
The Economics of Retailer Mergers

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Introduction – the challenges posed by retailer mergers

Mergers between retailers, wholesalers and local service providers have attracted close scrutiny from the UK competition authorities for many years.¹ This reflects the complex local and national competition issues raised by such mergers, as is illustrated by the Office of Fair Trading (OFT) and Competition Commission (CC) choosing to publish a detailed “Commentary on Retail Mergers” in March 2011 (the Commentary). The Competition and Markets Authority (CMA) is also holding a seminar on retailer mergers on 26 October 2015, with a particular focus on the implications of multi-channel competition and the growth in ecommerce.

Retailer mergers often raise three complex sets of competition issues.

First, the degree of rivalry between retailers may be affected by differences in their product and service offerings, such as the price, quality, range, and service levels (PQRS) they offer, and their geographical locations. In such cases, the effects of any loss of local rivalry on the merged entity’s incentives to worsen its competitive offer, whether locally and or nationally, cannot be assessed by calculating market shares or counting the number of competitors. This is the case irrespective of how the relevant product and geographical markets are defined.

In particular, rivals excluded from the market based on differences in their product/service offering or location may nevertheless be a competitive constraint, and similarly those included in the market may not all be of equal competitive importance. This points to competitors being given different weights according to the closeness of competition. The CMA adopted this approach in its phase 2 decision in *Poundland/99p* (2015) and its phase 1 decision in *Greene King/Spirit* (2015).

Second, competition between retailers may also occur nationally, because some aspects, or even all, of a retailer’s competitive offering may be determined nationally, rather than locally. This is notwithstanding that customers may choose to purchase locally.

In several recent phase 2 cases the UK authorities have ruled out local competition concerns, primarily on the basis that the merged entity would have no incentive to flex its local competitive offering where the parties’ outlets are close competitors. Moreover, they have also concluded that the merged entity would have no incentive to worsen its national offer materially.² The CMA also reached these conclusions in its phase 2 decision in *Poundland/99p*. The CMA’s reference decision in *Pure Gym/The Gym* (2014) provides a counterpoint as here the CMA identified both national and local competition concerns.

Third, retailer mergers may raise other competition concerns, such as creating excessive buyer power or the loss of a potential entrant.³ Such mergers may lead to a loss of potential competition, either in certain locations or potentially nationally, if the parties were likely to open new outlets in competition with one another in the absence of the merger. That retailer mergers may have adverse effects where one merger party has clear plans to enter a local market predominantly served by the other is not surprising. However, these concerns may be more wide-ranging as indicated by the CMA’s decision in *Pure Gym/The Gym*.

The complexity of these issues is often compounded by the need to assess rivalry across many local markets that differ in terms of the nature, size and locations of the parties’ outlets and those of local competitors. It is thus often necessary to collate extensive information on local markets, and customer surveys may be used to assess the closeness of competition between different retailers. Advisors acting on such mergers can, for example, expect to spend time looking at maps, the location and nature of local outlets, survey data and considering customers’ journey times to outlets and their willingness to travel.

This chapter focuses on how the CMA has assessed these issues in three recent cases, namely *Greene King/Spirit*, *Poundland/99p* and *Pure Gym/The Gym*.⁴ These cases are noteworthy as they illustrate when a retailer merger may raise local and/or national competition concerns.

In *Greene King/Spirit*, the CMA appraised a large number of local overlaps,⁵ but ultimately cleared the merger at phase 1, subject to undertakings in lieu of reference to divest only 16 pubs, which represented only 1.3% of the approximately 1,200 pubs acquired.

In *Pure Gym/The Gym*, at phase 1 the CMA had concerns at the national level, because the merger would reduce the number of national low-cost gym operators with more than 20 sites from four to three. Given these national concerns, the CMA considered that it would not be sufficient for the parties to make local divestments to address the loss of actual competition it had identified in ten local areas and the loss of potential competition in a further four locations. The CMA also considered, but did not conclude, that the test for reference may be satisfied in other localities where entry might occur.

In *Poundland/99p*, at phase 1 the CMA identified a loss of actual competition in 80 localities and a loss of potential competition in a further 12 localities. (The parties sold a range of food and non-food general merchandise, which is predominantly sold for £1 or 99p.) In phase 2, the CMA concluded that there were no local competition concerns, despite the parties being close competitors in many overlapping localities. The CMA instead considered that any

reduction in competition would only manifest at the national level, and concluded that there were no concerns at this level either.

The analysis behind these divergent decisions is considered below. The conclusions section highlights a number of key lessons from these cases.

Pure local issues: Greene King/Spirit

The CMA's methodology for identifying localities where *prima facie* competition concerns may arise

In *Greene King/Spirit*, the CMA dismissed the possibility of any competition concerns at the national level, because the parties' combined national market shares were modest⁶ and post-merger seven national pub operators would remain.

The CMA summarised the local competition concerns with retailer mergers as follows:

"A merger between two parties with sites (in the present case pubs) in a local area can affect the process of rivalry and lead to a worsening of some of the parameters of competition because it brings the sites under common ownership. Generally unilateral effects in local areas involve an increase in price, or a decrease in quality, at a site because a proportion of the customers would switch to a site belonging to the other merging party. As a result, instead of losing all of the profits associated with switching customers, the merged entity now recaptures a percentage of this diversion, making a previously unprofitable price rise profitable. Therefore, for unilateral effects to arise, the parties must have both the ability and the incentive to increase price or deteriorate quality at some of their pubs."

This highlights a number of important points. First, competition between retailers is multi-dimensional across price and quality (or more generally PQRS). As noted above, some or all aspects of a retailer's offer may be set nationally, rather than locally. In addition, the extent of any local flexing of PQRS by a retailer in those locations where it possesses some local market power will depend on the costs and benefits of doing so.

Second, the risk of anti-competitive effects depends on the closeness of competition between the parties, and in particular the "*proportion of the customers [who] would switch to a site belonging to the other merging party*" in response to one of the merging parties unilaterally worsening its offer. This proportion is commonly referred to as a diversion ratio.

Third, the change in pricing incentives also depends on profitability – namely the increase in profits achieved from incremental sales – of those customers who pre-merger would have switched to the other merging party.⁷

This raises the question as to how to identify where diversion ratios between the parties' outlets may be sufficiently high for *prima facie* competition concerns to arise, particularly as pubs' offerings vary substantially and so do their catchment areas.⁸

The CMA could have assessed the merger using the approach that had been applied to pub merger cases for many years.⁹ Under this approach, the CMA would simply have identified those petty sessional division (PSD) licensing areas where the merger increased the parties' combined share of the number of all pubs by at least 5% to over 25%.

However, the CMA rejected this historic approach, which is contrary to the guidance in the Commentary. Accordingly, perhaps the first lesson from this case is that regulatory precedent will not be slavishly followed. The historic approach to pub mergers is problematic, because pubs' offerings are differentiated and PSD licensing areas do not reflect pubs' catchment areas.

Instead, the CMA considered the results of a survey commissioned by the parties. This survey covered 40 pubs and was conducted online using email addresses from the parties' mailing lists from their managed pubs. The survey asked customers what establishment they would frequent if the pub at hand were closed. The results suggested that the "dry-led" pubs (where 30% or more of their turnover is from food) are closer competitors to each other than "wet-led" pubs (where this is not the case), but that dry-pubs do impose the same competitive pressure on wet-pubs as other wet pubs. Therefore, dry-led pubs were assessed with the competitor set including wet-led pubs, whilst the wet-led pubs competitor set did include dry-led pubs.

The survey also indicated the locations of pubs to which customers would switch, thereby revealing the local catchment areas of pubs. Having regard to this analysis, together with the parties' submissions and a consideration of travelling times,¹⁰ the CMA considered that it should adopt the following drive time isochrones centred on each of the parties' pubs: City Centre (two minutes); City Urban, Other Urban and Suburban (10 minutes); and Rural and Rural Town and Village (15 minutes).

Having identified the competitive set and catchment areas, the CMA then considered the appropriate threshold to identify those overlaps where *prima facie* competition concerns may arise. Typically in retailer mergers, the CMA counts the number of independent owned competing fascias, rather than market shares or the number of outlets. However, as the CMA observed:

"In general, the underlying assumption for a fascia count approach is that there will be uniform diversion to different fascia within an area, irrespective of the number of individual sites a company operates in that area. This assumption is generally more likely to hold where there is little variation between the offerings in each of the fascia's sites. In this case the CMA considers it appropriate to depart from this approach as there are a large number of different fascia operating in the pub market, each with a different percentage of leased and managed pubs within their estate. In relation to pubs, each fascia is operating a number of different brands as well as non-branded sites positioned at different points on the price and quality spectrum, often with little to tell the customer that they belong to the same company. The evidence available to the CMA indicates that customers will choose between individual pubs rather than fascia, and as such the number of distinct pubs a company has in an area will be important in determining the level of competition."

Accordingly, the CMA decided that local market shares were a better measure of local rivalry between pubs than counting the number of independent fascias.¹¹ Market shares were calculated centred on each party's overlapping pub.¹²

The market share level threshold applied historically by the OFT and CC was 25%, but this was applied to all pubs in a PSD area, whereas the CMA had decided to focus on a sub-set of pubs (as noted above) and specific catchment areas. The CMA also accepted that there was likely to be diversion to other options, including different types of pubs, restaurants and staying at home, outside of the defined competitor set. For example, the CMA noted that for 11 of the 23 dry-led pubs that were surveyed, diversion to restaurants was greater than or equal to diversion to the other merging party. The CMA therefore considered that the market share threshold set should have regard to the likelihood of constraints from other options.

The CMA added that it generally considers that retailer mergers only raise *prima facie* competition concerns if the number of fascias falls from four to three. This can be translated into a market share threshold as three equally sized competitors would each have a market share of 33%.

In the light of these considerations, the CMA concluded that it was appropriate to identify *prima facie* competition concerns where the merger increased market shares by over 5% to more than 35%.

Before proceeding further, it is appropriate to emphasise that the purpose of any initial threshold criteria is to highlight those locations where the parties are sufficiently close competitors such that local adverse effects on competition may arise. These locations can then be subject to further analysis. Accordingly, some conservatism in setting these initial criteria is appropriate, providing that there is sufficient additional scrutiny as to actual competitive conditions in the localities identified.

Regardless of the actual threshold set, it is also important to consider the likelihood of diversion outside the competitive set and catchment area adopted. For example, suppose that two pub operators each with a market share of 17.5% were to merge. With no diversion outside of the competitive set or catchment area, then diversion ratios between the parties would be 21.2%, assuming that diversion between competitors simply reflected market share.¹³ However, if say 20% of sales volume were to divert to competitors (or customers cease to buy) *outside* the competitive set and a further 20% to rivals outside the defined catchment area, then the diversion ratio between the parties would fall to 12.7%.¹⁴ In short, second stage analysis is important to ensure that due weight is given to area specific evidence suggesting that diversion ratios between the parties are in fact low.

The CMA's second stage analysis

The CMA's analysis suggested that *prima facie* competition concerns would arise in 56 local areas. However, the CMA was able to use the survey and other local information to narrow its concerns down to only 16 areas, notwithstanding that the parties' survey did not cover the majority of the potentially problematic overlaps.¹⁵

The CMA's primary filter disregarded all competition that dry-led pubs face from wet-led pubs. The parties' survey indicated that diversion from dry-led pubs to specific categories of wet-led pub was equivalent to approximately 20% of the diversion observed from one of the parties' dry-led pub to another dry-led pub. Recalculating market shares around dry-led pubs by giving a 20% weight to wet-led pubs increased the number of localities by 30 where the parties' combined market share was below 35%. The CMA thus concluded that there was not a realistic prospect of a substantial lessening of competition (SLC) in these areas.

This seems like a sensible refinement as giving zero weight to wet-led pubs would be inconsistent with the survey evidence.

More generally, whilst this does not apply to pubs or other businesses that provide local services, internet retailers may provide a source of competition nationally in many other product markets. Where there is evidence of appreciable diversion to internet retailers, it would seem sensible to include them in the assessment of competitive effects, even if the specific facts do not justify internet sales being given the same weight as local physical outlets.

The parties' survey also indicated that there were few sites where diversion ratios exceed 10% where the parties' pubs were more than half an isochrone away. Accordingly, the CMA concluded that there was not a realistic prospect of a SLC in two further locations where this was the case *and* there were at least two other competitors located nearer than the other merging party's pubs.

The CMA noted that there was a wide variation in the catchment areas suggested by the survey as regards City Centres (here London) across a small sample of pubs. The CMA therefore indicated that a sensitivity check was appropriate in applying this drive time criterion in London. The CMA applied a sensitivity of plus and

minus 30 seconds, and found that market shares would fall below 35% under these scenarios as regards four Central London overlaps. The CMA thus concluded that competition concerns did not arise as regards these overlaps.

Finally, the CMA also had regard to whether additional specific dry-led pubs nevertheless represented a sufficient further competitive constraint, having regard to their locations, prices, amenities and TripAdvisor ratings. The CMA concluded that this was the case as regards two further locations, with the CMA emphasising that the merged undertaking's market share in these locations was only marginally above 35% once wet-led pubs had been included in the market share calculations on a discounted basis (as discussed above).

National versus local competition concerns: Pure Gym/The Gym and Poundland/99p

The CMA referred both of these cases for phase 2 investigation. The parties then abandoned the *Pure Gym/The Gym* merger, and the CMA cleared *Poundland/99p* in phase 2.

As noted above, in both of these cases the CMA found the parties to be close competitors in many areas, and therefore the CMA held that there was a realistic prospect of a SLC at phase 1. However, what is interesting about these cases is the CMA's assessment of national competition issues, and whether these generate *additional* competition concerns or *remove* the possible existence of local concerns.

Local competition

At one level, *Pure Gym/The Gym* and *Poundland/99p* are similar cases. In *Pure Gym/The Gym*, the parties are two of only four national operators of budget gyms with more than 20 sites. Similarly, in *Poundland/99p*, the parties are two of the three national retailers of value general merchandise that operate a single price point business model (Poundworld being the other). In each case, the parties were considered by the CMA to be each other's closest competitor (along with Poundworld in *Poundland/99p*), notwithstanding that they face competition from other operators.¹⁶

In principle, survey evidence as to customers' choice of outlet and an analysis of the impact of new entry can reveal diversion ratios between the parties. In addition, they may also be direct evidence of the importance of particular rivals if, for example, their entry or exit has a significant impact on prices or other aspects of a firm's offer.

In *Pure Gym/The Gym*, the parties had limited survey evidence that could be used to assess diversion ratios.¹⁷ In addition, their entry analysis was partial.

In *Poundland/99p*, the parties commissioned an online survey aimed at estimating diversion ratios, with the online survey covering the entire Poundland estate and also each 99p store within one mile of a Poundland store. This suggested diversion rates between the parties of 10% to 20% nationally (including both overlap and non-overlap areas) and between 0-40% in local overlapping areas. In phase 1, the CMA appeared to accept that, if these diversion ratios were correct, the sales loss they would experience from increasing prices would be too great for a price increase to be profitable given the parties' gross margins.

However, the CMA raised a range of issues with Poundland's survey. In particular, the CMA was concerned with the online nature of the survey (the CMA's survey found that 21% of the parties' customers never go online) and it had a very low response

rate (well below 5%). An exit survey of customers leaving stores who were then followed up by a telephone survey also revealed higher diversion ratios between the parties. In addition, the CMA was concerned with the complexity of the calculation of diversion ratios in Poundland's survey.

Even in its phase 1 decision, the CMA nevertheless accepted that the body of evidence suggested that various value general merchandise retailers competed with the parties, rather than the market being limited to single price point retailers.

In phase 2, the CMA commissioned its own exit survey of overlapping stores in 15 areas. This revealed systematically higher diversion ratios between the parties than those indicated by Poundland's online survey, and the CMA argued that its survey was more reliable than Poundland's.

The CMA also carried out an econometric analysis of entry that derived higher diversion ratios between the parties than its survey. In general, it considered that greater weight should be given to the diversion ratios based on its econometrics since this reflected actual behaviour (rather than stated responses to a survey question) and the econometrics covered all of the parties' stores. Nevertheless, the CMA noted an important caveat in that the entry of supermarkets may increase overall footfall to an area (rather than principally stealing business from nearby outlets), and thus it considered that the survey results were more representative of rivalry from supermarkets.

To put these observations in context, the CMA's survey found that the diversion ratio between Poundland and 99p averaged 36-41% in the 15 overlapping areas surveyed. These diversion ratios would suggest that, unless the parties' profit margins were low, the merger could have a substantial impact on the merged entity's incentives to compete locally and lead to it worsening its competitive local offer.¹⁸ Notwithstanding this, the CMA cleared the merger. By contrast, the CMA identified further national competition concerns in *Pure Gym/The Gym*. To understand these divergent decisions it is helpful to highlight the relevance of national competition in both cases.

National competition removing local competition concerns

Even if the merged entity might have local incentives to worsen its local PQRS, it is necessary to assess whether it would in fact do so. In particular, pre-merger do the parties charge more or otherwise worsen the appeal of their offer where they have local market power?

In *Poundland/99p*, the CMA found that pre-merger:

- Poundland varies some aspects of its PQRS by location, but not others. In particular, Poundland does not vary its price or pack size locally, but it does vary its range by size of store; and
- historic variation in PQRS has not related to local competition, with very few exceptions.

Accordingly, in phase 2 the CMA considered whether any loss in local competition would be constrained by the benefits of maintaining a largely national policy as regards the setting of PQRS.

Such arguments did not apply in *Pure Gym/The Gym* as the parties admitted that they flex their pricing decisions across different areas, including with regard to local competitive conditions. This is notwithstanding that aspects of the parties' gym offering were determined nationally, including aspects of pricing structure, service offering and branding.

In *Poundland/99p*, after much consideration, the CMA concluded that the costs of Poundland flexing its competitive offering locally were not prohibitive.¹⁹ The CMA then considered whether the merger would appreciably change Poundland's incentives to do so.

Flexing PQRS locally enables retailers to set PQRS optimally reflecting variations in local conditions, including variations in local cost and demand conditions as well as local rivalry. Accordingly, the CMA analysed how the merger affected the variation in market conditions across Poundland's network of stores pre and post-merger.

In this regard, two different effects can be identified. First, the merger may nationally reduce the number of competitors that the merged business faces in local markets across the UK, depending on the overlap in the parties' store networks *and* the aggregate degree of rivalry they face from rival retailers.

Secondly, a merger may also increase or reduce the *relative* variation in competitive conditions across the merged entity's portfolio of stores. To give an extreme example, one retailer might operate in purely monopoly areas and another might operate only in areas with many competitors. Both of these firms might adopt national pricing policies pre-merger, because their profits would not increase by flexing their respective local offers. However, post-merger – and disregarding the effects of the merger on local rivalry – the merged entity might find it profitable to engage in local flexing due to the greater variation in competitive conditions across its store portfolio.²⁰

To explore these issues, the CMA sought to count the number of competitors that Poundland faced across the UK. A weighted store count approach was adopted focusing on areas in which there were two or fewer "weighted" competitors, with different weights being applied according to differences in competitors' relative diversion ratios based on the survey and econometrics evidence collated by the CMA.²¹

The results indicated that the number of stores in monopoly areas went from 44 outlets pre-merger to 71 outlets post-merger and those with 0-0.5 weighted competitors went from 133 to 241. However, in proportionate terms across the Poundland network the change was relatively small. For example, the CMA emphasised that the proportion of Poundland's stores in monopoly areas only increases from 8% to 9% as a result of the merger. The CMA thus concluded that the results do not indicate a material change in the variation in competition faced by Poundland, suggesting that the merger would not materially impact the incentives for Poundland to flex PQRS locally.^{22 23}

The CMA also dismissed any separate concerns associated with the possible impact of store closures on consumers, given that the average distance between overlapping stores is very small (0.1 miles) and the parties' offerings are very similar.

In the light of the above, the CMA concluded that the merger would not be expected to lead to local competition concerns.

The assessment of national competition concerns

In *Poundland/99p*, the CMA then turned to assessing whether the loss of rivalry between the parties would lead to national competition concerns.

It rejected the approach adopted in phase 1 of assessing national rivalry on the basis of national market shares. This is because this approach would not take account of the differences in the relative competitiveness of different retailers, differences in geographical overlaps across store networks, and would need to exclude the revenues of non-competing products.

The CMA instead assessed national competitive effects by estimating national diversion ratios between the parties based on the number of weighted competitors faced by the parties across their store networks. The CMA's estimated aggregate diversion ratio

from Poundland to 99p was 10%, and 21% from 99p to Poundland. Given that Poundland intends to convert 99p stores to Poundland stores, the CMA considered that greater weight should be given to the weighted average diversion ratio of 13%. The CMA also considered various sensitivities, and concluded that these diversion ratios implied that there would not be “a material adverse effect of the merger”.

The CMA then used these diversion ratios and the parties’ variable margins to estimate illustrative price increases assuming linear demand for 99p and Poundland.²⁴ The actual figures have been redacted, and the CMA considered that the illustrative price rise would lie between these two figures as Poundland’s offering would be the same across the merged store portfolio. Our assumption is that the mid-point of these estimates would suggest an illustrative price rise of less than 5%.²⁵

The CMA also added that the expansion plans of various competitors, and its finding that 99p would have been unlikely to open any new stores, were likely to reduce the aggregate diversion ratios between the parties.

Accordingly, the CMA concluded that the merger would also not have any adverse effects at the national level.

Given these findings the CMA also stated that it did not need to reach a view on the other countervailing factors identified by Poundland, namely efficiency benefits and potential entry.

It should be noted again the CMA’s survey found that the diversion ratio between Poundland and 99p averaged 36-41% in the 15 overlapping areas surveyed. Accordingly, the low estimated aggregate diversion ratio is largely attributable to:

- only about a third of Poundland’s stores competing locally with a 99p store; and
- the CMA including a number of value general merchandise retailers as competitors, namely Home Bargains, B&M, Wilko and Bargain Buys, as well as Tesco and Asda, albeit with a weighting of 0.5.

The findings in *Poundland/99p* also provide a basis to contrast the CMA’s identification of national competition concerns in *Pure Gym/The Gym*.

In *Pure Gym/The Gym*, the CMA relied on three key characteristics to determine if the parties compete nationally and whether the merger would likely result in a national SLC. First, whether competitive features of firms’ offerings are set nationally. Second, whether the parties are close competitors nationally, having regard to the number of areas in which they overlap and the degree of rivalry between them where they do compete. Third, whether the parties face significant residual national constraints from alternative national budget gym operators or higher priced gyms, even if the parties are each other’s closest competitor.

The CMA found that the parties compete nationally across a number of important parameters that were set nationally, such as pricing (‘price for life’ offer), service offering, location, and facilities.

As regards the second criteria, the CMA found that the parties were particularly close competitors and it noted that it had identified competition concerns in the majority of the overlapping areas it had investigated in detail (14/21). As noted above, the CMA did not have any survey or entry analysis that suggested that there was material rivalry between low-cost and more expensive gyms. The merger was abandoned, but customer surveys and detailed entry analysis could have been revealing as regards diversion ratios between the parties. In particular, it would have been interesting to explore from which competitors and from where new gyms had won their customers, particularly given the extensive new entry that had occurred in the low cost gym sector.

Moreover, respectively 64% and 68% of Pure Gym’s and The Gym’s network of sites overlap. As noted above, the limited network overlap was a key driver of the CMA’s provisional clearance decision in *Poundland/99p*.

Third, the merger would have resulted in there being only three national budget gym operators with more than 20 sites, with the CMA finding that the other two operators lack credibility given their relative small size and modest expansion plans. The CMA therefore concluded that there was a realistic prospect that the merger may be expected to result in an SLC at the national level.

The loss of potential competition

In *Poundland/99p*, the CMA’s provisional phase 2 decision dismissed any loss of potential competition. This is because the CMA considered that the financial position of 99p was such that it is likely that in the short term it would not have been able to pursue its previous expansion plans. Other competitors also had expansion plans.

In *Pure Gym/The Gym*, the CMA concluded that there was a realistic prospect of a SLC as regards the loss of potential competition in four locations.

However, the CMA also had concerns for a number of reasons that the merger would give rise to a broader loss in potential competition, although it did not formally conclude on this issue.

First, the parties are the two largest budget gym competitors, with Pure Gym having over 50 gyms and The Gym over 35 gyms.

Second, the CMA decision sets out in some detail that both parties had substantial planned expansion plans, and that rivals’ expansion plans were more limited. Indeed, the CMA emphasised that the aggregate expansion plans of rivals are less than the parties’ combined plans.

Third, the parties have frequently entered new areas in competition with another, and over the last five years had done this more frequently than any other operator by a substantial margin. Of the parties’ pipeline sites, almost half are within the catchment area of at least one site of the other party. The CMA indicated that the evidence suggested that other budget gym operators are less able to obtain similarly prominent locations. There was also evidence that other competitors focus on opening new sites in less central locations than favoured by the parties. In particular, the parties’ next largest competitor (Xercise4Less) operated only 19 gyms across the UK (with five in the pre-opening stage) and it was more likely to open in out-of-town locations.

Finally, the CMA considered that Anytime Fitness, which accounts for 38% of planned entry, is unlikely to be a significant constraint on the parties as it generally operates considerably smaller gyms in the local areas assessed in detail by the CMA, and it is not a low price operator. The CMA similarly discounted the competitive significance of other competitors’ expansion plans.

Conclusions - Lessons

Lesson 1: A key lesson from *Greene King/Spirit* is that regulatory precedent will not be slavishly followed. The substantive issue is the effects of the merger on rivalry, not establishing rules of thumb. In this regard, it should also not be assumed that fascia counts are always the best way of establishing thresholds for where *prima facie* competition concerns arise (*Greene King/Spirit*).

Lesson 2: Retailer mergers are highly fact specific, and thus data on rivalry between the parties and how they compete locally and nationally is essential.

Lesson 3: Good information on diversion ratios is often key to scoping the extent of the competition concerns, and it may be possible to extrapolate from survey data covering a range of areas to specific overlapping areas. This extrapolation was important in *Greene King/Spirit* as discussed above. If the CMA cannot narrow down the scope of the competition concerns, then this either points to extensive divestments to address broad competition concerns (which may not be commercially appealing), or simply a phase 2 investigation. This was certainly a key driver of the reference decisions in *Pure Gym/The Gym* and *Poundland/99p*.

Lesson 4: Focusing solely on catchment areas and a defined competitive set may not capture rivalry well. It may be better to give weights to competitors according to the closeness of competition. The alternative options of treating differentiated competitors as being either being equally important or disregarding them altogether would simply be mistaken. Accordingly, the approach taken by the CMA in *Greene King/Spirit* and *Poundland/99p* is sensible.

Lesson 5: It is also important to consider the importance of national competition. Where the parties predominantly set PQRS nationally (which may require detailed analysis), it may be the case that the merger does not appreciably change their incentives to maintain such a strategy *if* it does significantly change the degree and variation in competitive conditions across their store networks. This will be driven by both the importance of rivalry between the parties where they do compete *and* the extent of the geographical overlap across the parties' store networks.

These factors are also crucial as to whether the merger appreciably reduces national competition between the parties. These considerations explain the sharp distinctions between the CMA's phase 1 reference decision in *Pure Gym/The Gym* and its phase 2 clearance decision in *Poundland/99p*.

Finally, it should be borne in mind that retail markets are dynamically competitive and there is increasing competition across distribution channels, particularly from the internet and developments such as click-and-collect. These nationwide developments will tend to increase the costs of local price flexing, since internet sales are likely to increase if local outlets increase their prices and as consumers may increasingly expect prices to be uniform across distribution channels.

Endnotes

- 1 As shorthand, we refer to all of these mergers as retailer mergers, but the issues identified apply to mergers between wholesalers that supply business customers locally (such as electrical equipment wholesalers and building products wholesalers), and also outlets providing services locally (such as betting shops, bingo halls, bowling alleys, casinos, cinemas, funeral parlours, gyms, hospitals and travel agents).
- 2 Namely *Thomas Cook/Co-op/Midlands Travel* (2011), *Sports Direct/JJB* (2010), and *NBYT/Julian Graves* (2009).
- 3 Concerns as to excessive buyer power are often dismissed briefly. For example, in its phase 2 decision in *Poundland/99p*, the CMA observed that: "*In general, the CMA would regard an improvement in the negotiating strength of the merging parties as beneficial to customers if enough competition remains in the downstream market, so that lower prices or quality improvements that would be negotiated are passed on to customers. This issue therefore only arises if we find that the merger may be expected to result in competition concerns in our assessment of unilateral affects...*" (§6.95).
- 4 A broader review of the assessment of retailer mergers is set out in the article published in PLC in June 2009 entitled "Mergers between UK retailers: substantial local complexity?", by Mat Hughes and Neil Cuninghame, with there being further

updates on retailer mergers in "The Economics of Horizontal Mergers – Recent Lessons in Avoiding Surprises", by Mat Hughes and David Wirth, Ashurst LLP, in "The International Comparative Guide to: Merger Control 2011" and the UK chapter of the first and second editions of "Global Legal Insights – Merger Control" in 2012 and 2013 by Nigel Parr and Mat Hughes, Ashurst LLP.

- 5 The CMA found that around 1,000 Spirit pubs overlap with a Greene King pub in a local area.
- 6 The CMA excised the actual market shares, but we would assume that they were well under 20%.
- 7 These points are set out more fully in the Commentary, see §4.7*et seq.*
- 8 The CMA also considered whether the merged entity would have the ability and incentive to worsen the competitive offer of leased and tenanted pubs, where the parties' control over these pubs is clearly less than those pubs that they manage. The CMA concluded that "on a cautious basis" the parties' tenanted and leased pubs should be included in the local competitive assessment. It would have been interesting to consider this issue further in the 16 problematic areas, particularly whether it would have been profitable for the merged entity to seek to worsen the offer of any such pubs given the contractual constraints imposed by leases and tenancy agreements.
- 9 For example, in its *Elders IXL/Grand Metropolitan* (1990) report the Monopolies and Mergers Commission identified local competition concern in the retailing of beer by pubs. It recommended that the merged entity be required to reduce to 25% the proportion in any petty sessional division (PSD) in England and Wales of full on-licensed premises in their ownership and also tied to Courage for the supply of beer (other than guest cask-conditioned ales and non-alcoholic and low alcoholic beers) (§8.81(d)). The CMA's decision in *Greene King/Spirit* lists four cases from 2005 and 2006 in which the competition assessments of pub mergers by the OFT were based on market shares at the PSD level.
- 10 Typically, the CMA assesses catchment areas by analysing the data on customers' locations so as to ascertain the area from which a retailer draws 80% of its sales revenues. However, there may be some complexities in assessing this catchment area. In *Greene King/Spirit*, the CMA did not have data on customers' expenditure and thus agreed with the parties that it was more appropriate to focus on a catchment area accounting for 60% of those customers for which the parties had data. This is because nearer customers were more likely to visit the pub more frequently. In *Pure Gym/The Gym*, the CMA noted, however, that many people will visit a gym near their place of work and hence this threshold could overestimate the size of the catchment areas. Accordingly, the CMA considered other catchment areas as well.
- 11 Similarly, in its 2006 *CWS/Fairways* decision relating to funeral businesses, the OFT concluded that fascia count was not an appropriate filter, given that branding was not a strong feature of the funeral industry and that consumers were unlikely to be aware whether differently named businesses were part of the same group. Accordingly, the OFT assessed the merger on the basis of market share data.
- 12 In this regard, it should be noted that even if two competitors are in each other's catchment area, the identities and numbers of other rivals each outlet faces will often vary. This is because unless the merging parties' outlets are adjacent to one another, the geographical areas they serve will tend to be different and thus may encompass different local rivals. Accordingly, it is possible for there to be asymmetric competition concerns, which may impact on the competition analysis since one overlapping stores may face many rivals, whereas the other merging party may face few rivals.
- 13 $17.5\%/82.5\% = 21.2\%$.

- 14 60% of $17.5\%/82.5\% = 12.7\%$. There is no particular diversion ratio at which significant price increases may emerge since the change in a merged firm's pricing incentives depends on the interaction between profit margins and diversion ratios, disregarding for the moment the operation of any other competitive constraints, such as entry and expansion by new and existing rivals. However, in the *Somerfield/Morrisons* (2005) the CC required diversion ratios to exceed 14.3%, as well as illustrative price increases to exceed 5%, before it found there to be a SLC. This case is also referred to by the CMA in *Greene King/Spirit*.
- A further measure of the change in pricing incentives, which has been considered by the OFT and CC in a number of cases, is referred to as the gross upward pricing pressure index (GUPPI), which in its simplest form is calculated by multiplying gross margins by the diversion ratio between the parties. If, for example, the gross margin were to be 35% and the diversion ratio were to be 15%, then GUPPI would be 5.25%. It is also possible to estimate illustrative price rises subject to further assumptions as to how customer price sensitivity (or more formally, price elasticity of demand) varies with price. For example, if demand is linear and firms are symmetric (so that diversion ratios between them and their gross margins are the same), then illustrative price increases may be estimated using the formula $md/(2(1-d))$, where m is the gross margin and d is the diversion ratio. With these gross margins and diversion ratios, then the illustrative price rise would be only 3.1%. These methodologies are discussed further in the articles referred to in note 4.
- 15 Diversion ratios between specific pubs from the survey were only used by the CMA in relation to two of the 56 potentially problematic overlaps it identified.
- 16 For example, in *Pure Gym/The Gym*, the CMA excluded gyms from the competitive set charging more than 25% more than the price charged by virtually all of the parties' gyms. The CMA did, however, consider gyms that offered additional services or quality relative to the parties' gyms (such as a swimming pool) to be rivals, even if they were a certain amount more expensive than the parties' gyms.
- 17 The parties did have exit surveys as to customers' decisions when they were leaving a gym. However, the CMA observed that this revealed nothing about the choices of new customers joining a gym. This criticism is perhaps too harsh as the standard survey question asked by the CMA relates to how a customer would respond to the closure of an outlet.
- 18 Applying the simple formula set out at note 14 for linear demand and assuming a gross margin of 35% and a diversion ratio of 35% would suggest an illustrative price increase of about 9.4%.
- 19 These costs will include factors such as any reputational issues associated with varying their offer locally (which may be particularly transparent depending on the extent to which retailers also sell over the internet and whether those making local purchases compare prices), the costs of varying pack sizes/range by store, and the costs of locally monitoring and revising the local outlet's offer in the light of differences in local rivalry.
- 20 In our opinion, whether a firm sets PQRS nationally or locally should not be a competition concern per se in the context of assessing the effects of a merger. Instead, the substantive concern is whether the merged entity would have an incentive to abandon nationally setting PQRS in order to exploit the local market power it has acquired in certain localities as a result of the merger.
- 21 For example, based on estimated relative diversion ratios, the CMA gave a weight of 1 to other single price point national operators like Poundland (i.e. 99p and Poundworld) and 0.5 to Home Bargains, Wilko, Bargain Buys and Tesco and Asda, with the CMA also down weighting competitors by 0.5 where they were located between half of a mile to one mile away.
- 22 The CMA's focus on the proportionate impact across the Poundland network, rather than the total number of stores, assumes that the costs of local flexing are incurred on a per store basis. The CMA concluded that most of the costs of flexing PQRS would increase with the number of stores.
- 23 The CMA also carried out some sensitivity testing as to how the merger affects the degree of variation in competitive conditions across the Poundland store network by adding Poundstretcher to the competitive set and, in another scenario, dropping Asda from the competitive set. The CMA asserted that this did not have a significant impact. The CMA also added that new entry by competitors into areas served by Poundland could also reduce Poundland's incentives to depart from national set PQRS by increasing the cost and complexity of monitoring and adjusting local offerings as entry occurs.
- 24 The CMA's findings also note a further important assumption, namely that the post-merger diversion ratio (when the parties' prices have risen) is assumed to be the same as the pre-merger diversion ratio (which is what can be measured). The CMA observed that this: "would likely lead to overestimating the illustrative price rise to some degree. This is because we would expect a greater proportion of customers to choose alternative retailers as the Parties' prices rise relative to these alternatives" (footnote 142).
- 25 For example, assuming gross margins of 35% and applying the formula set out at note 14, would suggest that 99p would increase its prices by 5.7% and Poundland by 2.7%.

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AlixPartners

AlixPartners has a multi-disciplinary practice covering economics, forensic accounting, and information management services (such as e-discovery and applied data analytics). The firm also has post-merger integration experts who provide evidence on efficiencies in mergers, and restructuring experts who advise on "failing firm" viability issues. Combined with AlixPartners' industry expertise, this wide-ranging capability allows us to create robust evidence and analysis on the issues that matter most to the case.

Recent mergers that the team have worked on include noteworthy second stage EU and UK mergers, namely: BT-EE which is ongoing; Nynas/Shell, cleared by the European Commission on the basis of the failing firm defence and merger efficiencies; and Imerys/Goonvean, cleared by the then UK Competition Commission, subject only to price caps on certain products for five years.

AlixPartners' economics practice also engages in a range of other competition economics work. Members of the team are currently acting in relation to the European Commission investigations into credit default swaps and ebooks, and the UK Competition and Markets Authority (CMA) investigation into personal current accounts and SME banking and acted in relation to the recent market investigations concerning payday lending and private motor insurance. The team also advises in relation to various regulatory issues, and are acting in relation to British Gas' appeal of Ofgem's price control decision in relation to various electricity distribution network operators. AlixPartners' experts are highly experienced in antitrust damages work, having worked on many high-profile cases including *Polyurethane Foam*, *Bearings*, *Wire Harnesses*, *Variable Valve Timing Devices*, *Auto Glass*, *Libor*, *Copper Tubes*, *Gaviscon*, *Vitamins*, *Ice Cream*, *Recolight*, *Enron Coal*, and *Gas Insulated Switchgear*. The team also provides monitoring trustee services, which focus on the design and implementation of commitments.