwik Save, to undertake not to convert the Kwik Save store into a Somerfield store; nor to close or materially reduce the food sales area of the Kwik Save store nor sell the store without the consent of the OFT or the CC.

Somerfield proposed to produce an annual or six-monthly report to the OFT for the purposes of monitoring compliance with the undertakings. Somerfield also suggested an initial duration of the undertakings of two years prior to review by the OFT.

Assessment of Somerfield's behavioural remedies proposal

General considerations

11.3 Our merger guidelines comment upon the various factors relevant to considering the effectiveness of remedies. Among these factors is the clarity of the remedy both to the persons to whom it is directed and others, and the prospect of the remedial action being implemented and complied with, and our guidance also includes among the factors the ease of monitoring, notwithstanding the possibility of setting a compliance programme. In paragraph 4.15, our guidelines note that:

> The effectiveness of any remedy is reduced if elaborate, and possibly costly, monitoring and compliance programmes are required. One-off remedies that change the structure of the market (so-called structural remedies) are likely to be preferable to remedies that impinge upon the behaviour or conduct of firms (so-called behavioural remedies) as they address the effect of the merger directly and will require comparatively little, if any, monitoring or enforcement of compliance.

11.4 In the relevant markets in this inquiry, competition takes place across a variety of dimensions (PQRS) of which some, notably quality and service, would be difficult to quantify and monitor, and others, notably product ranges and prices, are subject to frequent changes. Somerfield's proposed behavioural undertakings would cover over 7,000 SKUs at stores with the Somerfield fascia and about 5,000 at Kwik Save stores; the need to look at such a product range at the 12 stores separately, and at the proximity stores in each case, would contribute to the complexity of the task. The proposals would also embrace a range of effects and complexity that is unprecedented. In such circumstances monitoring of behavioural undertakings is also likely to be highly complex and a significant proportion of the monitoring data provided by Somerfield may be difficult to verify. In addition, detection of breaches of compliance will be uncertain and effective enforcement of compliance in the event of breach is likely to be problematic.

11.5 Among our more detailed concerns about the behavioural remedies proposed by Somerfield (some of which were shared by the OFT) were:

(a) Current price tiers, service and quality benchmarks for the particular stores may not address the expected adverse effects. For example, they could not deal with any effects of the loss of competition to date. Moreover, it would be difficult to ensure that they remained appropriate as the retail environment changes. The duration of the adverse effects we have identified could be prolonged, so for most locations any behavioural undertakings might need to be maintained for far longer than the initial two years suggested by Somerfield. But, the longer the duration of the undertakings, the more difficult it would be to judge their effectiveness against the test we have to use, namely what would have happened in the absence of the merger, had competition been maintained.

(b) Identifying the appropriate participation of problem stores in sales promotions as Somerfield initially suggested, 'having regard to their size and characteristics in common with other Somerfield stores' may be highly judgemental, particularly should the current system including the allocation of tiers change, and thus be difficult to monitor and may not address the effects of the SLC. Somerfield's subsequent suggestion that it would commit to place all the stores at the most favourable promotional tier would still require extensive monitoring, for example, of the availability of products at promotional prices.

(c) Somerfield’s central standards for quality and service set minimum standards for compliance. We note that store and area management also have some discretion for allocating resources subject to achieving these minimum standards. Compliance with central standards may therefore still be consistent with a reduction in quality and service in the problem stores. We also referred in paragraph 7.52 to Somerfield’s comments on complaints about shorter opening hours at one of the acquired stores, which, it said, could not be regarded as a reduction in service given other factors to be taken into account. Those comments confirm to us that standards may not be clear and that there is considerable scope for dispute about whether any reductions in service could be regarded as justified or not.

(d) Refurbishment is also an important means of maintaining or developing quality, range and service at a local store level. Somerfield has the incentive and means to reduce or defer refurbishment expenditure in response to a lessening in local competition. Indeed, as we noted in paragraph 7.28, Somerfield told us that local competition was one of the factors taken into account in determining refurbishment programmes. Somerfield’s proposals do not deal with the issue of refurbishment though we consider that the concerns that we have expressed concerning clarity of any commitment and ease of monitoring and effective enforcement would also apply to this issue.

(e) Self-monitoring proposals, including reliance primarily on self-monitoring of service standards, such as Somerfield’s programme of three-monthly visits by ‘mystery shoppers’, are unlikely to provide an adequate assurance that service standards are being continuously maintained and pose a significant risk of non-compliance.

(f) It would be necessary for the OFT to monitor compliance in addition to the self-monitoring suggested by Somerfield. Because of the nature and complexity of the markets, an independent compliance officer paid for by Somerfield would need to be appointed to facilitate the monitoring process, but the OFT would have ultimate responsibility for monitoring, and the proposals would place a heavy burden on the OFT.

(g) If a breach were observed, the OFT would be constrained in enforcing compliance effectively. Either divestment of the stores or enforcement of behaviour might not be realistic options in the event of a series of breaches which might be argued at the time were due to factors outside management’s control.

(h) As noted above, the duration of undertakings should match the expected duration of the adverse effects and this may substantially exceed the initial duration of two years suggested by Somerfield.

(i) We see equal problems in Somerfield’s proposed undertaking to maintain existing Kwik Save stores as a separate fascia, which would also require specification and monitoring of the PQRS offered in such stores and of whether they could be regarded as offering any competitive alternative to the acquired stores.

Conclusions on behavioural undertakings

11.6 In our view, therefore, behavioural remedies would be complex and unclear; and difficult if not impossible effectively to monitor and enforce.

11.7 In view of all the above-mentioned concerns, we have concluded that the behavioural remedies proposed by Somerfield would not be effective in addressing the SLC. Moreover, given the fundamental concerns we have outlined, we consider that there is unlikely to be any prospect of developing Somerfield's behavioural proposals to form an appropriate remedy to the SLC identified. We therefore conclude that only structural remedies would address the SLC and the adverse effects we have set out, namely divestment of the stores.

Structural remedies

11.8 On structural remedies, Somerfield argued:

(a) on the stores to be divested, the competitive harm identified by the CC could be resolved by divestment of either the acquired store or the existing store, at Somerfield's discretion, as was the case for Morrisons following the Safeway report. It argued that the CC had measured the SLC on the basis that the constraint offered by an existing store to the acquired store was equal to the constraint offered by the acquired store to the existing store. Hence whichever was divested, the diversion ratio would be reduced, competition restored and the SLC avoided. It would not therefore, Somerfield argued, be appropriate for the CC to assume that, where an existing store was smaller than the acquired store, divestment of one should be preferred over the other. The only issue that was relevant in the context of remedies was whether a suitable purchaser could be found, which it believed would be the case by disposing of the existing stores where it wished to do so.

(b) on the divestment process, [✂] there should be flexibility on the timetable for the divestment.

The stores to be divested

11.9 Divestment of the acquired store to a suitable purchaser (as discussed in paragraph 11.24 et seq would normally remedy, mitigate or prevent the SLC. We suggested in the remedies notice that the stores to be divested in the relevant local market would be those stores acquired from Morrisons unless we considered that the divestiture of alternative stores would satisfactorily restore competition in the local markets concerned (remedies notice paragraph 4*(a)*).

11.10 In two of the markets where we expected an SLC to occur (Kelso and Littlehampton), Somerfield has closed but not yet sold a relevant existing store and concentrated its trade on an acquired store. We received considerable concern from residents in Littlehampton about the possibility that Somerfield may be required to sell the acquired store, depriving the town centre of its last remaining grocery retailer. However our concern is whether the SLC resulting from bringing the current Somerfield store and what is now the former Somerfield store under the same ownership can be remedied. Clearly, if we required Somerfield to sell its current store to another grocery retailer without requiring it to reopen its former store, this would fail to remedy the adverse effects of the merger, indeed merely exacerbate them. The alternative of Somerfield selling the closed store to another grocery retailer and retaining the acquired store would cause less disruption to shoppers and to Somerfield, by ensuring that there is no break in trading of the acquired store necessitated by, eg, temporary closure for refurbishment. So requiring divestment of the closed stores in Littlehampton and Kelso to suitable purchasers is, in our view, the most appropriate means of addressing the SLC in those markets.

11.11 We have considered whether the approach adopted following the 2003 Safeway report, to allow a choice of either the existing or acquired store to be divested, would be appropriate in this case. The stores which are the subject of this inquiry are very different from those in the Safeway inquiry. The latter were predominantly one-stop shops of over 1,400 sq metres (15,000 sq feet); the stores in this inquiry are almost all mid-range stores with a diverse range of characteristics: hence the methodology we developed to appraise the effects of the merger in this case to take into account the differing circumstances of the stores and their local markets. We have similarly taken those local characteristics into account in considering the most appropriate remedies, given the diversity of mid-range stores, in particular their size, profitability, condition, availability of car parking, and location, the latter being particularly important given the number of shoppers who walk to the stores.

11.12 To address the SLC, it is important first that the location of the store to be divested be such as to remedy the SLC identified, as would clearly be the case were the acquired store to be divested. If the existing store to be sold was some distance from the acquired store, it may be necessary to reassess the identity of appropriate purchasers for the store, requiring both a re-evaluation of the extent of competition in the isochrone of the existing store, and of the diversion ratios of customers of the existing, as opposed to the acquired store. In any cases in which there is more than one existing store, divestment of a more distant store, to which diversion ratios are likely to have been lower, may also fail to remedy the SLC identified. But secondly, it is important in order to address the SLC that the store offered for sale should be attractive to purchasers able to satisfy the criteria set out in the remedies notice. They should also be able to offer a comparable degree of competition with Somerfield on PQRS to that which existed prior to the acquisition. Where an existing store is relatively unprofitable, or has a significantly smaller sales area than an acquired store or has a disadvantaged store location, then there may be a significantly greater risk of not attracting a suitable purchaser and addressing the SLC.

11.13 We do not therefore accept Somerfield's argument that, as a matter of principle, it should generally be free to choose whether to divest the acquired or an existing store and that there is necessarily symmetry between divestment of either the acquired or existing stores. We are required to remedy the SLC and the adverse effects that have resulted from the merger, and this requirement determines the choice of store to be divested. We have therefore to consider, in the circumstances of each case, whether there are factors which suggest divestment of the existing store would be as effective in addressing the SLC as divestment of the acquired store. We now examine such factors.

11.14 In the case of five of the 12 stores to be divested, there is no disagreement between Somerfield and ourselves as to whether the divestment should be of the acquired or the existing store—namely, divestment of the two closed stores, both existing stores—Kelso and Littlehampton; and three of the acquired stores—Filey, Poole Bearwood and Whitburn.

11.15 In the case of the other seven stores, Somerfield has proposed divestment of the existing store, not the acquired store. These are at Johnstone, Middlesbrough Linthorpe, Newark, Peebles, Pocklington, South Shields, and Yarm.

11.16 Among the arguments put forward by Somerfield on these cases were that:

(a) For Johnstone, Newark, and South Shields, [✂].

(b) For Peebles, Pocklington, and Yarm, [✂].

(c) For Middlesbrough Linthorpe, [✂].

11.17 We do not accept that the cost of disposing of a store, be it freehold or leasehold, is relevant to our consideration of which store should be disposed. Paragraph 4.10 of our merger guidelines notes:

> … for completed mergers the Commission will not normally consider the costs of divestment to the parties as it is open to the parties to make merger proposals conditional on competition authorities' approval. It is for the parties concerned to assess whether there is a risk that a completed merger would be prohibited subsequently and the Commission will normally expect this risk to be reflected already in the acquisition price. Since the cost of divestment was, in essence, avoidable, the Commission will not, in the absence of exceptional circumstances, accept that the cost of divestment should be considered in the setting of remedies.

11.18 [✂].

11.19 On the basis of the information we have seen in the case of the existing stores at Johnstone (High Street), Peebles (Northgate) and Yarm (Healaugh Park), we noted that:

(a) The existing Somerfield store at High Street, Johnstone is located within one minute's drive-time of the acquired OSS. Although not classified as a one-stop shop, it is 13 per cent smaller than the acquired store, [✂]; more car parking; and is described to us as in good condition. Although we note that there are three existing stores in the Johnstone isochrone, we note that the other two existing stores are both smaller and further away; hence we believe that the removal of the High Street store will remedy the SLC.

(b) The existing Somerfield store at Peebles Northgate is 1.2 minutes' drive-time from the acquired store; is 10 per cent smaller; [✂]; described to us as in average condition (although that of the acquired store was good); and with more car parking, although with no rights or control over most of it.

(c) The existing Somerfield store at Healaugh Park, Yarm is 3.8 minutes' drive-time from the acquired store (but its location relative to other stores is not such as to call into question the isochrone analysis), 10 per cent smaller, [✂], with the same amount of parking and described as in good condition.

11.20 Somerfield assured us that there were no other relevant factors to be taken into account in these three cases. The factors outlined in paragraph 11.19 suggest there is little material difference in the characteristics of the acquired and existing store. On that basis, we conclude that divestment of either the existing store specified in paragraph 11.19, or of the acquired store would be equally effective in remedying the SLC.

11.21 In these three cases, therefore, Somerfield should initially be required to dispose of either the acquired or the existing store as specified above as it may choose.

11.22 In the other four cases, at Middlesbrough Linthorpe, Newark, Pocklington and South Shields, divestment of the existing store would be significantly inferior to divestment of the acquired store in remedying the SLC as these have a significantly greater risk of not attracting a suitable purchaser able to offer comparable PQRS to that which was offered before the acquisition.

(a) Middlesbrough Linthorpe: the existing Kwik Save store, at Eastbourne Road, is located 1.5 minutes' drive-time from the acquired store, but is less than half the size of the acquired store. [✂]; and described as in poor condition (as is the acquired store). [✂] There is another Kwik Save store within the isochrone of the acquired store. The divestment of the Eastbourne Road store, [✂], would not be as effective in remedying the SLC as selling the acquired store to a suitable purchaser.

(b) Newark: the existing Kwik Save store is 0.5 minute's drive-time from the acquired store, 25 per cent smaller than the acquired store, [✂]; has less car parking (although under Somerfield's control, unlike the acquired store's) and is described as in poor condition (the acquired store being in average condition).

(c) Pocklington: the existing, former Kwik Save store now under the Somerfield fascia is less than one minute's drive-time from the acquired store and about the same size, but, we observed, in poorer condition (Somerfield described its condition as average, that of the acquired store as good) with less car parking and a more constrained site and store layout. [✂]

(d) South Shields: The existing Kwik Save store is less than one minute's drive-time from the acquired store, and 40 per cent smaller than the acquired store, [✂] with slightly less car parking (although that of both stores is limited) and described as in poor condition (that of the acquired store being described as average). ([✂]) We also note that there is an additional Kwik Save store within the isochrone.

11.23 In summary therefore, Somerfield is required to divest to a suitable grocery retailer:

(a) the acquired stores at Filey, Middlesbrough Linthorpe, Newark, Pocklington, Poole Bearwood, South Shields and Whitburn;

(b) its existing closed stores at Kelso and Littlehampton; and

(c) either the acquired or the specified existing store as it may choose at Johnstone, Peebles and Yarm.

In each case, the divestiture is to be carried out in accordance with the process and timetable we now set out.

Identity of suitable purchasers

11.24 We stated in the Remedies Notice (paragraph 4*(b)*) that:

> Each store will be divested to a suitable purchaser that is independent of Somerfield and has the resources, expertise and incentive to maintain and develop the divested store as a viable and active competitor to the stores in the relevant local market, and would not be likely to recreate the expected adverse effects as a result of the divestiture.

11.25 We received some concern in comments on the provisional findings and remedies statement about divestment of mid-range stores to any of the three largest multiple retailers, given the strength of their position in the grocery retailing market, which, it was argued, would be increased by their acquisition of any of the stores. But, although certain acquisitions may be subject to review by the OFT, the national effects of the acquisition of such a small number of stores, with a very small share of the national grocery retailing market, are in our view likely to be limited.

11.26 In general, only operators within the competitor set identified in Stage 1 of the CC's analysis are likely to be viewed, in the initial divestiture period, as a viable and active competitor in the relevant market. However, we also believe it would be appropriate to consider purchasers who are not currently within that competitor set, because they do not currently operate within these geographical markets, but who could demonstrate that they can offer PQRS comparable to those previously available in these stores. This would include regional operators that currently do not operate in these particular areas, or new entrants that could demonstrate they would be able to compete effectively with a comparable offer.

11.27 It was also suggested to us (to which we referred in paragraph 6.90*(e)*) that at least one of the LADs should be included in the competitor set in Stage 1 of our analysis, and as a possible purchaser of any stores to be divested; but given the factors we have set out in paragraphs 6.43 to 6.45, including the very much smaller range of products of the LADs, we do not at present consider that they would be a suitable purchaser for the reasons given above at least in the initial divestiture period.

11.28 However, while divestment only to an approved potential purchaser, by which we refer to an operator within the competitor set or otherwise able to meet the requirements referred to in paragraph 11.26, is therefore likely to be viewed as fully addressing the SLC, if divestment to such an operator did not prove possible, then sale to other grocery retailers would need to be considered. Should Somerfield demonstrate to the CC after a stipulated period of time ([✂]) that there is no interest in acquiring any store from any of the relevant competitors, it would be allowed to market that store more widely (including, for example, to the LADs), before the involvement of a divestiture trustee to do so.

11.29 But, in addition, divestiture should also not be to any approved potential purchaser located within the isochrone of the acquired store. Neither should it be to any one – stop shop operator identified as having a diversion ratio from the acquired store of more than 14.3 per cent if located within a further 5 minutes' drive-time of the relevant isochrone of the acquired store (ie if located within 10 minutes' drive-time of an urban store or 15 minutes' drive-time of a rural store). This is to take into account the likely results of population-recentring around such stores. We list in Appendix G the identity of competitor retailers that would be excluded from acquiring specific stores since it would be unlikely to remedy, mitigate or prevent the SLC for these reasons. We would, however, allow divestments to operators located at a greater distance from two of the acquired stores, Peebles and Kelso, who, the survey suggests, have a diversion ratio from the acquired stores significantly below that to the nearby Somerfield stores but somewhat higher than 14.3 per cent. In these cases the nearest one-stop shop operators with a significant diversion ratio from the acquired stores are located about 30 minutes or more drive time from the acquired stores. Hence, the nearest supermarkets owned by these other operators are not in the same isochrone as the acquired store, and nor would they be in the same isochrone for any census areas under population recentring. A hypothetical acquisition by these operators of the acquired stores in the two locations would therefore not have been identified as a potential competition problem under any of the tests we used in this inquiry. Therefore we believe it is reasonable to allow the operators of these supermarkets some distance from Peebles and Kelso to be allowed to bid for the divested stores even though the diversion ratio shown in our survey was greater than 14.3 per cent.

11.30 In the case of Filey, a convenience store, the competitor set would be wider than that in the case of the mid-range stores, but still subject to the criteria set out in paragraph 11.24 such that it would provide satisfactory competition in the relevant convenience store market.

Divestment process

11.31 We also suggested in the Remedies Notice (paragraph 4*(c)*) that 'The CC will specify a period within which divestiture must occur (the initial divestiture period) and will consider using a divestiture trustee to divest any stores not divested within the initial divestiture period'. Somerfield will be required to organize the divestiture process to divest each store within the initial divestiture period with a suitable purchaser subject to the CC's approval. [✂] This initial divestiture period will remain confidential to prevent acquirers taking advantage of restrictions in the field of purchasers.

11.32 Somerfield will also be required to provide a specified minimum package of information acceptable to the CC for each store on request to any approved potential purchasers, except when specifically prohibited from acquiring particular stores. Somerfield argued it should market the stores widely, but, as it acknowledged, any sale would require the CC to be satisfied that the criteria for a suitable purchaser were met, for which we would apply the criteria set out in paragraphs 11.24 to 11.30.

11.33 If store divestitures are not agreed within the initial divestiture period, then unless there is a good reason to extend the initial divestiture period (for example, awaiting landlord's consent), the CC will appoint a divestiture trustee at Somerfield's expense who would be able to offer the stores in question [✂].

11.34 In addition, in the case of the three stores at Johnstone, Peebles and Yarm where Somerfield is required to dispose of either the acquired or the specified existing store, should it fail to divest its preferred store to a suitable purchaser and should a divestiture trustee be appointed, the divestiture trustee would be permitted to require divestment of the other store. In the case of South Shields, [✂].

11.35 The CC will permit stores to be divested individually or in packages provided that the suitable purchaser constraints and timescales for divestment are complied with.

11.36 Throughout the divestiture period, Somerfield will be required to maintain the competitive capability of the stores to be divested. Somerfield will report periodically to the CC on compliance with undertakings and the progress of the divestment process. If evidence emerges that Somerfield is not maintaining the capability of stores or not progressing the disposal process in the manner agreed in the undertakings, the CC will consider appointing a monitoring trustee to monitor Somerfield's compliance with the agreed undertakings.

11.37 The disposal process will be fully specified in undertakings. As noted in paragraph 11.31, the purchaser of each store will have to be approved by the CC.

11.38 We do not believe that structural remedies would put at risk any customer benefits of the merger.

12. Other aspects of the inquiry

12.1 We noted in paragraph 4.4 the view of some grocery retailers that there should be clear guidelines for assessing supermarket mergers—a 'bright line' approach. This concern was reiterated in comments we received on the provisional findings. In the circumstances of this particular merger, we adopted various approaches in Stage 1 of our analysis to identifying areas in which the merger could give rise to concern. We used store-based isochrones, based on data provided by Somerfield, but verified by GeoBusiness. We also used population-centred isochrones, based on analysis by GeoBusiness, which identified two stores that would not otherwise have been identified (although one of these did not give rise to an SLC due to development of a new store in that area). We then felt it necessary to conduct market surveys in as many as 56 local areas to enable us to take into account the individual circumstances of local markets. As is apparent in our discussion above, these surveys showed that, for most stores where acquisition was of concern to the OFT, and would also have been of concern to ourselves on the basis of Stage 1 of our analysis, the extent of competition between the acquired and existing Somerfield stores, as shown by the revenue diversion ratios to existing Somerfield stores, would not be sufficient for the merger to result in an SLC.

12.2 Having carried out the surveys we sought to derive a single formula which might have obviated the need for such extensive surveys and been used not only as an alternative to the methodology we have adopted in this report but as the basis for establishing 'brighter line' guidelines for use in the future both by the OFT and ourselves as well as the industry in planning their business. As noted in paragraphs 7.36 and 7.37, we did use this formula to reach conclusions on closed stores, but it did not fully explain the diversion ratios for each of the surveyed stores.

12.3 We nevertheless recognize the appeal of a bright line approach in this important sector of the economy, to avoid the need for similar surveys. We acknowledge these could not readily be carried out by the OFT in assessing future cases nor by the industry in planning their business, though it is possible that equivalent results could be obtained by other means.[44] We would be willing, after the completion of this inquiry, to discuss our methodology in this and earlier supermarkets reports with the OFT, the industry and other interested parties should they be interested in doing so. A number of retailers have responded positively to this suggestion in our provisional findings.

[44]It is not necessary to survey every store to estimate diversion ratios. For alternative methodological approaches to estimating diversion ratios see eg Baker, Coscelli and van Dijk (op cit), which uses national shoppers' surveys and loyalty card data, or New Zealand Commerce Commission decision 448 (Progressive Enterprises/Woolworths, December 2001), which uses local revenue market shares.