
Anticipated acquisition by Republic Technologies International of Swedish Match UK Ltd

ME/3918/08

The OFT's decision on reference under section 33(1) given on 19 December 2008. Full text of decision published 20 January 2009.

Please note that square brackets indicate figures or text which have been deleted or replaced at the request of the parties for reasons of commercial confidentiality.

PARTIES

1. **Republic Technologies International (RTI)** is a subsidiary of Republic Technologies (N.A.) LLC, a privately held firm based in the United States. It is a global firm active in the production of accessories for roll your own (RYO) and make your own (MYO) cigarettes, namely cigarette papers, filters, filter tubes, cigarette rolling machines and tubing machines. Its portfolio of brands includes Zig Zag, Altesse, Job, OCB, Memphis, Rolling and Top. Zig Zag, Job and OCB are available in the UK. RTI's products are sold in the UK through its exclusive independent distributors Zig Zag Limited and Basil Bush Limited.
2. **Swedish Match UK Ltd (SMUK)** is a subsidiary of Swedish Match AB, a company listed on the OMX Nordic Exchange in Stockholm. SMUK is active in the UK in the supply of cigarette papers and filters. SMUK's filters are produced by an independent third party, Filtrona, and are packaged in Belgium by Swedish Match AB. SMUK also imports and distributes other smoking related goods such as cigars, lighters and matches which are produced by subsidiaries of Swedish Match AB. SMUK's UK turnover in 2007 was £21 million.

TRANSACTION

3. On 3 November 2008 RTI announced its proposed acquisition of SMUK. As part of the agreement, RTI will acquire all the issued and outstanding shares of SMUK. In addition, RTI will acquire the 'Swan' trademark insofar as it applies to the supply of cigarette papers, filters, rolling machines, tubes, and tubing machines in the UK and Ireland, an exclusive contract lasting two years to distribute Swedish Match AB matches, lighters, and fire products in the UK and a manufacturing agreement whereby RTI will produce certain products for Swedish Match AB.¹ The OFT accepted RTI's informal submission as satisfactory on 4 November 2008. The administrative deadline is 6 January 2009.

JURISDICTION

4. As a result of this transaction RTI and SMUK (the parties) will cease to be distinct. SMUK's UK turnover in 2007 was £21 million so the transaction does not meet the threshold in section 23(1)(b) of the Enterprise Act 2002 (the Act). The share of supply test in section 23(2) of the Act is met, however, as RTI and SMUK together supply over 25 per cent of cigarette filters in the UK. The OFT therefore believes that it is or may be the case that arrangements are in progress on in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

MARKET DEFINITION

Product scope

5. There are no previous OFT decisions in relation to cigarette papers and cigarette filters. The parties have argued that cigarette papers, cigarette tubes and cigarette filters all belong to the same product market.
6. From a demand side perspective, the parties have submitted that cigarette papers and filters are part of the same market because both form part of RYO cigarettes. The argument for combining the market for papers and filters is that, since consumers consider the price of an RYO cigarette in aggregate, price increases in filters are constrained by the price of the bundle of goods used to make an RYO cigarette. The

¹ These will be distributed outside the UK and Ireland.

OFT views this as an indication that cigarette papers and filters are complements, rather than forming part of the same market. Notwithstanding this, if filters and papers were strict complements (that is, only used together and in fixed proportions, for example, one filter and one paper) then there could be a relevant market for the bundled product. However, filters are not an essential part of an RYO cigarette and, indeed, are often not used by consumers of RYO cigarettes. Accordingly, from the demand side, the OFT considers that cigarette papers and cigarette filters do not form part of a single product market. In addition, the OFT notes that retailer preferences are significant in determining substitutability in this market: while retailers' preferences may largely be determined by the preferences of RYO smokers, their customers, they may not be wholly synonymous with them. Therefore, to the extent that some RYO smokers do in fact view cigarette papers and filters as strictly complementary (meaning there could be a relevant market for the bundled product) retailers may be less likely to do so.

7. From a supply side perspective, the parties submitted that cigarette papers and filters should be viewed as belonging to the same market, as there is a high level of harmonisation at the manufacturing level and because barriers to entry for each product are very similar. The OFT's market investigation, however, has shown that the equipment required for the manufacturing of papers is very different to that for the manufacturing of filters. The manufacturing of cut corner papers (the type of cigarette paper that is predominantly marketed in the UK) also requires different equipment to that of normal cigarette papers. Entry barriers also depend on the type of papers or filters produced and the OFT's market investigation has not shown that there are necessarily similarities in the costs of entry for papers and filters. To the extent that entry from papers into filters or vice versa is a relevant consideration, the OFT considers it more appropriate take this into account at the competitive assessment, rather than the market definition, stage. The OFT, therefore, does not consider cigarette filters and papers to be substitutable either from a demand or a supply-side perspective.
8. In *Imperial Tobacco/Reemtsma Cigarettenfabriken*², the European Commission did not conclude on the issue of whether cigarette papers and cigarette tubes are in the same market. Given that there is no

² Case No COMP/M.2779. The German Federal Cartel Office has accepted that tubes and cigarette papers are in the same market because they serve the same purpose. (Decision of 31 August 2000 *Imperial Tobacco/EFKA*).

overlap between the parties on the supply of cigarette tubes³, the OFT will not take this segment further into account in its analysis, although this does not preclude the possibility that cigarette tubes could belong to the same market as cigarette papers.

Cigarette Papers

9. The demand for cigarette papers is a derived demand in that the ultimate unit of use by consumers is the RYO cigarette. In other words, the demand for papers by RYO smokers is derived from the demand for RYO cigarettes. However, and unlike filters, cigarette papers (along with tobacco) are essential components of RYO cigarettes. Further, there are no other products that could easily substitute for cigarette papers in the creation of a RYO cigarette.
10. The cost of cigarette papers is relatively low as a proportion of the cost of an RYO cigarette (the cost of the cigarette paper would be less than one pence whereas the cost of an RYO cigarette is approximately ten pence), so the demand elasticity for cigarette papers is likely to be lower than the elasticity for the RYO cigarette: put another way, an increase in the price of cigarette papers (even an increase somewhat greater than 10 per cent) will not add significantly to the overall price of an RYO cigarette. On this reasoning, it would take a price increase greater than 10 per cent to motivate consumers to switch to a potentially competing downstream product (such as factory manufactured cigarettes (FMCs)).⁴
11. The parties and several third parties have indicated that there is some brand loyalty, or at least consumer inertia, to Imperial Tobacco's (ITL) 'Rizla' brand due to the strong association of the Rizla brand with papers. None of the parties involved in our investigation indicated that there was any brand loyalty to either RTI's or SMUK's brands of papers.
12. There are various types of cigarette papers which can be distinguished in size, grade and paper thickness. Most suppliers sell a range of products based on the length and thickness of the paper. However, the OFT's investigation did not indicate that a further segmentation of the cigarette paper market by grade or size is required as the OFT

³ RTI is active on the cigarette tube segment in the UK whereas SMUK is not.

⁴ The OFT notes that the Commission's decisional practice consistently differentiates between a market for FMCs and a market for RYO/MYO cigarettes (COMP/M.4581 *Imperial Tobacco/Altadis*) so that it is unlikely that the prices of cigarette papers could be indirectly constrained by FMCs.

considers there to be substitutability both from a demand and a supply side perspective.

Cigarette Filters

13. Cigarette filters are not an essential part of an RYO cigarette but are used by some consumers of RYO cigarettes in order to limit the amount of chemicals inhaled while smoking. The OFT was not made aware of any other products that could substitute for cigarette filters in the creation of an RYO cigarette.
14. As with cigarette papers, cigarette filters' share of the overall cost of an RYO cigarette is low (the cost of the filter would again be less than one pence whereas the cost of an RYO cigarette is approximately ten pence). Their demand elasticity is therefore also likely to be low [].
15. In terms of packaging, filters are sold in (a) loose bags and boxes, and (b) pop-a-tip filters (that is, filters packaged together in cellophane wrap to form a tube of filters). SMUK was among the first firms to offer pop-a-tip filters in the UK. A number of competitors, including ITL, now supply tubes of filters. Filters are also available in regular, slim, and ultra-slim widths. However, the OFT's investigation did not indicate that a further segmentation of the cigarette filters product market by packaging or width would be required.

Conclusions on product scope

16. For the purposes of this decision, the OFT has examined the merger on the basis that the wholesale supply of cigarette papers and cigarette filters to retailers form distinct but complementary markets. In any event, however, it is not necessary for the OFT to conclude on the scope of the relevant market since there is no realistic prospect of a substantial lessening of competition as a result of the merger on any plausible candidate market.

Geographic scope

17. In *Imperial Tobacco / Reemtsma Cigarettenfabriken*⁵, the European Commission noted that the evidence 'tended to indicate the market for tubes and papers is Europe-wide.' This was due to low trade barriers, high trade flows within Europe, and the fact that 40 per cent of a typical plant's produce is exported.

⁵ See footnote 2.

18. As discussed above, the large majority of the cigarette papers sold in the UK are cut corner. Entry to supply the UK market would therefore be dependent on a firm producing/sourcing cut corner papers. Cut corner cigarette papers are sold in only a small number of other countries in the EEA and, although production is not in the UK, this could potentially indicate that the cigarette papers market is more narrow than the EEA, and possibly a UK distinct market. In terms of filters, UK consumers appear to have a strong preference for pop-a-tip filters which could potentially indicate a UK-wide market. The OFT does acknowledge, however, that on the supply side, and given the low transport costs, production of filters and papers could take place in any of the countries in the EEA.
19. The OFT considers that the geographic scope of the markets for cigarette papers and cigarette filters is at least UK-wide. The OFT has taken a cautious approach and examined the merger on the basis of a UK geographic market. It is not necessary, however, for the purposes of this decision for the OFT to conclude on the scope of the relevant geographic market since this does not impact on the OFT's analysis.

HORIZONTAL ISSUES

Introduction

20. The parties overlap in the wholesale supply to retailers in the UK of cigarette papers and filters used to make RYO cigarettes.
21. Because of data limitations at the wholesale level, the parties have submitted AC Nielsen data on shares of supply at the retail level, that is, sales by retailers to smokers. The OFT notes that, not only do AC Nielsen share data not reflect wholesale sales (that is, sales by distributors to retailers), they also do not take account of retail sales through (a) independent retailers, (b) independent wholesalers or (c) the 'grey market' (that is, through market stalls and through the internet) because AC Nielsen data is aggregated from supermarket scanner data. AC Nielsen figures are therefore likely to underestimate the shares of supply of firms that sell mainly through these other routes to market, notably RTI and Bull Brand Limited (Bull Brand).

Unilateral effects

Cigarette papers

Concentration and market shares

22. The supply of cigarette papers in the UK is characterised by the very strong position held by ITL's Rizla brand. According to AC Nielsen retail data, in 2006, ITL had a share of supply of around [80-90] per cent, SMUK of [one to ten] per cent and RTI of [one to ten] per cent.
23. Given the limitations of the AC Nielsen data, as described above, the OFT requested that the largest distributors in the supply of cigarette papers in the UK (that is, ITL, SMUK, RTI and Bull Brand) submit the volumes of cigarette papers that they sold in 2007. This measure is not without complications itself, however, because:
- Gallaher sources all its cigarette papers from RTI according to an annually-negotiated supply contract (and consequently could be considered not to be an independent competitor of RTI – although see discussion below)
 - Gallaher [] sells papers bundled with tobacco and ITL sells [] papers bundled with tobacco⁶
 - some distributed papers will be held in wholesalers' or retailers' stocks of inventory and not sold, and
 - cigarette papers distributed by the major players do not take into account those sold by other competitors through independent wholesalers for sale in the so-called 'grey market'.
24. Notwithstanding these limitations, the OFT considers that wholesale share data measured on this basis are preferable to retail share data. Wholesale shares are given in Table 1 on the alternative bases that (i) Gallaher is independent of RTI, (ii) Gallaher is not independent of RTI, and (iii) bundled books of papers are separate from unbundled books, and should be excluded.

⁶ [].

Table 1: 2007 UK wholesale sales data for cigarette papers by volume based on OFT analysis of submissions

	All books					
	Independent Gallaher		Non-independent Gallaher		Unbundled books	
Distributor (brand)	Millions	Per cent	Millions	Per cent	Millions	Per cent
Bull Brand	[]	[]	[]	[]	[]	[]
Gallaher	[]	[]	[]	[]	[]	[]
ITL (Rizla, Columbus and Ezee)	[]	[]	[]	[]	[]	[]
RTI (Zig Zag and OCB)	[]	[]	[]	[]	[]	[]
SMUK (Swan)	[]	[]	[]	[]	[]	[]
Combined RTI and SMUK	[]	[]	[]	[]	[]	[]
Total	[]	100	[]	100	[]	100

25. Under all three scenarios, ITL's Rizla brand is by far the most significant market player with a share of supply ranging between [50-60] and [60-70] per cent.
26. To the extent that Gallaher were to be treated as not being an independent competitor to RTI, the merger will reduce the number of market participants from four firms to three and give the merging parties a combined share of supply of over [30-40] per cent. The OFT does not consider this to be a relevant basis on which to assess the parties' combined competitive strength, however, given that:
- no competitor, customer or supplier that the OFT contacted suggested that Gallaher was not independent of RTI
 - Gallaher told the OFT that it had specific 'material specifications and qualifications for every product' that were independent of RTI (that is, that Gallaher did not simply buy RTI papers but essentially had RTI toll-manufacture papers for it), and
 - Gallaher submitted that [] could also supply it with papers.
27. Consequently, the OFT considers that the supply agreement between Gallaher and RTI allows Gallaher to compete with RTI for the wholesale supply of RYO cigarette papers to retailers in the UK. The issue of whether Gallaher in fact does so then turns on the extent to

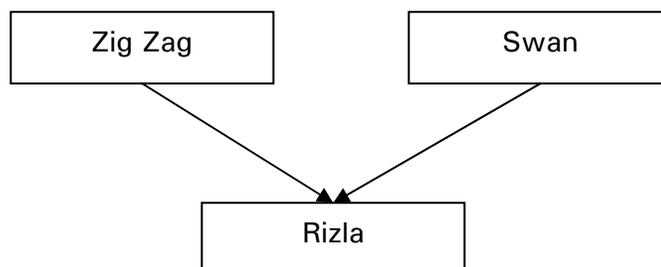
which its bundled RYO cigarette tobacco and paper product (and that accounted for by the small bundled proportion of ITL's paper sales) competes with unbundled cigarette papers.

28. In this regard, and consistent with our discussion of market definition above, the OFT notes that when asked what they would do in response to a small but significant and non-transitory increase in the price (SSNIP) of only RYO cigarette papers, retailers unanimously said that they would switch to other unbundled brands of cigarette paper and not that they would switch away from both unbundled rolling tobacco and unbundled papers to the bundled tobacco and paper product. This suggests that bundled RYO cigarette papers place less constraint on the price of unbundled papers than do other unbundled papers. Consequently, the OFT's best estimate of the combined share of supply of the merged firm on the basis of Table 1 is [20-30] per cent with an increment of [5-15] per cent, which is not a combined share or increment normally high enough to raise prima facie concerns over unilateral effects. The factors discussed further below provide additional reasons why no such concerns arise.

Ability of merged entity to increase prices or non-price factors

29. The OFT considered whether a post-merger price increase would be a profitable strategy as a result of the merged entity's ability to internalise any sales lost to the other party as a result of the price rise. The OFT has, however, dismissed this concern.
30. First, the parties do not appear to be each other's closest competitor. []⁷.

Figure 1: Consumer switching patterns following a price increase, as suggested by research on behalf of []



31. Second, retailers and wholesalers act as an important 'gateway' to consumers. Submissions from customers suggest that a 5-10 per cent

⁷ []

increase in wholesale prices would lead them to switch/delist the cigarette paper supplier. So, whilst a 5-10 per cent price increase may not be sufficient to motivate consumers to switch, retailers and wholesalers would be likely to switch: a retailer is likely to either delist the higher priced brand or even all of the brands supplied by the party.

32. Third, customers did not express any concerns about a lack of availability of alternative brands. Most retailers and wholesalers indicated that they typically stock either one or two brands, and therefore considered that a sufficient number of alternative brands of cigarette papers would remain post-merger to choose from.
33. Finally, the OFT notes that neither RTI nor SMUK has grown significantly over the past years. [] The OFT's market investigation has not revealed any evidence indicating that RTI has been acting as a significant competitive force in the market.

Cigarette filters

Concentration and market shares

34. The supply of cigarette filters in the UK is characterised by the very strong position held by SMUK's Swan brand. SMUK does not manufacture or package its own filters but outsources these tasks to companies like [] and [] respectively.
35. There was a greater consistency in the merging parties' and third parties' estimates of shares of supply in cigarette filters than in the supply of cigarette papers. Third parties agreed that Swan has a very high share and that the increment provided by RTI's share was actually very small.
36. A greater proportion of cigarette filters ([80-90] per cent, according to AC Nielsen data) than of cigarette papers ([70-80] per cent, according to AC Nielsen data) are sold through supermarkets and CTNs, meaning retail share data are a more accurate reflection of wholesale shares for cigarette filters. Further, unlike cigarette papers, the OFT received no evidence that sales of any particular brands of filters were concentrated in non-supermarket-and-CTN channels. According to AC Nielsen retail data for 2007, the merged firm's combined share of supply is [80-90] per cent with an increment of [one to ten] per cent (see Table 2 below), which is not an increment that would normally give the OFT cause for concern over unilateral effects even at such a high combined level of share of supply.

37. In addition to the AC Nielsen data, the parties provided a set of wholesale market shares, which they computed in four steps. First, the parties used the AC Nielsen estimate of SMUK's share of the volume of retail sales to consumers ([80-90] per cent from the first column of Table 2) coupled with the actual value of SMUK's wholesale sales to distributors [] to derive a value for the entire wholesale market []. Second, the parties used the AC Nielsen estimates of the shares of the volume of retail sales of ITL, RTI and others to derive values for their wholesale sales to distributors (see the second column of Table 2—so the parties estimated the value of ITL's wholesale sales as [], for example). Third, the parties replaced the implied value of RTI's wholesale sales on this basis ([]) with the actual value of its wholesale sales ([]), recalculating the value of the entire wholesale market (see the third column of Table 2). Lastly, the parties calculated wholesale market shares on the basis of the actual values of SMUK's and RTI's wholesale sales, and the implied values of the wholesale sales of ITL and others (see the fourth column of Table 2).
38. On this basis, the merged firm's share of supply is essentially unaffected from that derived from the AC Nielsen data alone ([80-90] per cent) but the increment increases to [one to ten] per cent, which is an increment that may give more cause for concern at such a high level of combined share of supply.

Table 2: AC Nielsen and RTI market share data, 2007⁸

	Implied value of wholesale sales (£m)			
	AC Nielsen retail volume market share (%)	SMUK actual	SMUK and RTI actual	Implied wholesale value market share (%)
ITL	[10-20]	[]	[]	[10-20]
RTI	[1-10]	[]	[]	[1-10]
SMUK	[80-90]	[]	[]	[70-80]
Combined RTI and SMUK	[80-90]	[]	[]	[80-90]
Others (principally Bull Brand)	[1-10]	[]	[]	[1-10]
Total	100.0	[]	[]	100.0

39. The OFT, however, has concerns about the accuracy of RTI's estimates, and considers that the AC Nielsen share data are more robust, and therefore provide a more accurate reflection of the relative strengths of the individual players in the market place. In particular:

- as discussed above, a significant proportion of cigarette filters ([80-90] per cent, according to AC Nielsen) are sold through supermarkets and CTNs, meaning retail market shares provide a relatively accurate reflection of wholesale market shares
- AC Nielsen data are taken from supermarket and CTN scanners, so they faithfully record what was actually sold by RTI, SMUK and others, whereas sales to distributors include filters for stock, and
- whilst the parties may know what they sold to distributors, their estimate of what others sold to distributors cannot be as accurate. Given that the latter (according to AC Nielsen data) comprises a significant part of the overall market, this raises doubts regarding the robustness of RTI's estimate of the overall size of the market, and the shares of the respective players in the market.

40. Significantly, the results of the OFT's market test tend to support the view that the AC Nielsen data in the supply of filters are a better reflection of competition in the market place. [].

41. In light of the above, the evidence available to the OFT is that the increment in share of supply in filters provided by RTI is very small,

⁸ AC Nielsen data as submitted by the parties.

and more accurately reflected by the AC Nielsen data. In addition, ITL (which is significantly larger than RTI) and Bull Brand will remain as important competitive constraints on the combined firm post-merger. In these circumstances, prima facie concerns over unilateral effects are unlikely to arise. The factors discussed further below provide additional reasons why no such concerns arise in this case.

Ability of merged entity to increase prices or non-price factors

42. There are several important differences in the parties' market orientations and product propositions that indicate that they place a limited competitive constraint on one another. As shown in Table 3 below, these include packaging, positioning and pricing strategy, product line extensions, and route to market.

Table 3: RTI's and SMUK's market orientations⁹

	RTI	SMUK
Packaging	Zip-lock bags	Boxes
Positioning/pricing strategy	Value/low cost	High quality
Product line extensions		Charcoal filters, menthol filters, combi-packs ¹⁰
Routes to market	Exclusive distributors and retailers	[]

43. As mentioned above, SMUK has grown its market share in filters through several product innovations over the past five years including non-wrapped acetate and pop-a-tip filters. There is no indication [] that SMUK considers itself constrained in filters by RTI or that []. The competitive constraint imposed on SMUK by RTI is therefore likely to be limited.
44. As regards any loss of competitive constraint on RTI by SMUK, the sharp contrast in RTI's and SMUK's shares of supply can, at least in part, be explained by the different routes to market used by the firms. In addition, evidence before the OFT in relation to the positioning of the various brands suggests that other value brands (such as Bull Brand) place a more significant competitive constraint on Zig Zag than Swan.

⁹ Source: Publicly available sources and parties' submission.

¹⁰ Combi-packs combine 50 filters and 50 cigarette papers in one unit.

Conclusion in respect of unilateral horizontal effects

45. The OFT does not believe that the merger creates the realistic prospect of unilateral horizontal behaviour which will substantially lessen competition in relation to either the supply of cigarette papers or filters.

COORDINATED EFFECTS

46. The OFT has also examined whether the merger may – as a result of a reduction in competition – increase the probability that post-merger, firms in the same market will tacitly (or explicitly) coordinate their behaviour to raise price, reduce quality or curtail output.¹¹
47. The OFT notes that the tobacco sector is the subject of a current investigation by the OFT, and has also been investigated by the European Commission in the past. However, these investigations (summarised below) relate to distinct (albeit neighbouring) markets from the ones currently at issue.
- The current Competition Act 1998 investigation of certain FMC producers:¹² the alleged practices in that investigation relate to (a) arrangements between certain manufacturers and certain retailers that restricted the ability of those retailers to determine their selling prices independently, by linking the retail price of a manufacturer's brand to the retail price of a competing brand of another manufacturer¹³, and (b) the indirect exchange of proposed future retail prices between competitors.¹⁴
 - The European Commission has investigated and subsequently imposed fines on certain tobacco companies operating in Italy and Spain.¹⁵
48. In the present case, the OFT received a complaint [] regarding the possibility of pre-existing explicit market sharing. However, the [complainant] did not provide any evidence to substantiate this claim,

¹¹ See OFT *Mergers - Substantive assessment guidance* OFT 516 May 2003 (paragraphs 4.11 to 4.16) (the OFT Guidance), and OFT decision *Anticipated acquisition by Wienerberger Finance Service BV of Baggeridge Brick plc* 11 December 2006.

¹² www.of.gov.uk/news/press/2008/56-08#_note-see%20note%205.

¹³ The alleged infringements span different periods for different parties between 2000 and 2003.

¹⁴ The alleged infringements span different periods for different parties between 2001 and 2003.

¹⁵ COMP/38.238 Raw Tobacco (Spain) and COMP/38.281 Raw Tobacco (Italy).

and so the OFT was not able to investigate it any further or place any weight on it. Accordingly, in the absence of any evidence of pre-existing explicit coordination in the market place, the OFT considered whether the merger would increase the likelihood of coordination post-merger.

49. In summary, for the reasons set out below, the evidence before the OFT does not support a theory that the merger will 'tip' the market towards coordination.
50. Considering each of cigarette papers and cigarette filters in isolation, the OFT considers that coordination would be unrealistic due to the asymmetry in ITL's and the merged entity's respective shares of supply (that is, with ITL being the market leader by some considerable margin from the merged entity in papers, and the reverse in filters). However, contact in more than one market can provide additional punishment opportunities for firms and thereby reinforce coordinated behaviour. Further, contact in papers and filters ('multi-market' contact) could smooth the share of supply asymmetries in the two individual markets, and help facilitate collusion. Collusive behaviour in this context could result in market sharing or the adoption of collusive pricing practices by industry participants in relation to both products.
51. As discussed in the OFT Guidance, in order for coordination to emerge in a particular market (or, in this case, two complementary candidate markets) the following conditions would normally need to be satisfied:
 - firms need to be able to reach and monitor the terms of coordination
 - coordination must be internally sustainable, and
 - coordination needs to be externally sustainable.

Reaching and monitoring the terms of coordination

52. The OFT considers that some characteristics of the candidate markets for the supply of cigarette papers and cigarette filters may be conducive to coordination. For example, costs may be relatively symmetric because production is outsourced by many of the firms in the industry, in particular in relation to filters. In addition, prices are fairly transparent, especially at retail level which can provide a reasonable proxy for supply upstream, although the OFT notes that

sales via the grey market lower transparency in relation to production output.

Coordination must be internally sustainable

53. For firms to have an incentive to coordinate, they have to find it in their individual interests not to take advantage of their competitors' reduced competitiveness by competing aggressively. This can arise in situations where the firms that coordinate are able to adopt a strategy which results in the deviating firm seeing its profits reduced, that is, it can be punished for deviating from the coordinated behaviour.
54. The OFT considered whether the merged entity and the leading papers supplier, ITL, would be incentivised to coordinate, in particular whether they would have the incentives to punish deviation by pricing low in the product market in which it has market power (that is, ITL in papers, and the merged entity in filters). However, based on turnover and gross margin figures, the value and profitability of the supply of papers and filters is very asymmetric.¹⁶ The parties' incentives to coordinate would therefore not be at all aligned, that is, the parties would be unable to discipline each others' behaviour given that the value of their market share in each market would remain substantially different post merger.

Coordination needs to be externally sustainable

55. For coordination to be sustainable, it is important that the outside competitive constraints on the firms involved in the coordination are insufficient to defeat it. In this instance, the OFT does not believe that coordination is sustainable as it is satisfied that there is a competitive fringe of firms that are developing their product offerings (as discussed below) and competing with the merging parties on price. In addition, barriers to entry, as discussed below, are not particularly high and the existence of a degree of countervailing buyer power in this case would serve to stimulate competition by customers delisting or threatening to delist the products of the coordinating firms – customers stated, in response to the OFT's market investigation, that they would have no difficulty in sourcing alternative brands from fringe competitors.

¹⁶ Using SMUK gross profit margins in papers and filters as representative of the industry, the relative value of papers to filters is around [].

Conclusion in relation to coordinated effects

56. The OFT considered whether it should be concerned about the prospect of multi-market contact and its potential facilitation of collusion post-merger. However, the OFT is satisfied that the value (and profitability) of the shares of supply of cigarette papers and cigarette filters is not symmetric, there is a competitive fringe of firms, barriers to entry in both of these candidate markets are not particularly high and customers appear able to exert a degree of countervailing buyer power. Taken together, the OFT believes that these factors preclude a finding of a realistic prospect of coordinated effects concerns arising as a result of the merger.

RIVALRY ENHANCING BENEFITS

57. The parties claimed that the merged entity is likely to be a stronger competitor against ITL and this view was confirmed by at least one major retailer []. In addition, retailers appear to prefer to source a range of RYO cigarette accessories/brands from one firm, rather than dealing with separate firms. ITL currently offers tobacco and at least three brands of cigarette papers – the offering of the Swan brand products in addition to RTI's own brands would make the merged entity a more effective competitor to ITL. The parties, however, did not provide any supporting evidence to substantiate these claims. While the OFT considers that the parties' arguments appear plausible (albeit unsubstantiated), the OFT does not need to reach any conclusions on this issue given that the merger does not result in any prima facie unilateral or coordinated effects concerns.

BARRIERS TO ENTRY AND EXPANSION

58. Given that no prima facie unilateral or coordinated effects concerns arise from the merger, the OFT does not need to conclude on the existence or otherwise of barriers to entry. However, as certain third parties had raised concerns in relation to this issue, the OFT has examined barriers to entry and expansion in more detail.

Actual entry and expansion

59. There has been at least one successful example of entry over recent years by Bull Brand.¹⁷ The OFT also understands that [at least one

¹⁷ Bull Brand has a market share in papers of approximately [] per cent (see paragraph 24).

firm]¹⁸ that is currently active in the UK on a small scale intend[s] to improve [its] current filter offering [].

Potential entry

Brand loyalty/recognition

60. Certain parties were concerned that brand loyalty and brand recognition would act as a barrier to entry. However, the OFT's market investigation indicated that competitive pricing can overcome this potential barrier.

Source of supply

61. Several firms are willing to supply papers and filter rods¹⁹ to a new entrant. The number of firms providing (or willing to provide) these services to the UK market has increased in recent years. In particular, [] and [] advised that they have or can create excess capacity and could therefore expand supply to new customers, if required.
62. While one competitor was concerned that Filtrona has a monopoly position in the supply of filter rods and would not necessarily supply filters to all potential new entrants or supply them at higher prices, the OFT's market investigation has revealed that there are [] other companies in a position to provide filter rods to new entrants.

Retail and distribution

63. Bull Brand has submitted that it has faced some difficulty in gaining access to large multiple grocers. However, it has gained entry through independent stores, it is listed in one major retailer and [].
64. One party viewed access to retailers as a barrier to entry since it can be difficult to convince a retailer or a wholesaler to carry your brand if you are a small player. However, the same party also acknowledged that any entry difficulties could be overcome by following a competitive pricing strategy. Furthermore, another party submitted that the difficulty in entry to retail level outlets could be partially overcome by agreeing to pay a listing fee to wholesalers.

¹⁸ [].

¹⁹ Filter rods are long white tubes that are cut in order to create individual cigarette filters. Filter rod manufacturers may supply customers with either filter rods or with cut/packaged filters.

Advertising

65. The Tobacco Advertising and Promotion Act 2002 allows for advertising that encourages switching but prohibits marketing communications that encourage consumers to start smoking or increase consumption.²⁰ Whereas gaining market share could be difficult due to these advertising restrictions, the OFT notes that no competitors considered that advertising restrictions or advertising costs formed a barrier to entry.

Conclusion in relation to barriers to entry

66. The OFT considers that barriers to expansion or entry in the supply of cigarette papers and filters do not appear high and that the evidence of actual entry and future expansion plans confirms this. In any event, as no prima facie competition concerns arise from the merger, it is not necessary to conclude on the issue of barriers to entry.

BUYER POWER

67. As discussed above, large groceries and wholesalers play a significant role in determining the brands of cigarette papers and cigarette filters that they will offer in their stores. The OFT's market investigation, has confirmed this. Customers indicated that they have buyer power and that they could discipline a potential price increase by de-listing a particular brand. No customers expressed any concern regarding the merger.

NON-HORIZONTAL ISSUES

68. The OFT also considered whether it was possible that the merged entity could leverage its 'Swan' brand filters, a leader in the filters category, to force retailers to accept other products in its portfolio such as cigars, papers (both Swan brand and Zig Zag), lighters, matches, rolling machines, tubes, and tubing machines.²¹

²⁰ The OFT notes that the Department of Health's recent consultation paper on the tobacco sector suggested that the advertising of tobacco paraphernalia, including papers and filters, should be prohibited.

²¹ The OFT notes that the acquisition agreement also provides for RTI to be the exclusive distributor of Swedish Match matches, lighters and fire products in the UK so that RTI will be able to distribute a very wide portfolio of products with some very strong brands.

69. However, since the evidence received by the OFT is that RTI's brands are not market leaders or 'must have' brands in their categories,²² any ability by the merged entity to full line-force would not be as a result of the merger.²³

THIRD PARTY VIEWS

70. None of the customers contacted by the OFT expressed any concerns about the proposed merger as they felt that RTI is a very small player, both in filters and in papers. In addition, one customer thought that the merged entity would be a better competitor to ITL.
71. The view from competitors was mixed. One competitor complained about the potential coordinated effects of the merger in that the merged entity would be in a position to better engage in market sharing with the leading papers supplier, ITL and therefore foreclose the competitor in question. However, the OFT does not consider that the merger will result in coordinated effects in the supply of cigarette papers and cigarette filters.
72. Two competitors shared concerns about the ability of a new entrant to gain shelf space with retailers, specifically large grocery stores, following the merger. However, submissions from retailers suggest that they are price sensitive and that a more efficient firm could undercut rivals to gain shelf space. Moreover, we note that one retailer currently stocks four producers' brands (including Bull Brand), indicating that competitive firms can gain entry at the retail level.

ASSESSMENT

73. The parties overlap in the supply of cigarette papers and cigarette filters in the UK.
74. For the purposes of its assessment, the OFT analysed the merger on the basis of the supply of cigarette papers and, separately, cigarette filters in the UK. The OFT did not find it necessary to conclude on the scope of the relevant product and geographic markets since the outcome of its competition assessment does not vary according to the market definitions used.

²² [].

²³ The OFT has not seen any evidence of SMUK trying to full line-force in the past.

75. The merger will reduce the number of market participants from, essentially, four firms to three. The OFT is satisfied that the merger will not result in any unilateral effects in the supply of cigarette papers as ITL remains in a very strong position, the parties' products do not appear to be each other's closest competitors, the merger does not result in the removal of a significant independent competitive constraint and customers did not express any concern about the availability of alternative brands of cigarette papers. The OFT notes that it is plausible that the merger will result in a stronger competitor to ITL in cigarette papers, with the ability to offer a broader range of products, although it has not had to conclude on this point.
76. In respect of cigarette filters, the OFT considers that the increment to SMUK's pre-existing leading position is very small. In addition, there are several important differences in the parties' commercial strategies and product propositions that indicate that they place a limited competitive constraint on one another.
77. While the OFT notes that the supply of papers and filters exhibits some of the characteristics that may be conducive to coordination, a combination of the asymmetry in incentives to coordinate (based on the parties' respective positions in relation to papers and filters in terms of value and profitability), the existing and potential competitive fringe, the fact that barriers to entry are not particularly high and that customers appear able to exert a degree of countervailing buyer power were sufficient to offset any concerns.
78. None of the customers contacted by the OFT expressed any concerns about the proposed merger as they view RTI as a very small player both in filters and in papers. The OFT's market investigation also confirmed that large groceries and wholesalers have a degree of countervailing buyer power such that they could discipline a potential price increase by de-listing a particular brand. However, the OFT did not find it necessary to conclude in relation to barriers to entry given that prima facie concerns did not arise.
79. In light of the above, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

80. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.