Anticipated acquisition by Orbital Marketing Services Group Ltd of Ocean Park Ltd

ME/3863/08

The OFT's decision on reference under section 33(1) given on 14 November 2008. Full text of decision published 9 December 2008.

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. **Orbital Marketing Services Group Ltd (OMSG)** carries out marketing services operations in the travel, tourism, education and healthcare sectors. It also has a general direct mail and fulfilment business. **BP Travel Marketing Services (BP),** a trading division of OMSG, provides brochure distribution and mailing services to tour operators, supplying brochures and information to travel agents.

2. **Ocean Park Ltd (OP)** is the holding company for **AU Logistics** (**AU**). OP was founded in 2002 with support from tour operators, Thomas Cook and First Choice. AU provides brochure distribution and mailing services to tour operators, servicing travel agents with brochures and information. OP's UK turnover for the year ended August 2007 was £5.3 million.

TRANSACTION

3. OMSG has signed a conditional agreement to acquire 100 per cent of the share capital of OP. The parties notified the proposed transaction on 19 September 2008 and the administrative deadline for a decision is 14 November 2008.

JURISDICTION

4. The OFT believes that as a result of this transaction OMSG and OP will cease to be distinct. Both parties are involved in the bulk distribution of travel brochures to UK travel agents and at least one quarter of all services of that description would be supplied by one and the same person following the merger. Therefore the share of supply test in section 23(2) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

MARKET DEFINITION

5. Both parties are active in the bulk distribution of travel brochures for tour operators to travel agents, and in call centre and fulfilment work for travel and non travel companies. In relation to the latter, the parties' estimated combined share of supply is less than five per cent (increment less than one per cent) and is therefore not considered further.

Product Scope

6. The bulk distribution of travel brochures service offered by the parties includes storage, order taking and processing, stock picking, consolidating orders, arranging delivery, and the supply of management information and account management.

7. Tour operators arrange a print run of their brochures which are then sent to the warehouse of whichever of the parties they have a distribution contract with for storage/delivery. Tour operators will then request an initial brochure launch to all/most travel agents for the start of each booking season, in the winter and summer, and as the season progresses either tour operators or travel agents will request brochures to be replenished and delivered to retail outlets. All these requests are incorporated into a daily travel agent delivery schedule. This schedule means that each week all travel agents will receive a delivery of brochures from both parties [ ].

8. Based on this delivery schedule each party will pick brochures for various tour operators from their warehouse, the brochures for each tour operator

will form a pack [ ] and these packs of brochures are [ ] for collection and distribution to travel agents by a contract carrier. The basic service includes mainland delivery, which is charged on a [ ] rate ([ ] for the higher volume contracts). The contracts which the customer (the tour operator) enters into with either of the parties will usually be for [ ]. The travel brochures remain the property of the tour operator and the travel agent does not pay for any part of this service.

9. Both parties are therefore essentially specialist warehousers / consolidators and use external delivery contractors for final delivery of the parcels from their warehouses to the travel agents. OMSG subcontract to a consortium of regional carriers and a national parcel carrier, while OP currently uses [ ] for deliveries nationwide.

10. The parties' customer base is some [ ] tour operators / brands and other travel principals, who need to distribute brochures to approximately [4,000 – 5,000] high street travel retailers.

11. OMSG accepts that the relevant market, at its narrowest, can be considered to be the market for the delivery of brochure packs to travel agents. However, it has argued that the market may be wider on both the demand and supply side.

Demand side substitution

12. The parties gave examples of tour operators moving away from making printed travel brochures available to travel agents, including: JetSet, which has moved to an emailed pdf brochure, [ ], which has reduced its support to the trade and concentrated more on direct mailing and internet bookings, and [ ], which despatches brochures from its own office. OMSG also commented that many tour operators' websites now contain virtual tours of the resorts and hotels that they offer. These alternative forms of marketing meant that, on the demand side, the market should be widened.

13. Evidence from third parties, however, is not conclusive on whether the demand side market is wider. Although there was clearly a trend towards electronic brochures, most third party customers argued that it would always be necessary to have brochures distributed to travel agents regardless of any alternatives.

Supply side substitution

14. Historically, entrants to this market have been from newspaper and magazine distributors, for example WH Smith in 1990 and Dawson who acquired ABC [ ] in 2000. The parties have also suggested that existing logistics companies, already operating weekly drops on the high street, could easily expand into this market.

15. By way of illustration, OMSG pointed to the recent experience in Germany, where the market for bulk distribution of travel brochures was, it said, dominated by Infox until, in 2005, a logistics company entered the market and acquired the contracts for the [ ] and is, it said, now the dominant distributor, [ ].

16. Those potential entrants who were contacted by the OFT did express an interest in entering the market, although [ ]. In particular, the majority of third parties identified the obstacle to entering as being the need to obtain sufficient scale for the entry to be profitable, a point that the parties acknowledged and which is considered further in the section on barriers to entry and expansion below. It was not clear from the third party evidence received by the OFT that supply side substitution would be either feasible or profitable in the event of a five - ten per cent price increase.

Geographic scope

17. Both parties operate mainland distribution operations from a single warehouse: OMSG from Ashford in Kent and OP from Birkenhead in Merseyside. As explained above a number of consolidated parcels are collected daily for onward delivery to high street travel agents across Great Britain. Third parties have confirmed that it is essential for their supplier to have a national presence, that is, across Great Britain.

Conclusion

18. Therefore, taking a cautious approach, we consider the appropriate market definition to be the bulk delivery of brochure packs to travel agents in Great Britain.

UNILATERAL EFFECTS

MARKET SHARES

19. The parties overlap in the provision of bulk distribution of travel brochures on behalf of tour operators to travel agents in Great Britain. They are the only two providers of this particular service identified by themselves and third parties. As such, the merger is to monopoly (although the OFT considers the issue of supply-side substitution again under entry, below).

UNILATERAL EFFECTS FROM MERGER TO MONOPOLY

20. In summary, and for the reasons set out in more detail below, the OFT considers that

    - Prices are individually negotiated with each tour operator customer, such that customers could experience differential effects of the merger.

    - The two largest operators, TUI and Thomas Cook, each unilaterally have countervailing buyer power because they can leverage their volume of demand to sponsor entry by other logistics providers, with volumes of other customers potentially following.

    - However, to the extent that the simple threat of sponsorship prevented Orbital from raising prices or lowering service to the Top Two post-merger, no post-merger entry to restore two competitors, from which smaller customers could benefit, would occur.

    - In such circumstances, it would not be feasible or rational for smaller customers, facing a 2 to 1 merger of dedicated travel brochure distributors, and a consequent price increase, to sponsor entry or switch to outside options (for example, logistics providers).

    - Accordingly, while Orbital can be expected to offer competitive terms to the Top Two customers based on TUI's and Thomas Cook's threat of outside options, it can equally be expected to raise prices profitably to smaller customers (unless and until one or both of the Top Two were to sponsor actual entry and thus permit smaller customers to benefit also).

- On the balance of the evidence, the merger is therefore likely to result in a substantial lessening of competition in relation to smaller customers.

STRUCTURE OF DEMAND

21. Within the parties' customer base, it is helpful to distinguish between four customer groups based on the volumes of brochures that the parties handle. These four categories are: TUI and Thomas Cook (the 'Top Two' tour operators, originally the top four prior to their own tour operator industry mergers), the 'First 10' clients, the 'Second 20' clients, and a remaining group of approximately [ ] tour operators with very small brochure distribution requirements.

22. The current structure of the market resulted from the creation of OP. This was deliberately encouraged by two of the original top four tour operators – Thomas Cook and First Choice – in 2002, seemingly in response to OMSG's failed attempt to merge with Dawson, another travel brochure distributor. The OFT was told by the parties that, at the time, Thomas Cook and First Choice considered it important to have two suppliers in the market in order to meet the then-prevailing levels of demand. Thomas Cook and First Choice effectively sponsored entry by paying OP distribution rates [ ].[1]

23. As a result of the above, in terms of current position, each of the Top Two customers is now served by both parties, as a result of Thomas Cook and First Choice being served by OP, and TUI and MyTravel being serviced by OMSG.[2] Both OP and OMSG then serve some of the First 10 and Second 20 customers as well as some of the smaller clients. The split, by volume, for these last three groups of customers is approximately two thirds with OMSG and one third with OP.

SWITCHING BETWEEN SUPPLIERS

24. Following competition in the first contractual renewal cycle (2003-2005) after it was created, OP gained around 70 customers, initially mainly from Dawson (which exited the market in 2005) and then from OMSG. Until 2006, competition had been present with a number of customers switching

[1] [ ].
[2] TUI merged with First Choice and Thomas Cook merged with MyTravel.

distributors each year as contracts ([ ]) fell due for renewal. OMSG argued that the market has been driven by OP offering lower prices to its smaller customers due to [ ] paid by its founding customers (as explained above).

25. The latest round of contract renewals has been characterised by customers choosing to remain with their existing distributor with annual inflation indexed prices for the following contract term of [ ]. This lack of customer switching may indicate a low ability of either provider to compete for each others business (or a lack of incentive on the part of customers to invest effort in reducing their distribution costs). [ ].

26. The parties have stated that only [ ] from the First 10 and Second 20 customers have switched in the last two years (both to gain rates below average distribution cost). Out of the [ ] other customers, only [ ] other switching examples have been identified.

27. With two of the original top four tour operators effectively sponsoring OP — OP's two major clients provide 50 per cent of their volume [ ] — OMSG has effectively been unable to compete for their business. Therefore, the parties argue that – to the extent that competition exists – it has been strongest for the customer group immediately below the Top Two.

28. Overall, based on its inquiries of customers as well as information provided by the parties, the OFT concludes that there has been very limited switching between the two parties across all groups of customers. Such limited switching may indicate limited competitive interaction between the parties, although it may be that the limited switching reflects the fact that customers are able to achieve competitive pricing levels by credibly threatening to switch to the other supplier without actually having to do so. In this case, however, the parties argued that they do not compete for smaller customers and that these contracts are frequently renewed via exchange of emails. Evidence from third parties confirmed the parties' submissions in this regard – and the OFT received very little evidence of customers threatening to switch suppliers in order to obtain improved terms.

BUYER POWER AND SPONSORED ENTRY

29. In this case, entry and buyer power are considered together as a key issue is the ability of customers to sponsor entry such that the new entrant –

which is most likely to be a logistic company already distributing to high street retailers – gains sufficient volume to have the profit incentive to enter.

Entry sponsored by one or both of the top two tour operators

30. OP itself was created and distributing brochures within six months from the time OMSG announced its intended purchase of Dawson. Critical in that case was sponsorship of two of the (then) top four customers to allow it to operate while it obtained sufficient volume to then benefit from economies of scale. The most likely source of sponsorship for any de novo entry is likely to result from dissatisfaction by one of the Top Two with the service, or cost, provided by the incumbent.

Parties' views

31. With a reduction in economies of scale accelerating as volumes decrease for each distributor and with volume increasingly concentrated in the Top Two (previously top four), the parties argue that the Top Two are increasingly able to 'dominate' the market and dictate its shape. It is the parties' belief that neither can afford to be without at least one of the Top Two. They consider that the strength of the Top Two's power can be demonstrated by the sponsorship of OP as a new entrant six years ago and their continued support to date, using their financial size to shape the market [ ].

32. The parties argued that whilst there are two distributors, the likelihood of a new entrant is low, but post merger with only one, the possibility, through sponsorship by the Top Two, re-emerges.

33. The parties also argued that economies of scale can be delivered by either the Top Two tour operators, or one of the Top Two and two or three of the First 10 customers. In either of these scenarios, a number of the smaller tour operators might follow at their next contract renewal.

Views of the Top Two customers

34. Neither of the Top Two was concerned about the merger. One of the Top Two customers noted that as a result of this merger there would be no competition in the market since it was unaware of any other companies

that provide this exact distribution model. However, it thought that other distribution companies or companies that regularly visit nationwide retail outlets could potentially provide this service, (for example [ ]) since some of these companies already deliver other products (for example, stationery) to the company's travel agencies.

35. This view was endorsed by the other Top Two customer who added that should it have concerns following the merger it could consider encouraging a potential competitor from existing logistics companies such as [ ], bringing the distribution in-house, or sponsoring a new entrant.

36. The reaction of the Top Two in favour of the merger appear to reflect the following considerations:

- if prices increase above competitive levels they would be able to sponsor new entry and therefore enjoyed significant buyer power in their negotiations with the parties

- the merger ensures security of supply of, not only their own brochures into high street travel agents, but also those of complementary tour operators into their own retail outlets

- as it declines, the bulk distribution sector will support only a single supplier anyway (considered further in the counterfactual section, below), and

- that the consolidation of their previously separate contracts for distribution will result in lower charges compared with the combined prices of the separate contracts they were paying previously.

Their evidence is consistent with countervailing buyer power based on an ability to sponsor entry, the real issue in this case is therefore merger effects on customers other than the Top Two.

Entry not sponsored by at least one of the Top Two

37. The parties consider that at least 10-12 medium customers totalling [ ] million annual revenue would justify new entry. However, from other statements made by the parties such entry in the current market conditions is very unlikely. The parties have also argued that there is no prospect of

any substantial new tour operators entering the market, which would provide additional volume either for the parties or a new entrant.

38. The views of third parties on this point were mixed. A small customer said that the possibility of an existing logistic supplier expanding in this market was realistic. However, one third party argued that the biggest barrier to entry was a lack of volume of brochure packs to be able to consolidate deliveries and operate cost effectively (essentially economies of scale). It was felt that an alternative supplier would have to have sufficient volume at launch to be able to compete with existing suppliers on price.

39. In terms of third parties of the type identified by the parties as potential entrants, one commented that it would only consider the service if it were able to obtain a £5 million turnover. By contrast, another similar third party said that they would consider it and were not concerned about a minimum viable scale, which suggested that this might add value to distribution runs already programmed. Finally a third such identified potential entrant said it would consider entering on a small scale, but would not be able to serve the whole of the country.

40. However, significantly, none of the third parties contacted by the OFT (including the third party that did not identify a minimum viable scale required to identify the market) said that they had definite plans to enter the market in the near future, and it is far from clear that, irrespective of the ability to enter, it would be sufficiently profitable that a logistics player would have the incentive to do so. While the actual delivery runs of brochures to high street outlets (the 'shipping' element of distribution) could simply entail adding brochure packs to existing runs of delivery vans, a new entrant would have to replicate the upstream 'picking and packing' elements of brochure distribution, would require IT and other warehouse-level investments. A small but significant price increase of 5-10 per cent on very small customer volumes is unlikely to result in customers searching for — and logistics suppliers responding with — new entry.

CONCLUSION

41. For the reasons set out above, the OFT considers that the top two tour operators enjoy countervailing buyer power and have the potential to sponsor entry. However, despite the fact that logistics firms are able to enter this market with relative ease, the profit incentive to do so in

response to the merger is questionable, provided that the Top Two customers use the threat of sponsored entry as leverage against the merged firm. In such a scenario, which seems reasonably likely based on the negotiations with them as to post-merger supply, smaller customers are likely to face potential price increases without being able to sponsor entry, or create a sufficiently attractive profit opportunity for a potential entrant.

42. In this respect, the Top Two customers are conceptually distinct in terms of the effect of the merger from the remainder of the parties' customer base. Those customers outside the Top Two would not necessarily be protected by the buyer power of the Top Two given that contracts are negotiated individually (therefore allowing for price discrimination) and the Top Two would expect to exercise their buyer power through threatening to sponsor new entry, rather than actually having to do so.

43. By merging the only two incumbent specialist distributors of travel brochures, the merger is likely, on the balance of probabilities, to result in a substantial lessening of competition, potentially for all customers save for the Top Two, or in any event a substantial proportion of them. This conclusion would change were the OFT to adopt a counterfactual that did not attribute a causal link between the merger and the reduction of competition but as set out below, the OFT does not consider it appropriate, in the context of its duty to refer, to depart from comparing the merger against its default of pre-merger conditions.

THIRD PARTY VIEWS

44. Third party views have largely been discussed above in the text of the decision. Customers noted that the merger would result in just one supplier of the service, however the general view was that this was inevitable given the market shrinkage in tour operators, travel agents and the number of brochures, which are points discussed further in the counterfactual section, below. Only two small customers considered that the merger itself would result in competition concerns.

45. As noted, there was some evidence that switching pre-merger, and therefore the potential for merger effects as marginal customers become infra-marginal to the merged firm, was relatively modest: for example, a smaller customer commented that they did not expect any major changes

as a result of the merger and were happy to support the merger. Another customer said that even with a choice of supplier it would not switch.

COUNTERFACTUAL

Introduction

46. In order to decide whether the duty to refer applies, the OFT must consider the merger's impact relative to the situation that would prevail absent the merger (that is, the counterfactual).

47. The OFT's general approach is that it relies on pre-merger conditions as the appropriate proxy for the counterfactual and will 'test' the competitive impact of any transaction against such a standard before proceeding to consider whether another counterfactual should be substituted. In general, where the merger raises no concerns relative to pre-merger conditions, nothing will turn on the OFT's adoption of its default counterfactual of pre-merger conditions and there will be no need to consider the detailed factual questions that arise under substitute counterfactuals that, for example, the failing firm defence engages.

48. Where the merger does raise concerns relative to the pre-merger situation, the OFT is slow to clear a transaction based on the 'inevitability' of exit of the target business, reflecting the caution required of the OFT by the 'realistic prospect' standard within the statutory duty to refer test. That is why, where a seller wishes to exit a market, normally because the relevant business is failing or distressed, the OFT will not lightly depart from judging the impact of such a sale as against pre-merger conditions, and will only do so when it has sufficient compelling evidence that exit is inevitable (such that there is no realistic prospect of a substantial lessening of competition resulting from the business remaining in the market), in line with the two criteria of the failing firm defence, namely:

    - inevitability of market exit of the firm (or relevant division or business) in question absent the merger, with no serious prospect of re-organisation, and

    - no less anti-competitive alternative to the merger, in other words, that is no realistic acquisition by a less anti-competitive

purchaser and no substantially better competitive outcome following failure of the firm in question).[3]

49. In this case, as discussed above, competition concerns do arise on the basis of pre-merger competition (that is, that both parties were active in the bulk distribution of travel brochures on behalf of tour operators to mainland travel agents, and actively seeking to renew existing contracts as they fell due).

Parties' argument re inevitability of exit as a result of shrinking market

50. The parties have argued that, although not immediately a failing firm, the financial viability of OP as a standalone business in its existing structure over the current contract lifecycle is in doubt. This is because OP is supported by two of the former Top Four major operators [ ]. The parties argue that this de facto support is unlikely to continue after the renewal of the current contracts following the industry mergers which created the Top Two tour operators.

51. It is alleged that the lost of this de facto support will affect OP's ability to compete and, according to the parties, it will either have to seek additional business or raise prices.[4] Its ability to attract non brochure distribution business has, to date, been limited and with many contracts outside the Top Two already locked in to [ ] there is limited scope to acquire additional brochure business.

52. OMSG commented that it considered that[1] OP's prices for customers other than the Top Two were economically too low and has therefore normally chosen not to compete to keep such customers at all costs. Although average distribution costs are similar, OSMG has higher marginal distribution costs (due to OP's particular carrier arrangement) and is therefore less likely to follow prices down.

53. OMSG argued that the critical volume of brochures necessary to sustain two distributors throughout the year is no longer available. The increasing number of weeks with low volumes requiring distribution inevitably drives

[3] See further OFT *Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson)* 11 December 2007.
[4] [ ].

costs up, as it is not possible to recoup lost efficiencies in low volume weeks in the higher volume weeks.

54. The parties have pointed to a shrinking market for the bulk distribution of travel brochures caused by a reduction in the in the number of tour operators, (for example the recent collapse of the XL Leisure Group with a loss of over 80,000 brochure packs per year) size and use of brochures,[5] and number of retail outlets[6], as well as the underlying current financial climate. This view of the market is echoed by those third parties that responded to the OFT's enquiries.

55. The parties also argued that there had been an increase in potential demand side substitution as tour operators explore, among others, 'e-brochures' and online 'virtual' tours which would continue to act as a constraint on price increases after the merger.

56. The parties have both stressed that there is a minimum efficient scale, below which it becomes uneconomical to continue to supply the bulk distribution service. At present both parties are operating at or above the minimum efficient scale, largely because they both have a contract with half of one of the Top Two operators, a legacy of their own pre merger contracts. The Top Two tour operators, together account for approximately 50 per cent of the parties' volume. In the short term should one of the parties win the distribution contract for both of the Top Two the parties consider it inevitable that the other party will exit the market as it would have to obtain the distribution contracts for all the remaining smaller operators to obtain sufficient volume to continue, and with many contracts for the smaller tour operators not coming up for renewal until 2010, there is limited scope for this strategy to succeed.

57. Moreover, neither party currently has the capacity to handle all of the demand. Therefore, while the winner of both the Top Two contracts will have some capacity to take smaller customers it will not be able to take

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[5] Cosmos Holiday's sales director commented in Travel Weekly 6/7/07 that Cosmos 'had cut its brochure print for mainstream products, and will axe printed brochures for the programme altogether within three years'. The parties have also said that between 2004/5 and 2007/8 Thomas Cook (excluding My Travel) reduced their brochure packs by [ ] per cent, Thomson by [ ] per cent, First Choice by [ ] per cent and the Cosmos Group by [ ] per cent.

[6] The number of high street travel outlets has dropped from over 6,000 in 2004 to around [4,000 – 5,000] in 2008 and during the first five months of 2008, Association of British Travel Agents (ABTA) retail membership has fallen by a further 186 outlets.

them all. Therefore, in the short term these customers will either face no distributor for their brochures or will have to use the unsuccessful bidder (for the Top Two contracts) which, without the economies of scale, might be expected to have to charge higher prices. In the longer term, the successful bidder might be able to expand its storage/picking facilities or alternatively might choose to follow any increase in price to smaller tour operators.

58. The parties considered that during the natural industry lifecycle (defined as each three year contract period with the Top Two) OP (or OMSG) will become unprofitable and have no prospects of recovery except at the expense of the other or through significantly above inflation price increases for customers. Even if the businesses themselves do not fail, OMSG consider that it is reasonably certain that either it or OP would have to terminate brochure distribution. The parties emphasize that it is likely that by the time the Top Two's contracts come up for their next renewal in 2010 onwards there will only be one distributor.

59. The parties consider that, even if one of the Top Two customers' contracts go to each of the parties and they each compete to gain a reasonable 'share' of the remaining customer base, by the end of the next contract term in 2010, as a result of the shrinkage described above, the predicted size of the distribution sector will only be enough to support one distributor. Given the declining market the need for expansion mentioned above may not be necessary at that time.

OFT conclusion on counterfactual

60. The OFT has carefully considered the points made by the parties in respect of the correct counterfactual for this transaction. In doing so, it notes that the parties' view – that the shrinking size of the industry meant that having two distributors in the market was not sustainable – was supported by third party customers (including the Top Two).

61. However, the OFT does not consider that the evidence presented is sufficiently compelling to establish that one of the parties would *inevitably* have exited the market absent the merger in the short term. Neither party is in such a parlous financial situation that, without the merger, it and its assets would exit the market in the very near future (that is prior to the award of the Top Two contracts). Neither party has put forward any

assessment of any other means of restructuring that they have considered – as such it may be the case that an alternative restructuring or change of model may have enabled both parties to continue to operate. Finally, it is at least realistic (even if unlikely) that each party may have won one of the Top Two contracts, thereby potentially both continuing in business for some period of time. In many of these potential scenarios, there would have been at least some time period over which the parties continued to compete independently in the absence of the merger.

62. Therefore, overall, the OFT considers it is appropriate to consider as the correct counterfactual in this case the pre-merger conditions of competition.

63. However, the OFT accepts that, whilst insufficient to conclude there is no realistic prospect of the merger resulting in a substantial lessening of competition for at least some period of time, the evidence on the shrinking market as against minimum necessary scale does suggest – in particular given the corroboration of customers' own views on this point – that there is a likelihood that one of the parties – probably OP – would have exited the market in the short to medium term absent the merger.

ASSESSMENT

64. The merger combines the only two bulk distributors of travel brochures on behalf of tour operators to travel agents in Great Britain.

65. As discussed above, only the Top Two customers possess countervailing buyer power, with the volumes of business enabling them to encourage entry by a potential competitor or sponsor new entry in the event of dissatisfaction with the service of or prices charged by the merged entity. Smaller customers, in contrast, do not have sufficient purchasing scale to sponsor new entry and would not be protected by the 'umbrella' of the buyer power of the Top Two if the latter do not sponsor new entry, but merely discipline the merged firm by threatening to do so, as is likely to be the case in at least the near term.

66. The merger is therefore more likely than not to result in a substantial lessening of competition for small customers (even if the period for which

any adverse effects are attributable to the merger may be more limited than ordinarily the case).

67. Consequently, the OFT believes that it is 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.

EXCEPTIONS TO THE DUTY TO REFER

Introduction

68. The OFT's duty to refer under section 33(1) is subject to the application of certain discretionary exceptions, including the markets of insufficient importance, or de minimis, exception under section 33(2)(a) and the undertakings in lieu exception under section 73(2) of the Act. OMSG argued that the OFT should apply the de minimis exception to the duty to refer[7], notwithstanding that this is a '2 to 1' merger, on the basis that the total annual revenue from the parties activities in travel brochure distribution is well below £10 million and declining.

Undertakings in lieu of reference and de minimis

69. As stated in the Dunfermline/BRN case,[8] and as explained further in the BOC/Ineos case,[9] the OFT believes that it would be proportionate to refer a problematic merger (that is, not to apply the de minimis exception) where the OFT considers that it is 'in principle' clearly open to the party or parties to offer a clear-cut undertaking in lieu of reference – but they choose not to do so. This is because the recurring benefits of avoiding consumer harm by means of undertakings in lieu in a given, and all future like cases, outweighs the one-off costs of a reference.

70. In this case a structural remedy of part of the overlapping business is not realistically open to the parties if the transaction goes ahead. Therefore, since the OFT considers that, in principle, a clear cut divestiture package is not available the OFT accepts that it would not be appropriate, at this

[7] See OFT 516 b, November 2007.
[8] OFT *Completed acquisition by Dunfermline Press Limited of the Berkshire Regional Newspapers business from Trinity Mirror plc* 4 February 2008.
[9] OFT *Anticipated acquisition by BOC Limited of the packaged chlorine business and assets carried on by Ineos Chlor Limited* 29 May 2008.

stage of the analysis, to rule out an evaluation of the de minimis exception in this case.

Application of the markets of insufficient importance exception to this case

71. The pivotal issue for the OFT in applying its de minimis exception is determining whether the impact of the merger is likely to be particularly significant (such that the de minimis exception should not be applied) or more limited (when the OFT may apply the de minimis exception).

72. The factors that the OFT considers in making this determination were set out in detail in the *BOC/Ineos* case and were applied again recently in *FMC/ISP*[10] and *Stagecoach/Cavalier* [11] (in favour of exercise of the discretion) and in *Nufarm/AH Marks* (against the exercise of the discretion).[12] Those factors are:

- market size
- strength of the OFT's concern (that is, its judgment as to the probability of the SLC)
- magnitude of competition lost by the merger
- durability of the merger's impact, and
- transaction rationale and the value of deterrence.

73. The OFT has considered each of the factors above in determining whether to exercise its discretion in this case.

74. Market size – The OFT considers that the proposed acquisition creates a realistic prospect of a substantial lessening of competition in the market for the bulk distribution of travel brochures.

75. The OFT has considered whether any adverse effects arising from the merger would be felt by all customer segments or whether any should be excluded from the market size because they were clearly not affected by the substantial lessening of competition.

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[10] OFT *Anticipated acquisition by FMC Corporation of the alginates business of ISP Holdings (U.K.) Limited* 30 July 2008.

[11] OFT *Completed acquisition by Stagecoach Bus Holdings Limited of Cavalier Contracts Limited 18 September 2008.*

[12] OFT *Completed acquisition by Nufarm Limited of AH Marks Holdings Limited* 29 August 2008.

76. In principle, the Top Two tour operators may be expected to experience some lessening of competition in the short term as the merger does, after all, merge their only two existing suppliers. However, they were unconcerned about the merger, cited an ability to sponsor entry to replace lost competition if they were dissatisfied with the terms on offer from the merged firm, and, indeed, had already negotiated and 'agreed' post-merger prices and terms of supply with the parties in the expectation that the merger would go ahead.

77. Therefore, the OFT concluded that these customers wield countervailing buyer power such that any lessening of competition would not be substantial, because these sophisticated customers do not, by their own account, consider themselves materially adversely affected by the merger. Given that the position of the Top Two customers was clearly and conceptually distinct (in terms of their ability to sponsor or encourage entry) from those of the remaining customers in the market, the OFT considers that the parties' turnover attributed to these Top Two customers should be excluded from consideration when determining the size of the 'affected' market for the purposes of the de minimis exception.[13] For the reasons given above, the OFT does not consider that any other customer group should be removed from the affected market.

78. The result of this is that the total size of the 'affected' market is around £4 million, in the lower-mid range along the OFT's general £0 - £10 million band for de minimis purposes. This means that whilst the de minimis exception is potentially applicable, the size of the affected market (segment) is nevertheless more than negligible.[14]

79. Strength of the OFT's concerns – The OFT's belief that the transaction may be expected to result in a substantial lessening of competition for the remainder of the parties' customers is on the balance of probabilities (that is, over 50 per cent likely, or at the 'is the case' standard in the wording of

[13] See also FMC / ISP paragraph 71.

[14] The OFT considers that, notwithstanding its conclusion that sales to the Top Two should be removed from the market when calculating the market size, the decision whether or not to refer the merger based on the de minimis discretion would not differ even if the Top Two were included. This is because the magnitude of competition lost by the merger would be very greatly diluted if the Top Two were included, and would overall (given that the Top Two represent approximately half of the total market) fall significantly short of the scale that would normally be expected from a '2 to 1' merger.

section 33 of the Act). As a result, the strength of the OFT's belief that harm will result from the merger, although not in itself conclusive, tends to point away from the exercise of the de minimis exception in this case.

80. Magnitude of competition lost by the merger – The merger causes a reduction in the number of suppliers of bulk travel brochure distribution from 2 to 1. The parties acknowledge that smaller customers — especially those that obtained particularly favourable terms from OP — would face higher charges post merger. On the other hand, OMSG contended that such higher charges might be expected to result anyway without the merger since OP would not have been able to continue to cross subsidise these smaller customers.

81. Actual and potential competition between the parties has been limited, the parties were only able to point to [ ] instances of a tour operator switching distribution between the parties in the last two years. Most of the switching to OP had been of ex-Dawsons customers when it exited the market in 2005. This apparent lack of competition for all categories of customer is notable, especially [ ]. It suggests that, despite the potential for competition, customers are not in fact using competition to obtain better prices. The commercial relationships between tour operators and brochure distributors are typically long term. [ ].

82. These factors suggest that – even for those customers outside the Top Two – the magnitude of competition lost as a result of the proposed merger is not what would normally be expected from a 2 to 1 merger, but is more likely to be at the lower to mid range and therefore weighs in favour of exercising of the de minimis discretion.

83. Durability of the merger's impact – When considering the correct counterfactual for this case, the OFT concluded that the merger should be considered against the status quo ante, as there was insufficiently compelling evidence that one of the two firms would inevitably have exited the market in the short term. However, it does not follow from this that the OFT should not consider the expected duration of that substantial lessening of competition when exercising its de minimis discretion. When considering the likely duration of any adverse effect in this context, the OFT will take account of evidence that one of the firms would have been likely (on a balance of probabilities standard) to exit the market absent the merger —

notwithstanding that that evidence is insufficient to change the pre-merger counterfactual. Both the parties and – more significantly – third party customers have pointed to a shrinking market for the bulk distribution of travel brochures caused by a reduction in the number of tour operators, consolidation of brochures (smaller in size)[15], and reduction in the number of retail outlets. Therefore the duration of any harm arising from this transaction may only be evident for two to three years at the most, and, depending on whether a single party wins the Top Two's business, the duration of the harm may be significantly less (potentially only lasting for a few months until award of the Top Two contracts).

84. Transaction rationale and the value of deterrence – OMSG stated that the rationale for this transaction was, in part, to avoid a disorderly exit due to the sudden failure of one of the parties. On the basis of the experience when Dawson exited the market in 2005, an unplanned exit would result in tour operator's brochures being caught up at the exiting party's warehouse. As mentioned above, the remaining distributor may not have the spare capacity to cope with the whole market's volume of brochures, the supply chain would struggle to cope, leaving disgruntled customers — both affected tour operators unable to get their brochures to travel agents and travel agents unable to replenish their stock of brochures. An orderly transition, it was argued, will benefit long term relationships between the distributor and the tour operators, which OMSG considers an important way of preventing tour operators exploring other methods of getting their brochures to the high street. OMSG would itself therefore benefit from an orderly exit of OP from the market rather than simply waiting for OP to fail and hence was prepared to pay a (relatively small) price to avoid a disorderly exit.

85. The OFT notes that it has seen no evidence to suggest that the transaction involves the acquisition by OMSG of market power through the removal of OP. Indeed, the OFT notes that the consideration for the acquisition, excluding payment for assets, was around [ ] relative to a turnover of [ ] million. Such a low price-turnover ratio does not imply any payment for market power. Considering the very particular circumstances of the current case, the OFT considers it appropriate not to consider deterrence a particular aggravating factor in this decision for the purposes of its de

[15] The parties have suggested that brochure packs are down some 14 per cent year on year for the first 10 weeks of the financial year[2].

minimis assessment. In addition to the plausible explanation given by OMSG, why they were prepared to pay for the OP business at all, is the lack of concerns raised by third parties and the likely exit of one of the parties in the short to medium term in any event. It would appear quite plausible that at least the Top Two (and possibly) other customers valued an orderly transition to preserve security of supply via amalgamation, rather than waiting to let one party fail, as more in their overall interest. This would follow because failure of timely distribution of travel brochures would cause substantial hardship to the tour operators (and travel agents) in question, especially during peak travel booking periods, including to the smaller customers at issue with respect to merger effects.

86. Overall, the OFT considers that the evidence points towards the impact of the merger being relatively limited both in scope and time. In particular, the size of the market after the removal of the Top Two customers is well below the £10 million threshold, the scale of any anti-competitive effects arising from the merger is likely to be limited by the relatively low level of customer switching and, in turn, competition between the parties, the shrinking market and the potential constraints from demand side substitutes suggested by third parties, as well as the parties. In addition the duration of any harm is considered to be of a relatively short term nature. The OFT therefore has decided to exercise its discretion not to refer this transaction to the Competition Commission on the grounds that the market is of insufficient importance.

DECISION

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

END NOTES

1. OMSG has corrected this statement to read ' it considered that some of OP's prices for customers other than the Top Two were economically too low.....'
2. This is OP's financial year which ends in September.