Bulletin

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In for a penny

ECONOMIC ISSUES IN THE POUNDLAND/99P STORES MERGER

At Phase I of its investigation of Poundland's proposed acquisition of 99p Stores, the Competition and Markets Authority (CMA) concluded that there was a realistic prospect of a "substantial lessening of competition" in over 90 local areas. However, in the CMA's first Phase II scrutiny of a local retail markets merger, it changed its standard approach – and the transaction was cleared unconditionally. What were the circumstances that led it to do so, and what are the implications for others?

The CMA's standard approach in local market cases is to consider the scope for a substantial lessening of competition (SLC) in individual local areas. First, the CMA identifies "overlaps" – local areas where the merging parties were both present. Second, the CMA considers whether the customer offer would deteriorate post-merger in such areas, as it would be expected to do where the parties had been close competitors. The merging parties might be required to divest stores in these areas to address such concerns.

FLEXIBLE FRIENDS?

This approach assumes that the merging parties can vary, or "flex", their propositions at the local level, in response to different degrees of competition. Competition authorities often assume that firms will do so – see, for instance, the UK Competition Commission's (CC's) decisions in the Somerfield/Morrison merger and the Groceries Market investigation, amongst many other cases.

However, there may be good reasons why, in practice, firms don't flex. It may be operationally costly to do so. Variations in the offer may alienate customers and stimulate adverse social media comment. And the conditions of competition may not vary materially, meaning that that the benefits of local flexing would be marginal.

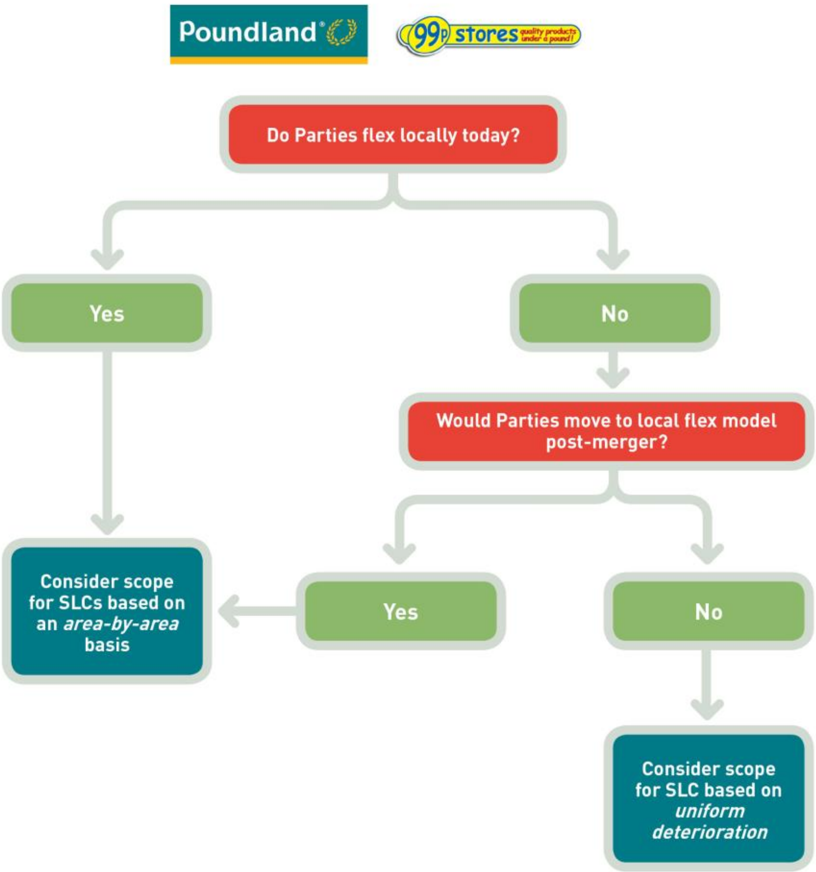
So how would a competition authority approach a merger where the parties argued that, in fact, they had not flexed at all pre-merger? This takes us to Poundland/99p Stores. The CMA had to modify its usual framework[1] in order to answer three questions:

1. Could it be sure that the parties had not flexed locally pre-merger?

2. Even if it could be sure of that, would the parties continue to operate a no-flex business model post-merger? Or would the merged entity start flexing locally – in order to raise prices, or to diminish its proposition, in areas where the merger had led to a reduction in local competition?

3. And even if the merged parties did continue to set uniform policies, would they have an incentive to diminish their offering everywhere – in response to a change in the "average" level of competition they faced?

1 The closest precedent for this approach was taken by the authorities in JJB Sports/Sports Direct, which followed a similar structure of analysis, although Sports Direct was only acquiring a relatively small number of stores (31). The main difference is in the approach to the assessment of the deterioration at a national level, which was somewhat more complex in Poundland/99p Stores than in JJB/Sports Direct.



MIND YOUR PQRS

Establishing an absence of flex pre-merger was critical to Poundland's case in the Phase II inquiry. To be fully convinced, the CMA undertook a forensic examination of how Poundland set price (P), quality (Q), range (R) and service (S) pre-merger, with a particular focus on the extent of any variation in these factors with respect to local competition.

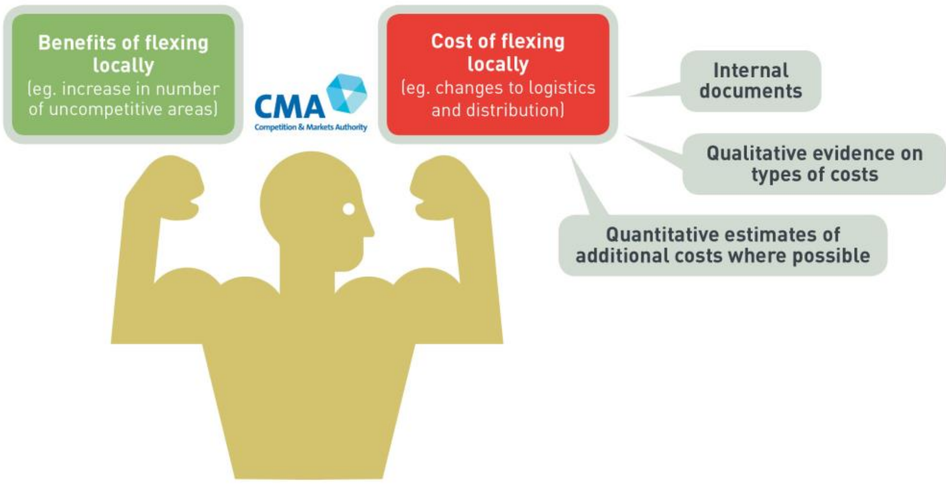
- **Price.** With exception of a small number of deviations, Poundland has – as its name suggests – operated at a single price point (£1) for 25 years. While Poundland had trialled a small number of promotional events in response to the entry of a competitor, these were deemed by the CMA to be negligible.

- **Range.** To the extent that Poundland flexed its range with respect to local competition, one might expect to see it earning higher gross margins in areas with fewer competitors (by stocking products that offer less value for money, or indeed smaller pack sizes, in less competitive localities). However, a performance-concentration analysis submitted by Poundland showed that there was no relationship between its margins and local competition, consistent with its assertion that it did not flex range or pack sizes pre-merger, and the CMA's own analysis confirmed this finding.

- **Quality and service.** The CMA also examined whether Poundland varied opening hours, staffing levels and its programme of refurbishments in relation to local competition. A trawl of internal documents, and an econometric analysis showing that local competition had no impact upon when a Poundland was refurbished, allowed the CMA to get comfortable there was no pre-merger flex in quality or service.

Taken in the round, the evidence submitted by Poundland led the CMA to conclude that it "*supports the view that the variation in PQRS has not been related to the local competition faced by the parties*".

Having concluded that Poundland did not flex pre-merger, the next question the CMA had to answer was whether the merger would "tip" Poundland into changing its business model – starting to flex locally post-merger. Whether this would occur in practice required an assessment by the CMA of the likely costs and benefits of moving to a local flex model.



The evidence considered by the CMA was as follows.

- **Costs.** As noted by the CMA, the fact that Poundland had not adopted a local flex model suggested that there were costs associated with such an approach. Moreover, Poundland was able to provide evidence that the costs of moving to a model of local flex would be considerable. For example:
  - varying prices by local area would likely cause customer resentment and adverse publicity;
  - offering smaller pack sizes in less competitive areas would require substantial changes to Poundland's procurement and distribution processes, leading to increased costs; and
  - a number of suppliers (e.g. Cadbury's and Coca-Cola) told the CMA that they did not offer bespoke pack sizes to Poundland.

- **Benefits.** To assess the benefits of changing the business model, the CMA considered whether the merger would lead to a material increment in the number of "uncompetitive" local areas in which Poundland was present. The more such areas the merger created, the greater the potential benefits from varying PQRS. However, using a modified fascia counting methodology, the CMA arrived at the conclusion that there would not be a material increase in the number of these less competitive areas – and therefore the benefits of flexing would not be great.

As a result, the CMA concluded the costs of moving to a model of local flex post-merger would outweigh the benefits of so doing.

POUND-AND-ONE-PENNY-LAND?

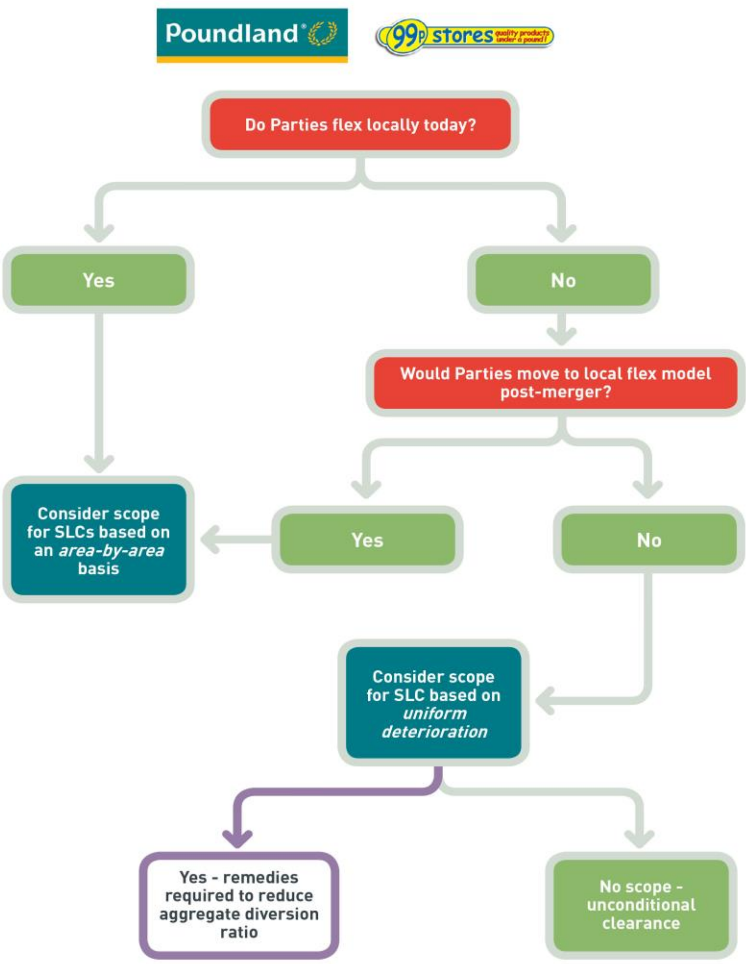
The final piece in the CMA's jigsaw was its assessment of whether the merger would give rise to a uniform deterioration in the merged entity's proposition – derived from the extent of the average loss of competitive constraint in all overlap areas. To explore this, the CMA investigated:

- the proportion of areas where both Poundland and 99p Stores were present, and therefore a deterioration in the offer by one merging party might lead to a capture of sales by the other; and
- the importance of the competitive constraint imposed by the merging parties on each other in these areas, as measured by the "diversion ratio" – the proportion of one merging party's customers who would choose the other merging party's store as their next best option.

The CMA estimated an "aggregate" diversion between the merging parties – i.e., the proportion of lost sales that would be recaptured by one merging party if the there was a uniform deterioration in the other's proposition. The level of aggregate diversion estimated by the CMA was relatively low – 13% on average – and therefore the CMA concluded that that Poundland would not have the incentive to degrade its offering uniformly post-merger.

Suppose the CMA's analysis had resulted in an aggregate diversion ratio that suggested a significant – and uniform – post-merger deterioration. Would this have led to a prohibition of the merger? We do not think that this necessarily follows. To mitigate the SLC concern, the merging parties could have divested stores from sufficient overlap areas to ensure that the aggregate diversion ratio remained within reasonable bounds. And to meet such a requirement, the merging parties could have been given considerable freedom over which local areas to divest from, as various different combinations of divestments would have led to the necessary reduction in the aggregate diversion ratio.

The CMA's approach to the Poundland/99p Stores merger also demonstrates how the incentive to degrade the offer generally depends solely on the change in the aggregate level of local competition. To the extent that there is an incentive to degrade an offering nationally post-merger, this can be remedied by requiring (sufficient) divestments from overlap areas. There is no national issue over and above the sum of the local issues.



CONCLUSION

Poundland/99p Stores was the first local markets merger to be reviewed by the CMA at Phase II. The analysis indicates an evolution of the CMA's thinking in relation to retail mergers, when local flexing is not considered to be feasible. The CMA's conclusions that (i) Poundland would not move to a local flex model post-merger, and (ii) there was no incentive for a uniform degradation in the offer post-merger, led to the transaction being unconditionally cleared.

The CMA's approach leads us to believe that parties considering retail mergers would be advised to consider whether they can show that local flexing is not a concern. Success in doing so may help them to avoid divestment requirements, or at least some freedom to say which stores they would choose to divest.

Frontier Economics advised Poundland throughout the CMA merger process.

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