

Illustrative price rises in retail chain mergers

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Overview

Purpose

- To give an overview of simple quantitative techniques used for first phase competitive assessment of 'retail chain mergers'

Outline

- Background on UK merger control
- Recent examples of retail chain mergers examined by OFT/CC
- Description of diversion ratios and 'illustrative price rises', with examples

UK merger control

- **System**

- Is administrative, not judicial
- Has two phases (8 week 'first phase' and 24 week 'second phase')
- And two institutions (OFT and CC)
- But is voluntary, not mandatory (though OFT has 'mergers intelligence' function)

- **OFT examines around 100 mergers annually, CC around 10**

Retail chain mergers

- **'Retail chain mergers' prevalent in the UK**
- **Arise when one 'fascia' (brand of retailer) buys all or part of the estate of another fascia**
- **Often involve many (dozens or hundreds of) local geographic markets**
- **Main distinction between retail chain mergers analysed at first and second phase is number of local markets and overlaps involved**
 - Generally, CC more likely than OFT to consider merger involving one fascia buying entire portfolio of another

Recent OFT & CC retail chain mergers

OFT cases*	Year	Market	Overlaps	CC cases	Year	Market	Overlaps
Morrison's/Co-Op	09	Groceries	7/30	Holland&Barrett/Julian Graves	09	Health foods	214/350
Co-Op/LBA	09	Groceries	49/53	GAME/Game Station	08	Video games	179/252
Sports Direct/JJB	09	Sportswear	20/31	Tesco/Co-Op	07	Groceries	1/1
Co-Op/Somerfield	08	Groceries	210/877	Waterstone's/Ottakar's	06	Books	33/141
Cineworld/Show Case	08	Cinemas	1/1	Vue/Ster	06	Cinemas	4/6
Homebase/Focus	08	DIY	12/27	Somerfield/Morrison's	05	Groceries	56/115
Ladbrokes/McCartan	08	Betting	2/6	Morrison's/Safeway†	03	Groceries	79/481
Tesco/Brian Ford	08	Groceries	1/1				
Tesco/FreshExpress	07	Groceries	5/5				

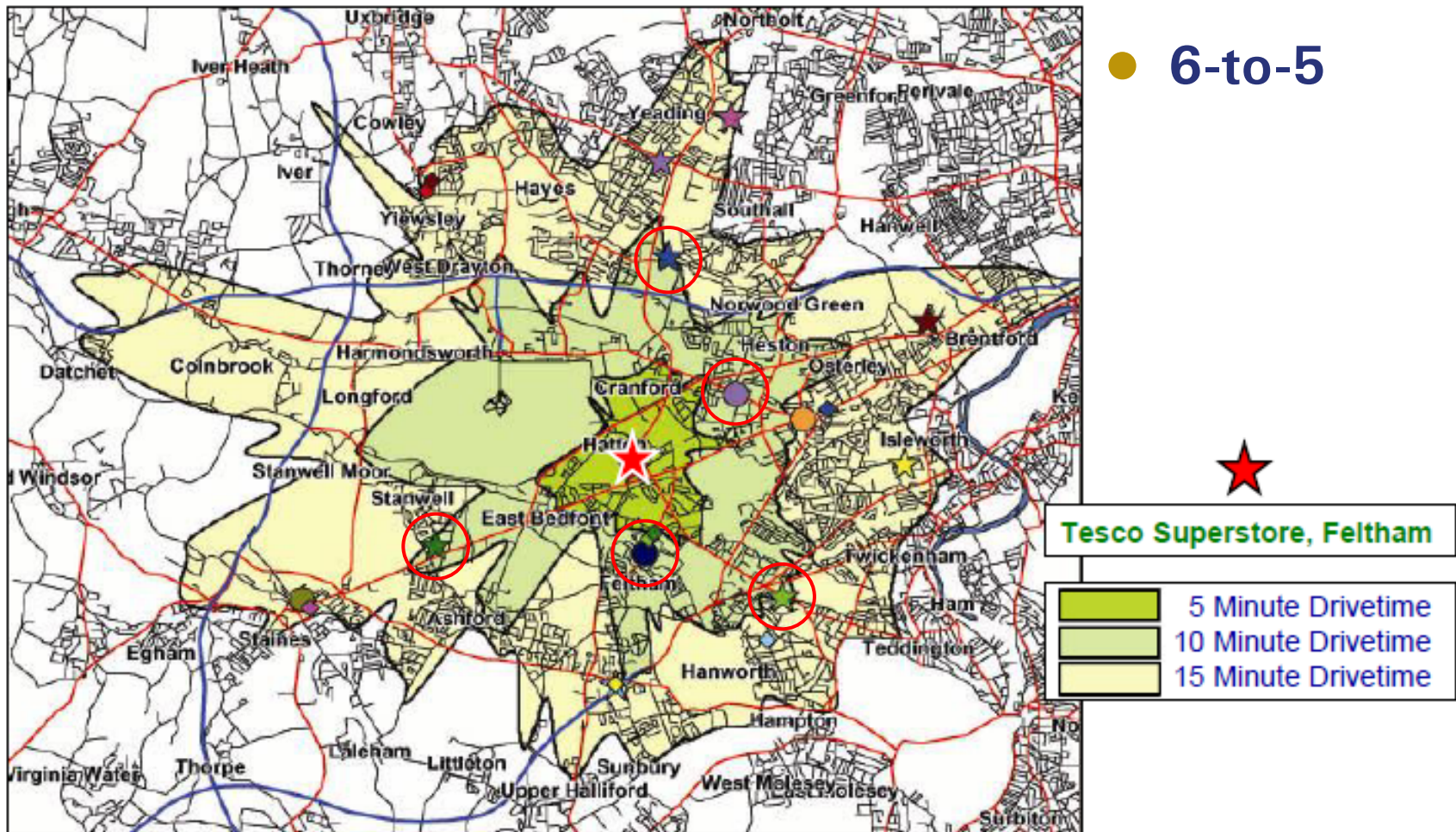
*CRM cases except Morrison's/Co-Op
†Morrison's overlaps only

Fascia counting

- **OFT and CC 'filter out' presumptively non-problematic overlaps by**
 - Looking at fascia reduction...
 - ...in plausible candidate geographic markets defined by 'isochrones' (areas of equal drive-time around retail outlet— can be thought of as an outlet's catchment area)
- **So if the effect of the merger in a given isochrone is to reduce the number of effective competitors from (say) 5 to 4, then the OFT/CC presume it's not anticompetitive and don't examine it further**

For example

● 6-to-5



Diversion ratios

- For local overlaps not filtered out, OFT and CC use diversion ratios to measure the closeness of competition between merging parties
- Defined as proportion of firm A's business that goes to firm B when firm A raises price and/or worsens non-price factors (quality, range, service etc.)
 - Higher this is, more problematic is the merger
- When products are differentiated, will not be well measured by market shares
- Can be measured by econometrics*, surveys†, event studies‡, internal documents§

*InBev/Anheuser Busch †Co-Op/Somerfield ‡Tesco/FreshExpress §Lovefilm/Amazon

How high is too high?

Case	SLC	No SLC
Holland&Barrett/Julian Graves (CC)		22
Morrison's/Co-Op (OFT)		15–27
Co-Op/LBA (OFT)	> 14	< 14
Tesco/Brian Ford (OFT)		[5-15]–[25-35]
Co-Op/Somerfield (OFT)	> 14	< 14
Homebase/Focus (OFT)	[> 25]–[> 50]	[< 15]–[> 25]
Waterstone's/Ottakar's (CC)		44–62
Somerfield/Morrison's (CC)	17–72	0–14

Diversion ratios & price-cost margins

- **Though high diversion ratios tell us merger parties are close competitors, not sufficient in themselves to say merger is problematic**
 - High percentage 'price-cost margins' (incremental profit margins) can indicate market less competitive generally, meaning *any* merger more problematic per se
 - So combination of high diversion ratios between merger parties and high incremental profit margins may be probative of unilateral effects

Upward pressure on prices

- **Diversion ratios and margins can be combined by invoking economic models to give a measure of upward pressure on one/both merger parties' prices ("illustrative price rise")**
 - Not really 'merger simulation'
 - estimate of pressure, not movement—assumes rivals do not react
 - only for one/both merger parties' prices, not equilibrium market-wide effect
 - and firms compete on aspects other than price

- **E.g. Somerfield/Morrison's (CC, groceries, 2005)**

	<i>Customer diversion ratio</i>	<i>Revenue diversion ratio</i>	<i>Gross margin</i>	<i>Illustrative price increase (i)*</i>	<i>Illustrative price increase (ii)*</i>
Johnstone	59.4	72.1	26.9	1,898.4\$	34.7
South Shields	40.7	43.4	25.7	36.0	9.8
Peebles	46.3	36.2	20.8	17.5	5.9
Middlesborough Linthorpe	23.1	34.3	26.0	22.4	6.8
Frome King St‡	29.9	29.3	25.3	16.3	5.2
Pocklington	37.1	28.4	30.7	21.3	6.1
Yarm	29.0	22.4	28.8	13.2	4.1
Newark	23.6	23.4	25.8	11.9	3.9
Paisley‡	19.3	21.4	25.4	10.3	3.5
Filey	21.2	20.6	27.8	11.1	3.6
Poole	14.9	18.8	25.3	8.5	2.9
Whitburn	16.3	16.7	24.8	7.1	2.5

Issues

- **Measuring price-cost margins**
 - To capture incremental profit margin, need to select a unit of output and a period of time
- **Allowing for efficiencies**
 - Supply-side (variable cost reductions), can be incorporated relatively easily
 - Demand-side (product repositioning) as retail chain mergers usually involve re-branding, much harder to allow for
- **IPR threshold**
- **Restrictive assumptions inherent in all economic models**
 - Many can be relaxed
 - Recent work by OFT suggests ranking of problematic overlaps essentially unaffected

“Restrictive assumptions...”

Thank you

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