

**PROPOSED ACQUISITION OF OTTAKAR'S PLC BY  
HMV GROUP PLC THROUGH WATERSTONE'S BOOKSELLERS LTD**

**Provisional findings report**

Published: 31 March 2006

The Competition Commission has excluded from this published version of the provisional findings report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by ✂.

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**Contents**

	<i>Page</i>
Provisional findings .....	2
1. The reference.....	2
2. Industry background and the companies .....	3
The book industry .....	3
Customer characteristics .....	7
HMV .....	8
Ottakar's.....	9
3. The proposed merger .....	10
History of the proposed merger .....	10
Structure of the proposed merger .....	11
Rationale for the proposed merger .....	11
Jurisdiction .....	12
4. Market definition.....	13
Product market definition .....	13
Geographic market definition .....	15
Conclusions on market definition .....	17
5. Assessment of the competitive effects of the proposed merger .....	17
Other retailers .....	18
Specialists .....	18
WH Smith and British Bookshops .....	19
Supermarkets .....	21
Distance sellers .....	22
Entry and expansion .....	22
Underlying factors affecting competition in book retailing.....	24
Market shares and concentration .....	24
Pricing and promotional activity .....	26
Existing degree of competition.....	28
Local competition .....	29
National competition.....	36
Counterfactual.....	48
Effects of the proposed merger.....	49
Local competition .....	50
National competition.....	53
Vertical effects.....	56
Conclusions on SLC test.....	57
 Appendices	
A	Terms of reference and conduct of inquiry
B	The book supply chain
C	Market shares and prices
D	Stock management systems
E	List of overlap locations
F	Local competition
G	Ottakar's financial performance

Glossary

## Provisional findings

### 1. The reference

- 1.1 On 6 December 2005 the Office of Fair Trading (OFT) referred the proposed acquisition of Ottakar's plc (Ottakar's) by HMV Group plc (HMV) through Waterstone's Booksellers Ltd (Waterstone's) to the Competition Commission (CC) for investigation and report. The reference was made under section 33(1) of the Enterprise Act 2002 (the Act). Our terms of reference are set out in Appendix A. We are required to publish our final report by 22 May 2006.
- 1.2 In accordance with our terms of reference, if we find that a relevant merger situation has been created (see paragraph 3.9), we must decide whether it may be expected to result in a substantial lessening of competition (SLC). As we explain in our guidelines,<sup>1</sup> competition is a process of rivalry between firms seeking to win customers' business over time. Our focus, therefore, is on the likely effect of the proposed merger on that process of rivalry. Our remit does not cover wider concerns such as cultural diversity.
- 1.3 This document, together with its appendices, constitutes our provisional findings. We are required to notify our provisional findings to the parties (HMV and Ottakar's) under the CC's *Rules of Procedure*, CC1. Further information, including non-sensitive versions of written submissions, summaries of third party arguments and views, and the results of our customer survey, can be found on our website.<sup>2</sup> We refer to these documents as appropriate.

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<sup>1</sup>CC2 Merger References: Competition Commission Guidelines, June 2003.

<sup>2</sup>[www.competition-commission.org.uk](http://www.competition-commission.org.uk).

## 2. Industry background and the companies

2.1 In this section we describe the major features of the book industry, customer characteristics, and the companies that are the subject of this inquiry.

### ***The book industry***

2.2 Consumer demand for new books has risen over the past five years, and is forecast to continue to grow at around 5 per cent a year, in both value and volume terms.<sup>3</sup> In 2005 over 300 million books were sold in the UK with a value of £2.4 billion.<sup>4</sup> The top 5,000 titles in a calendar year, which in this report we define as best-sellers,<sup>5</sup> accounted for 57 per cent of sales by volume and 49 per cent of sales by value in 2005. In 2005, the single best-selling title (*Harry Potter and the Half-Blood Prince*)<sup>6</sup> had sales of £34 million and the ninth best-selling title had sales of £3 million. Average sales were £400,000 for titles ranked between ten and 999 in sales over the year, £75,000 for titles ranked 1,000 to 4,999, and £24,000 for titles ranked 5,000 to 19,999.<sup>7</sup>

2.3 There are almost 2 million titles in print<sup>8</sup> and over 180,000 new titles were published in 2005, of which around 120,000 were published for the consumer market (trade titles).<sup>9</sup> Over the period 2001 to 2004, the total number of new titles increased by 17 per cent (and trade titles by 51 per cent). In 2005, however, the number of new titles decreased by 7 per cent. It should be noted that the numbers of titles are based on ISBNs and there is often more than one ISBN for an individual title, representing different formats (such as hardback or paperback) or different media (such as

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<sup>3</sup>Consumer demand over the past five years based on Nielsen Book Services Limited (Nielsen) Bookscan data for the Total Consumer Market (TCM) and Taylor Nelson Sofres (TNS) data. Experian predicts 5 per cent growth a year between 2004 and 2010 (HMV 2004 strategy document).

<sup>4</sup>Source: TNS.

<sup>5</sup>The remainder are defined as 'deep-range titles', see paragraph 4.4.

<sup>6</sup>*Harry Potter and the Half-Blood Prince*, JK Rowling, 2005 published by Bloomsbury Publishing plc.

<sup>7</sup>Source: Nielsen Bookscan data. Excludes any sales by retailers not covered by Nielsen Bookscan.

<sup>8</sup>1,957,016 titles in print at February 2006 according to Nielsen Bookscan, based on the TCM. 850,648 were academic, medical, and educational; the remainder were more general in nature and could be described as 'trade titles'.

<sup>9</sup>185,533 according to Nielsen Bookscan, of which 121,983 were trade titles. The figures for new titles and titles in print are based on the number of new ISBNs each year.

audiobooks). There are no available industry data adjusting for this duplication so that the figures given in this paragraph are overstated.

- 2.4 We looked at whether there was likely to be a significant change in the market over the foreseeable future. We were told that e-books (texts downloaded electronically and designed to be read on a computer screen or handheld device) were unlikely to be widely used for the next five years although this will depend on technological advances. E-books were also currently more likely to be used for specialist, non-trade rather than trade titles.
- 2.5 Until 1995 the Net Book Agreement (NBA) allowed publishers to set the retail price of a book. Since the end of the NBA,<sup>10</sup> publishers have continued to recommend retail prices (the recommended retail price (RRP), usually printed on the book), but retailers have increasingly discounted the prices of some titles below RRP,<sup>11</sup> and new types of retailer have entered the market.
- 2.6 The key participants in the book industry are authors (usually represented by literary agents), publishers, wholesalers and retailers. These are described briefly below. Further details of the book supply chain are set out in Appendix B.
- 2.7 There are over 10,000 publishers in the UK. The ten largest publishers of trade titles in the UK represented more than half of total consumer sales by value and volume in 2005, and the top ten publishers accounted for almost 95 per cent of all sales of fiction in 2005.<sup>12</sup> There have been several recent mergers leading to an increase in concentration among publishers. In particular, Hachette Livre UK Limited (Hachette) entered into agreements to acquire Time Warner Limited in February 2006. This

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<sup>10</sup>The NBA was disbanded in 1995 and outlawed by the Restrictive Practices Court in 1997.

<sup>11</sup>Nielsen Bookscan data show average discounts off RRP from 1998 to 2003 of around 15 per cent, rising to 17 per cent in 2004 and 21 per cent in 2005.

<sup>12</sup>Source: Nielsen Bookscan data.

would make Hachette the largest publisher in the UK. The publishers hold copyright licences on behalf of the authors for the majority of the books that they publish, set RRP, and negotiate promotional terms with retailers. Publishers use distributors to supply books directly to retailers or to wholesalers.<sup>13</sup>

2.8 Wholesalers have a non-exclusive relationship with publishers and sell books to retailers. Following a recent period of consolidation, there are now three major traditional wholesalers in the UK (Total Home Entertainment Distribution Limited (THE), Gardners Books Limited (Gardners), and Bertram Group Limited (Bertram)). Historically wholesalers primarily supplied independent bookshops,<sup>14</sup> although they are increasingly supplying Internet and other retailers. They offer a 24-hour delivery service on many books. In addition, wholesalers such as Entertainment UK Limited supply books and provide additional services such as merchandising and category management to some supermarkets.<sup>15</sup> We were told that wholesalers printed a small number of books on demand, and that the costs of doing so were declining with improvements in technology.

2.9 There are four different broad types of book retailer, although we note that the distinctions between them are somewhat blurred:

- (a) specialist 'bricks and mortar' book retailers such as Waterstone's, Ottakar's, and Borders (UK) Ltd (Borders) as well as independent bookshops;
- (b) bricks and mortar retailers for whom books are an important category, such as WH Smith plc (WH Smith) and British Bookshops and Stationers plc (British Bookshops);

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<sup>13</sup>Some distributors are in-house. Many act for several publishers.

<sup>14</sup>In this report, when we refer to independent bookshops, we include all independents with five or fewer outlets.

<sup>15</sup>This includes advising the supermarket on its range of books and undertaking the supply, stocking and layout of the display.

- (c) bricks and mortar retailers that sell books as one part of a wide range of goods, including, in particular, the supermarkets and major multiples such as Woolworths Group plc (Woolworths); and
- (d) distance sellers (including Internet retailers such as Amazon.co.uk Limited (Amazon) and book clubs).

Some bricks and mortar retailers also offer distance selling (for example Tesco.com). The major multiples and the supermarkets stock a relatively small range of titles, many of which are best-sellers, whereas the specialist bookshops and Internet retailers offer a much wider range of titles. The market share of the Internet retailers, the supermarkets, and, to a lesser extent, the large specialist chains has grown over the last five years. Book clubs have suffered a significant decline in market share. Further details of the different types of retailers and their market shares are set out in section 5 and Appendix C.

- 2.10 The commercial terms offered by publishers to their different UK sales channels are typically expressed as a discount off RRP. Retailers and wholesalers negotiate both standard discounts and promotional discounts with publishers. Standard discounts apply to the whole of a publisher's output and are generally reviewed yearly; additional promotional discounts are negotiated title by title. Bertram said that, in its view, discounts given by publishers to retailers varied from 35 to 45 per cent for the independent bookshops to as much as 65 to 80 per cent for book clubs. Further details of the discount structures are set out in paragraphs 5.24 to 5.27.
- 2.11 Retailers usually buy books on a sale or return basis. They pay for the books that they stock, and on the subsequent return of the stock are generally given a credit note against future purchases.<sup>16</sup> An industry code of practice on returns was

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<sup>16</sup>In a few cases books are bought on a firm basis, generally when the book is exclusive to the retailer.

produced in 2000.<sup>17</sup> This recommends that books should not be returned within three months of the publication date or more than 15 months after the date of the last dispatch. We were told that return rates to wholesalers were generally lower than to the publishers but that the typical proportion of titles subject to returns across the industry was 10 to 20 per cent.

2.12 Book retailers can monitor their sales quickly and accurately using information collected from Electronic Point of Sale (EPOS) systems because each book has an ISBN and a barcode. In addition, IT systems can be used to manage the books stocked so as to ensure that titles that sell well are in stock and the amount of 'dead' stock<sup>18</sup> is reduced, releasing cash and space for other titles which might sell faster.<sup>19</sup> Bookselling chains can also use IT systems to identify titles which are selling well in some stores in the chain but not in others, potentially giving rise to decisions to stock those titles more widely. Further details on stock management and buying at Waterstone's and Ottakar's are set out in Appendix D.

### ***Customer characteristics***

2.13 A recent study into buying new books indicated that 33 per cent of adults in the UK had not bought any new book in the last 12 months while 22 per cent of adults had bought more than 11 books. The same study indicated that people bought approximately twice the number of books for themselves as for others, including children. Women tend to buy more books than men. The number of books bought increases with socio-economic group and level of education.<sup>20</sup>

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<sup>17</sup>The code of practice was drawn up by the Book Industry Supply Chain Steering Committee.

<sup>18</sup>Dead stock is stock that cannot be returned (beyond the 15-month period) or sold.

<sup>19</sup>For example, one UK bookseller (Borders) announced in September 2005 that its new system would allow increased stockturn without any reduction in range, automated rather than manual replenishment and reduced returns.

<sup>20</sup>Source: *Expanding the Book Market*, BML, 2005.

- 2.14 GfK NOP Limited conducted a customer survey on behalf of the CC to get a better understanding of book-buying decisions, covering 73 stores and 2,454 individuals. The results of our survey are on our website.<sup>21</sup> This suggested that, for respondents who had bought a book in the Waterstone's or Ottakar's stores which we surveyed:
- (a) around two-thirds had planned to visit the bookshop and a similar proportion had planned to buy at least one of the books actually bought;
  - (b) on average respondents bought just under two books and spent around £15. Around two-thirds were bought for the respondent's own use and the remainder for family, friends or colleagues;
  - (c) nearly all respondents had bought at least one other book in the last 12 months, and about six in ten had bought a book in the last month;
  - (d) just under half said that they had bought a book of some type on the Internet at some point and about 30 per cent had bought a new book on the Internet in the past 12 months; and
  - (e) respondents' main reasons for visiting Waterstone's or Ottakar's were the convenience of the store location and the likely availability of the books that they wanted.

### **HMV**

- 2.15 HMV is a UK-based company selling books, recorded music, pre-recorded videos and electronic games. HMV was formed in 1998 following the acquisition of the HMV business from EMI Group Plc (including Dillons bookstores) and the Waterstone's business from WH Smith. HMV was listed on the London Stock Exchange on 15 May 2002. In mid-January 2006, it had a market capitalization of approximately £710 million.<sup>22</sup> Turnover for the year ended 30 April 2005 was £1.89 billion.

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<sup>21</sup>[www.competition-commission.org.uk](http://www.competition-commission.org.uk).

<sup>22</sup>Speculation at the end of January 2006 about a bid by Permira Advisers Limited (Permira) led to an increase in the share price of HMV and a corresponding increase in market capitalization of around £30 million. Rejection of the first offer by Permira

- 2.16 HMV trades in the UK mainly under two brands: HMV and Waterstone's.<sup>23</sup> Its book retailing business is primarily carried out through its Waterstone's branded stores. It sells a limited range of books in HMV branded stores<sup>24</sup> which we do not consider further in this report.
- 2.17 Waterstone's was founded by Tim Waterstone in 1982.<sup>25</sup> On 31 December 2005 it had 190 bookshops in the UK, including 31 on university campuses and six in Northern Ireland.<sup>26</sup> Total sales for the year ended 30 April 2005 were £446.1 million, of which £416 million were in the UK.<sup>27</sup>
- 2.18 Waterstone's range of titles stocked varies according to the size of the store, but is typically 30,000 to 40,000. In addition to printed books, Waterstone's sells small quantities of spoken word recordings, children's toys and trading cards, stationery items and book-related products. It has let concessions to sell coffee and light refreshments in 34 stores.

### ***Ottakar's***

- 2.19 Ottakar's was formed in 1987 by James Heneage and Philip Dunne. Their aim was to establish a chain of bookshops in market towns in Great Britain. Ottakar's has grown both organically and through acquisition (including acquiring James Thin's Booksellers in March 2002 and much of Hammicks Bookshops<sup>28</sup> in April 2003). On 31 December 2005, it had 141 stores.

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led to the share price settling at around 185p to 190p a share. HMV also rejected a second offer of 210p a share on 13 March 2006. Permira announced on 20 March 2006 that it would no longer be bidding for HMV.

<sup>23</sup>The exception is Hatchard's bookshop in Piccadilly, London, which has retained its brand name.

<sup>24</sup>These are primarily specialist titles relating to music and films, amounting to [£] million in 2004/05 (less than [£] per cent of Waterstone's turnover).

<sup>25</sup>Tim Waterstone is no longer involved in running Waterstone's.

<sup>26</sup>One of the bookshops in Northern Ireland is on a university campus. Waterstone's announced on 20 March 2006 that it would close six university campus sites.

<sup>27</sup>Waterstone's also has one store in each of Belgium and the Netherlands, and a limited presence in the Republic of Ireland.

<sup>28</sup>Ottakar's acquired 24 outlets when it acquired Hammicks Bookshops.

2.20 Ottakar's was listed on the London Stock Exchange in March 1998. It has a current market capitalization of approximately £70 million.<sup>29</sup> Total sales for the year ended 28 January 2006 were £176.5 million.

2.21 Ottakar's range of titles stocked varies according to the size of the store, but is typically 20,000 to 30,000. In addition to printed books, Ottakar's sells small quantities of spoken word recordings, children's toys and trading cards. It has let concessions to sell coffee and light refreshments in 42 stores.

### **3. The proposed merger**

#### ***History of the proposed merger***

3.1 In the spring and early summer of 2005, a management buyout (MBO) team made up of James Heneage (CEO, Ottakar's), Michael Hitchcock (Finance Director, Ottakar's) and Philip Dunne (Chairman, Ottakar's) decided to try to buy back Ottakar's shares, backed by the private equity house Phoenix Equity Partners Limited (Phoenix). They hoped that this would enable Ottakar's to raise capital to invest in 'the systems necessary to remove costs and working capital from the business'.<sup>30</sup>

3.2 On 16 August 2005 Ottakar's announced that discussions had taken place with the MBO team that might lead to a possible offer for the company. On 25 August 2005 HMV announced that it was considering making an offer for Ottakar's. The following day, 26 August 2005, BSA, the MBO bid vehicle, made a recommended bid for Ottakar's of £3.50 a share. This was increased to £4.00 a share on 6 September 2005.

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<sup>29</sup>Share price of 320p at 6 February 2006.

<sup>30</sup>Part 2, paragraph 8 of the offer made by Bookstore Acquisitions Limited (BSA), the MBO private equity-backed bid vehicle.

3.3 On 8 September 2005, HMV announced its bid for Ottakar's at £4.40 a share. On 13 September 2005, the independent directors of Ottakar's withdrew their recommendation to shareholders to accept the BSA offer and recommended HMV's offer. HMV posted its offer document to Ottakar's shareholders on 19 September 2005.

3.4 The proposed transaction was notified to the OFT on 9 September 2005. HMV's offer for Ottakar's lapsed as a result of the OFT's announcement on 6 December 2005 that it had referred the transaction to the CC.

### ***Structure of the proposed merger***

3.5 HMV told us that [redacted].<sup>31</sup>

### ***Rationale for the proposed merger***

3.6 HMV said that the proposed merger should be seen in the context of the 'substantial financial pressures' facing specialist bricks and mortar book retailers. They were caught in a 'pincer movement' between, on the one hand, the supermarkets offering a limited range but substantial discounts, both on best-sellers and on an increasing number of deep-range titles, and, on the other hand, the Internet retailers offering a very extensive range. The proposed merger would enable Waterstone's to compete more effectively with Borders, WH Smith, the Internet retailers and the supermarkets, as well as other specialist retailers.

3.7 Both Waterstone's and Ottakar's have reported difficult trading conditions over the 2005 Christmas period. Despite Waterstone's heavy discounting and national television advertising, its like-for-like sales for Christmas 2005 decreased by 2.5 per cent by value compared with the same period the previous year.<sup>32</sup> Ottakar's did not

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<sup>31</sup>[redacted]

<sup>32</sup>The change in like-for-like sales is the change in the volume or value of sales at continuing stores compared with the similar period the previous year.

discount as heavily as either Waterstone's or WH Smith; its like-for-like sales for the Christmas 2005 trading period remained stable.<sup>33</sup> Ottakar's has, however, seen like-for-like sales fall by 3 per cent in the financial year ended 28 January 2006 compared with the previous year, a fall of [redacted] per cent against budget. Further analysis of Ottakar's financial position is provided in Appendix G.

3.8 HMV said that it was seeking three benefits in particular from the acquisition of Ottakar's:

- (a) efficiency improvements through the introduction of its integrated stock management system (Phoenix v9) into Ottakar's stores, enabling Waterstone's to offer a wider range of titles in these stores;<sup>34</sup>
- (b) increased economies of scale [redacted]; and
- (c) [redacted]

### ***Jurisdiction***

3.9 Under section 36 of the Act, the CC is required to decide whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation such that:

- (a) two or more enterprises cease to be distinct; and
- (b) either the turnover test or share of supply test is satisfied.

3.10 As a result of the proposed merger, HMV and Ottakar's will cease to be distinct. The UK turnover of Ottakar's exceeds £70 million, so the turnover test in section 23(1)(b) of the Act is satisfied. We therefore conclude that arrangements are in progress or in contemplation which, if carried into effect, would result in the creation of a relevant merger situation.

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<sup>33</sup>Source: Waterstone's and Ottakar's post-Christmas trading statements. Waterstone's Christmas period is defined as the five weeks ended 7 January 2006; Ottakar's has defined it to be the four weeks ending on the same date.

<sup>34</sup>HMV said that this benefit was not necessarily merger-specific.

#### **4. Market definition**

4.1 We considered the appropriate product and geographic market definitions, applying the methodology set out in our guidelines.<sup>35</sup> We do not regard market definition as an end in itself, but rather as a framework within which to analyse the effects of a merger on competition. The definition of the relevant market is a useful tool for analysing the competitive constraints faced by the parties to the merger from other firms supplying the market.

##### ***Product market definition***

4.2 Different views were put to us on product market definition. Both the parties argued that the market should be defined as the retail sale of all new books to individual consumers (ie excluding sales to institutions).<sup>36</sup> Several third parties supported the OFT's conclusion that there was an important distinction between large range and smaller range book retailers. Others said that there were separate market segments, covering, for example, bricks and mortar bookshops, the supermarkets, and Internet retailers (notably Amazon).

4.3 The narrowest possible product definition would, in theory, be that of an individual title. However, we did not consider that such a definition (or the slightly wider definition of a genre of books) would, in practice, be helpful to our understanding of the dimensions of the market within which rivalry between Waterstone's, Ottakar's and other book retailers occurs. We therefore considered how best to aggregate titles.

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<sup>35</sup>CC2 Merger References: *Competition Commission Guidelines*, June 2003.

<sup>36</sup>Sales to institutions (such as businesses, libraries, schools and other academic institutions) account for only a small proportion (less than [~~3~~] per cent) of the parties' total sales. We accept the parties' arguments that sales to institutions are in a different market from sales to consumers; that they face competition from other specialist suppliers in the market for the supply of books to institutions; and that the proposed merger will not substantially lessen competition in the institutional market.

4.4 Many parties described titles in terms of best-sellers and deep-range and we considered whether there was a separate market for deep-range titles. For these purposes, we defined best-sellers as the 5,000 top-selling titles for a particular calendar year, while deep-range titles<sup>37</sup> encompassed the remainder. However, we did not think that this distinction was appropriate for the purpose of market definition<sup>38</sup> because:

(a) many titles have widely differing sales rankings during the course of a year;<sup>39</sup>  
and

(b) there are no retailers selling only deep-range titles and we were told, and we accepted, that this would not be a viable business model.

4.5 We therefore conclude that there is not a separate market for deep-range titles. We recognize, however, that the competitive effects of the merger on deep-range titles may differ from the competitive effects on best-sellers, and our assessment takes any such differences into account.

4.6 We also considered whether it might be possible to define separate markets according to type of retail outlet. However, consumers' book-buying patterns are varied. For example, some want to buy a best-seller cheaply whilst others are looking to browse; some plan a purchase ahead of time whilst others make a decision on the spur of the moment; and some are looking to own the book immediately whilst others are prepared to wait for delivery.<sup>40</sup> We were told that although retailers considered that the browsing experience at retailers with a wide range of titles (both bricks and mortar and Internet retailers) was important, there was no clear relationship between

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<sup>37</sup>We defined deep-range titles as those ranked below 5,000 for the year in question because this appeared to be the point at which discounting began to level off (see Figure 5 in Appendix C).

<sup>38</sup>We attempted to assess whether it would be profitable for a hypothetical deep-range monopolist to impose a small but significant increase in prices but found the evidence was difficult to interpret, for example we noted that trends in the volume and price of deep-range titles, relative to best-sellers, could be affected by different underlying growth rates.

<sup>39</sup>HMV said that in any year approximately 20,000 titles in total would be listed in the top 5,000 when calculated on a weekly basis.

<sup>40</sup>We received a variety of evidence on consumer behaviour, including our survey and the research carried out in June 2005 for Waterstone's by Researchcraft (a telephone survey of 1,000 ABC1 adults who had bought a book in the previous six months).

different types of consumer behaviour and different types of retailer. We therefore did not find it helpful to define a market according to type of retail outlet.

4.7 We also received evidence that there was price competition on best-sellers between all types of retailer (see paragraph 5.64). We therefore considered that competitors in the market included all types of retailer, both specialist and generalist bricks and mortar retailers, and distance sellers including Internet retailers and book clubs.

4.8 HMV told us that around 25 per cent of all books were bought as gifts and suggested that the market could therefore be wider than just books. We received no evidence that a small rise in the price of books would cause enough consumers to purchase something other than a book as a gift to justify drawing our market definition more widely. We also did not consider that our market definition should be extended to include second-hand books or public libraries.

### ***Geographic market definition***

4.9 Despite an increasing percentage of people using Internet retailers (see Appendix C), many people buy books from bricks and mortar retailers convenient to their home or work.<sup>41</sup> The major retailers, including the merging parties, operate throughout the country and have national branding and primarily uniform national prices (see paragraph 5.35). A hypothetical local monopolist that set uniform prices nationally would be constrained from raising prices locally indicating that the effects of the proposed merger on price should be considered primarily at the national level.<sup>42</sup>

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<sup>41</sup>TNS data suggests about 25 per cent of books were bought from distance sellers (including the Internet and book clubs) in 2005, and our survey suggests Waterstone's and Ottakar's customers spend an average of 18 minutes travelling from home or work to their shopping destination.

<sup>42</sup>We considered whether mix effects affected average prices but did not find that local competition (measured by whether there was an Ottakar's store in close proximity to Waterstone's and vice versa) affected the average price charged per book (see Appendix F).

- 4.10 We noted that there may be some local variation in service quality and we therefore consider competition at the local level. We consider the geographical scope of local competition in paragraphs 5.31 to 5.34. We conclude that local competition between Waterstone's and Ottakar's occurs principally within the same shopping location, in most cases the same high street.
- 4.11 As regards national competition, although the operations of some retailers, notably Amazon, go beyond the UK, retailers have a UK-specific offering with UK prices. We consider the geographic market to be no wider than the UK. Ottakar's has no stores in Northern Ireland but other retailers (including Waterstone's) have stores in Northern Ireland which operate according to the UK model (see paragraph 4.9).<sup>43</sup> We therefore saw no reason to exclude stores in Northern Ireland from our consideration of national competition.
- 4.12 We also considered whether narrower markets should be defined to cover, for example, Scotland, Wales, or the English regions. Some parties told us that there were, in particular, separate markets in Scotland and Wales, implying that a lack of substitutability in both consumers' demand and the supply of titles could make it possible for a hypothetical regional monopolist to increase prices profitably by a small but significant amount, or to reduce range or quality of service.
- 4.13 Book prices in Scotland and Wales are similar to book prices in England. Waterstone's charges the same price across Great Britain for titles accounting for the vast majority [§] of their book sales, and the same is true of Ottakar's.<sup>44</sup> We looked at whether there were substantially different titles on sale or promotion in, for

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<sup>43</sup>HMV told us that Waterstone's had a weekly top 40 'chart' list for Ireland (Northern Ireland and the Republic of Ireland), a few specific price promotions (Book of the Month; Best of Irish '3 for 2' campaign; and ten featured new titles), and a local buyer for Irish titles, but these constituted less than [§] per cent of its total sales in Northern Ireland.

<sup>44</sup>HMV told us that Waterstone's Scottish/Welsh price promotions included one title a month as Book of the Month, and 100 best Scottish Books of all Time (during most of 2005)/around 50 titles in a Best of Welsh campaign. Ottakar's discounts a limited number of Scottish titles [§]. In all cases, sales of these titles represented a very small percentage ([§]) of the parties' total value of sales in Scotland or Wales in 2005.

example, Scotland and Wales. HMV told us that Waterstone's had a core range specific to Scotland containing some [X] titles, as well as separate weekly top 40 'chart' lists for Scotland and Ireland. However, more than 95 per cent of its core range was the same throughout the UK. Ottakar's also told us that most of its core range [X] was graded equally in Scotland and the rest of Great Britain, and it did not have a separate core range for Wales or the English regions. We concluded that the vast majority of titles were common throughout the UK and that there was no evidence to support the definition of separate geographic markets in Scotland, Wales or the English regions. Nevertheless, we considered it important to look at the effects of the proposed merger on individual geographic areas.

### ***Conclusions on market definition***

4.14 We therefore concluded that the product market was the retail sale of new books to consumers, although we believed it appropriate to assess separately the competitive effects of the proposed merger in terms of sales of deep-range titles and best-sellers. We concluded that the geographic market was no wider than the UK, but that we should look separately at local, regional and national aspects of competition.

## **5. Assessment of the competitive effects of the proposed merger**

5.1 In order to assess the competitive effects of the proposed merger, we first looked at the other retailers in the market, their expansion plans, and the possibility of entry into the market. We considered the underlying factors that affected competition, including market shares and concentration, pricing, and promotions. Next we looked at the existing degree of competition in the market at a local, regional and national level. Following our assessment of the counterfactual, we analysed the effects of the proposed merger on local and national competition. We also considered the possibility that there might be vertical effects arising from the proposed merger (ie effects on publishers from the increased concentration in the retail market).

5.2 As set out in paragraph 1.2, we are restricted to answering the questions raised in our terms of reference. These questions relate to whether we expect there to be an SLC as a result of the proposed merger. Wider concerns such as cultural diversity fall outside our remit and we have therefore not taken these into account in reaching our conclusions.

### ***Other retailers***

5.3 As discussed in paragraph 2.9, there are four broad types of retailer competing to sell books in the UK. We describe each of these in turn, including any relevant expansion plans. Paragraphs 2.15 to 2.18 and 2.19 to 2.21 describe HMV/Waterstone's and Ottakar's respectively and we set out details of the Waterstone's and Ottakar's stock management systems in Appendix D. Details of Ottakar's financial performance are set out in Appendix G.

### ***Specialists***

5.4 Borders Group Inc, based in the USA, is the second largest bookseller in the world. Borders has been present in the UK since 1997 when it acquired Books Etc Limited (Books etc). Borders now runs 36 superstores, principally in out-of-town locations across Great Britain and 33 small format stores under the Books etc and Borders Express brands, based mostly in London and the South-East of England. Borders' superstores carry a very extensive range of books, typically 50,000 to 80,000 titles, whilst the Books etc stores have a smaller range (20,000 to 30,000). Books make up about two-thirds of total sales value in the Borders superstores.

5.5 Borders told us that its buying for its superstores took place centrally. The central buying team make all the new title and replenishment decisions and allocate stock to stores. In the case of the Books etc stores, run on an older model, the inventory systems are discrete to each branch, and the buying takes place in the branch. A

new stock management system, covering both Borders and Books etc stores, is to be implemented by the end of 2006. Events such as book signings are arranged centrally by Borders' marketing department.

5.6 Borders said that it planned to continue to expand its superstore format, opening around seven stores each year for the next five years. Two Books etc stores have recently been disposed of to non-book retailers.

5.7 Other specialist chains include Blackwell UK Limited (Blackwell), which has 56 stores in university towns, many of which are on the university campus, and smaller regional chains such as Methvens Booksellers, which has eight stores in the South-East of England.

5.8 Independent bookshops differ hugely in size and range. We include both small chains of independents with five outlets or fewer (such as Mahers Booksellers Limited and Daunt Books Limited), as well as individual bookshops (of which a few, such as Foyle's, are very large, but the majority are relatively small). Data from the Booksellers Association shows that the total number of small independent outlets has fallen in the last ten years from almost 1,900 in 1995 to around 1,550 in 2005, although the decline has stabilized in the last two to three years (see paragraph 5.17).<sup>45</sup> We were told that independents were often situated in tertiary sites away from town centres, or in smaller towns without one of the large chains.

### *WH Smith and British Bookshops*

5.9 WH Smith's retail business sells books, stationery, cards, newspapers, magazines, entertainment material (eg DVDs) and confectionery from high street stores. Its travel

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<sup>45</sup>The Booksellers Association told us that its membership accounted for approximately 95 per cent of traditional bookshops that primarily sold books from retail premises on the high street. They account separately for small independents, which have between one and five outlets.

stores sell a tailored range of newspapers, magazines, books and confectionery in locations such as airports and railway stations. In the year to 31 August 2005, book sales accounted for [X] per cent of total WH Smith retail sales. WH Smith has 545 high street stores, of which about 350 have a typical range of 5,000 to 10,000 titles and the remainder have a typical range of 10,000 to 20,000 titles, and 127 travel stores selling a tailored range of titles. WH Smith also has a newspaper and magazine wholesaling and distribution business.

5.10 WH Smith said that it focused on selling and promoting new titles and best-sellers in its high street stores. It has a 'self-service' business model with limited levels of specialist advice available in-store. It sets prices, ranges, staffing levels, stock levels and store layout centrally. The centre decides on locally-relevant stock (eg local maps and history books). Scottish stores had a slightly different range, which was also centrally bought.

5.11 WH Smith told us that, in order to increase its range of titles, it had reformatted around 200 space-constrained stores by increasing the book fixture heights, allowing them to carry a greater number of titles. In addition, several third parties told us that WH Smith had plans to launch a large number of stand-alone bookstores. WH Smith, however, stated that it was undertaking a trial of opening second stores in towns where it did not have sufficient space in an existing store to have an appropriate offer in all product categories. It stated that it was currently trialling the creation of two stores in six towns, with each store having different mixes of products: for example, if a store focuses predominantly on books (or books and entertainment), the other would carry stationery and WH Smith's other core product categories. WH Smith's trial currently includes proposals to open second stores in up to a further [X] towns. [X] of the new stores are intended to focus on stationery, leaving space in the existing store for more books and/or other WH Smith product categories. WH Smith

stated that its future strategy would be influenced by the success or otherwise of these trials. If the trials are successful, they could be applied to around [X] towns in which WH Smith is space constrained.

5.12 British Bookshops is a wholly-owned subsidiary of Eason & Son Limited of Dublin. It sells books, stationery and cards, with a total turnover of about £40 million. It has 51 small stores (140 to 420 sq metres (1,500 to 4,500 sq feet)) mainly based in smaller towns in the South-East of England, supplied from a central warehouse in Brighton. Each store has a range of 5,100 titles, all discounted and all available at every outlet. British Bookshops said that a central book-buying team decided which titles were stocked. Local managers had limited flexibility as to how stock was displayed. British Bookshops told us that it had opened two new stores in the past 12 months and was looking at new outlets within the South-East.

### *Supermarkets*

5.13 All the major supermarkets sell some books in some or all of their stores.<sup>46</sup> Although the supermarkets focused initially on paperback best-sellers, cookery books and children's books, they are now starting to stock a wider range of titles.<sup>47</sup> Stock levels and layouts are generally set centrally. Tesco Plc (Tesco) said that its ranges of books were refreshed regularly [X]. The amount of space allocated to books was reviewed much less frequently as it was a major logistical exercise.<sup>48</sup> We were told that the major supermarkets were seeking to expand their non-food sales, including books. Supermarkets, with the exception of Asda Group Limited, source books from merchandisers and wholesalers rather than direct from the publishers.

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<sup>46</sup>Tesco, for example, told us that it sold books in 653 stores across the UK.

<sup>47</sup>We were told, for example, that the largest Tesco stores had bays on history, literary prizewinners etc.

<sup>48</sup>[X]

### *Distance sellers*

5.14 Amazon is the UK's largest Internet book retailer and sells a very wide range of new and used books as well as a large variety of other products. In 2005 it had a net turnover from its book sales of £[⌘] million and a positive gross margin of [⌘] per cent. Amazon has a dedicated warehouse, buys books primarily from publishers, and distributes the books to customers. Other Internet retailers include Tesco.com and BOL.com. Many of these use wholesalers for the fulfilment of orders and management of the supply chain.

5.15 Other retailers include book clubs and direct selling organizations. Book clubs either buy books from publishers (in large quantities) or license the copyright and print them, often on lower quality paper, at lower cost. Book Club Associates Limited (BCA), wholly owned by Bertelsmann AG, is the largest book club company. It has a number of clubs covering a wide range of topics. The Book People Group Limited supplies discounted books direct to consumers by monthly mail order catalogues, an Internet site and through its nationwide distributor network, which delivers directly to workplaces and schools.

### ***Entry and expansion***

5.16 We outlined the expansion plans for existing competitors in paragraphs 5.4 to 5.15. The main parties, and some third parties, have submitted evidence to show that entry at a local level is relatively straightforward and represents a considerable competitive constraint:

- (a) a financial model of the costs involved was submitted by HMV, and concludes that overall capital costs are low;
  - (b) HMV submitted further evidence that there is no shortage of suitable premises;
- and

(c) a ready supply of a large range of books on sale or return, advice on bookselling, and IT systems are available from wholesalers.

5.17 We agreed that in principle setting up a single bookshop would be relatively straightforward. The main requirements are working capital, a suitable retail site, access to stock (which can be obtained from wholesalers on a sale or return basis), and skills (which appear to be readily available, in particular among former managers of retail chains). We were also told that wholesalers provided additional support, particularly in relation to stock and EPOS systems and range of titles to stock. Data for 2004 and 2005 showed that there were over 50 new small independents a year joining the Booksellers Association (although there has been a small net decline—see paragraph 5.8).

5.18 A small entrant would be likely, however, to obtain lower discounts off RRP from the publishers or wholesalers. Discounts for independents, either from wholesalers or direct from publishers, are lower than those available to larger retailers. Independents may also face some other cost disadvantages, for example on advertising. Consequently, independents are less able to compete on price, in particular on best-sellers. Hence, other things equal, they achieve lower sales and profits than multiple retailers and tend to be located at tertiary locations (which in turn further reduces the level of sales that independents can achieve compared with branches of multiple retailers).

5.19 In principle, if an independent or other small chain of bookshops expanded rapidly, it could achieve similar discounts and similar levels of costs to multiple book retailers. HMV argued that it was possible for a bricks and mortar retailer to expand rapidly.<sup>49</sup>

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<sup>49</sup>HMV quoted the example of a DVD retailer, Silverscreen, which opened its first store in August 2003 and had 60 stores (typically 140 to 280 sq metres (1,500 to 3,000) sq feet) trading by October 2005. There are also examples of rapid expansion in other areas of retailing, such as clothing.

We noted, however, that no chain of book retailers has achieved such a rapid expansion from a very small base. HMV constructed a financial model which assumed ten store openings a year and achieved a size of 40 stores after four years. We were also told that conditions for entry into UK book retailing were less favourable than in the past, in particular because of the increasing market share of supermarkets and Internet retailers. Ottakar's told us that it did not think that there would be major new entry on a national level. HMV said that it thought that the intensely competitive market made such entry into the UK market difficult. We saw no indication that foreign book retailers, such as Barnes & Noble, were likely to enter the UK in the foreseeable future.

5.20 The parties argued that barriers to entry to setting up as an Internet retailer were particularly low. An online entrant would not incur store rental costs but would incur set-up and marketing costs, although these would be less for an existing Internet retailer of other goods.<sup>50</sup> Such an entrant might face a similar problem to a bricks and mortar entrant in obtaining sufficient discounts to enable it to compete with the larger existing retailers, including Amazon. Alternatively, an Internet retailer entrant might operate on a specialized basis. HMV told us, for example, of booksfromscotland.com, an Internet retailer holding 18,000 Scottish titles, set up in November 2005 in response to recommendations in a 2004 Arts Council report.

### ***Underlying factors affecting competition in book retailing***

#### *Market shares and concentration*

5.21 Data is readily available on sales in the book industry and individual retailers have access to figures for industry-wide sales by title. The two main sources are TNS data, based on a panel of 10,000 consumers,<sup>51</sup> and Nielsen Bookscan, which records

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<sup>50</sup>For example, lastminute.com sells books in association with thehut.com.

<sup>51</sup>TNS data is subject to sampling and reporting error and is believed to under-represent students and overseas visitors (source: HMV).

sales from till data.<sup>52</sup> Table 1 in Appendix C gives estimated 2005 market shares both for all books and for deep-range titles only, based on both data sources. We estimated Waterstone's market share of all books to be around 17 per cent (17 per cent of deep-range titles), and Ottakar's to be 7 per cent (7 per cent of deep-range titles). Table 1 shows a summary of 2005 UK market shares by type of retailer.

TABLE 1 National market shares in the book market, 2005

	%
Waterstone's	17
Ottakar's	<u>7</u>
Total	24
Other specialist bookshops*	15
Other stores incl WH Smith	19
Supermarkets	8
Internet	8
Book clubs and other distance sellers	15
Other†	<u>10</u>
Total	100

Source: CC calculations based on TNS and Nielsen Bookscan data. Market shares are based on the value of sales.

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\*Including Borders and Blackwell.

†Includes bargain bookshops.

Note: Individual market shares do not sum to 100 due to rounding.

5.22 As set out in Appendix C, the main trends have been an increase over time in the market share of supermarkets and Internet retailers, each of which increased by about 4 percentage points between 2001 and 2005; and a decrease in the share of non-Internet distance sellers (principally book clubs). Waterstone's share of all book sales fell over the period (by about 4 percentage points), but Ottakar's and Borders (both of which were rapidly expanding their number of outlets) increased their share of the market. The share of smaller chains of specialist bookshops and independents has also fallen although this may be accounted for, at least in part, by acquisitions by the major chains rather than closures.<sup>53</sup>

5.23 The UK retail market for books is not concentrated at national level and concentration has changed little during the past five years. Concentration is somewhat higher for

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<sup>52</sup>The Nielsen data does not achieve complete coverage; in particular it does not cover sales through distance sellers other than Internet retailers.

<sup>53</sup>TNS data shows that the share of other specialist bookshops declined from about 14 per cent in 2001 to 10.5 per cent in 2005. (Nielsen Bookscan data does not cover other specialists fully, particularly independents.)

the deep-range segment.<sup>54</sup> Based on our market share figures in Appendix C, the four largest retailers (WH Smith, Waterstone's, Ottakar's and Borders) have 45 per cent of the market and 55 per cent of the deep-range segment.

### *Pricing and promotional activity*

5.24 As set out in section 2, the RRP for a book is set by the publishers and represents, in practice, a maximum price that can be charged. The RRP is generally printed on the book and is rarely changed post-publication. We were told that publishers set RRP's according to a judgement about what the market would bear; it was not cost-related. Publishers said that they took likely levels of discounting by retailers into account in setting RRP's.

5.25 Following the end of the NBA, many titles are no longer sold at the RRP. The size of the discounts and the number of titles discounted have increased over time (see paragraph 2.5). For the market as a whole, average selling prices were around 60 per cent of RRP for the nine best-selling titles in 2005, rising to about 90 per cent of RRP for deep-range titles (see Figure 1 in Appendix C). We were told that most deep-range titles were not discounted by bricks and mortar retailers but were discounted to a greater extent by supermarkets and Internet retailers (see paragraph 5.62). The bricks and mortar retailers' discounts on deep-range titles primarily resulted from genre discounts (for example, a discount on all travel books) or discounting of individual titles which were not sufficiently popular to make the top 5,000 for the year.<sup>55</sup>

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<sup>54</sup>The Herfindahl-Hirschmann index of concentration (HHI) is about 700 for the market as a whole, and about 1,000 for the deep-range segment.

<sup>55</sup>Ottakar's told us that deep-range titles sold at a discount might include, for example, titles included in 3 for 2 offers (which are effectively sold at a discount of up to 33 per cent), or titles included in promotions on specific topics, such as Ottakar's 2005 promotion on the Battle of Trafalgar.

5.26 The price charged by retailers is influenced at least in part by the discounts off RRP that they negotiate with wholesalers or publishers. We received information on discounts from a variety of sources, including publishers, wholesalers and retailers. These are set out in Appendix C. Bertram, the wholesaler, provided the estimates of discounts shown in Table 2. The evidence we received on discounts was mixed. The size of discounts that publishers offer to different types of retailers was not transparent. In general, we found that the independent bookshops received the lowest discounts, and the supermarkets and book clubs the highest. We also found that retailers' discounts from wholesalers were, in general, lower than the discounts they received directly from the larger publishers. [X]

TABLE 2 Bertram's estimates of typical discounts from publishers

	<i>Typical discount (%)</i>
Independent outlet	35–45
Trade wholesalers	45–55
Major chains	45–55
Internet retailers	50–60
Supermarkets	55–65
Discount clubs	65–80

Source: Bertram.

5.27 The discount structure includes a standard discount (generally across the entire range of a publisher's books), a promotional discount (on some individual titles), and, in some cases, additional discounts or payments relating to promotional spend, retrospective discounts etc. Discounts and other buying terms, including credit terms and limits on the percentage of books returned, are negotiated bilaterally between retailers and publishers, though retailers often use wholesalers to purchase their requirements from smaller publishers.

5.28 Price-promoted books are prominently displayed by the retailer, and we were told that price promotion had a significant impact on sales. The publishers told us that price promotions, especially through the specialist retailers, were a particularly

effective method of raising customer awareness and increasing sales of a particular title. They also told us that price promotion by authoritative specialist retailers was particularly important for new titles, including those by previously unknown authors or in innovative genres. This is discussed in more detail in paragraphs 5.71 to 5.79.

5.29 However, several parties told us that price promotion was one of several ways in which a particular title could be drawn to the attention of the consumer. The range of possible promotional activity included the following:

- (a) book reviews in newspapers and magazines and other media coverage such as television and newspaper book club selections;
- (b) direct advertising to consumers, including television and billboard advertising, catalogues, mailing lists etc;
- (c) publicity events including book signings, author readings etc;
- (d) in-store price promotion (including 3 for 2 promotions, chart promotions, genre promotions etc); and
- (e) other in-store non-price promotion such as point-of-sale publicity and display tables.

Ottakar's told us that of the 100,000-plus new trade titles that were published each year, only a small proportion (less than [X] per cent) were price-promoted by Waterstone's or Ottakar's during the course of the year.

### ***Existing degree of competition***

5.30 We considered the existing degree of competition between Waterstone's, Ottakar's, and the other retailers both at the local level and the national level. We considered whether there was a distinct regional dimension to existing competition. In each case we focused on three possible dimensions of rivalry: price, range of titles stocked, and service quality.

## *Local competition*

### *Geographic scope*

- 5.31 In order to assess the extent of any rivalry at the local level, we needed to consider its geographic scope. Both Waterstone's and Ottakar's provided us with an analysis of the impact of store openings in specific locations on store revenue. They calculated the variance in revenue from like-for-like sales three months prior to, and subsequent to, a competing store opening.<sup>56</sup> The results suggested that the greatest impact on revenues is on the stores in the immediate vicinity (within approximately one mile) of the opening store.
- 5.32 We undertook an 'event analysis' approach to explore the geographic extent of local competition, examining the impact on revenue in surrounding stores at varying distances from four new Waterstone's or Ottakar's store openings. This analysis is described in more detail in Appendix F. It showed that there was an impact on the volume of sales for stores on the same high street following a new entry at the local level which continued for at least 12 months following the store opening. Both Waterstone's and Ottakar's store openings had an impact on WH Smith stores' sales of books in the same location. There was also evidence of WH Smith's additional store openings having an impact on Ottakar's, suggesting that WH Smith is a local competitor to Waterstone's and Ottakar's and vice versa. However, the impact of Waterstone's and Ottakar's store openings on stores located further away was lower, and difficult to distinguish from other factors affecting sales.
- 5.33 We noted that, according to our survey, up to one-third of customers in overlap locations (and one-fifth elsewhere) travelled over five miles to get to a Waterstone's or Ottakar's store. We were also given evidence showing that the opening of a Borders superstore had an impact on sales over a much wider area compared with

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<sup>56</sup>Ottakar's also provided data for a longer period following the competitor store opening to see the longer-term impact.

the opening of a Waterstone's or an Ottakar's store. However, we noted that Borders' superstores were considerably larger than most high street stores and some might represent a 'destination' in themselves. It was therefore possible that a Borders store competes as a destination with local high streets for customers, whilst Waterstone's and Ottakar's stores (located almost entirely in high street locations) compete for customers once they have chosen a high street destination. Our survey did not identify whether customers were travelling to a particular high street rather than the book store itself, nor whether Borders (or other stores, such as supermarkets) competed as a destination. It did, however, suggest that a majority of the Ottakar's and Waterstone's customers surveyed considered their closest alternative bookstore to be in the same shopping location.<sup>57</sup>

5.34 We therefore concluded that local competition, to the extent that it exists, is concentrated on nearby stores (within the same shopping location), and also encompasses out-of-town stores which may themselves be shopping destinations, such as supermarkets and Borders' superstores. Waterstone's and Ottakar's do not in general have such destination stores and therefore our assessment of local competition was focused on nearby locations. On this basis, we conclude that there are 33 relevant overlap areas (see Appendix E). The overlap stores are not concentrated in any particular region, but are located over the entire breadth of Great Britain.

#### *Extent of local competition*

5.35 Waterstone's and Ottakar's have primarily uniform national prices.<sup>58</sup> We consider in paragraph 5.92 whether the proposed merger would lead to a change in national pricing. The quality of each book sold is clearly the same regardless of the store in

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<sup>57</sup>85 per cent of respondents in overlap stores; 59 per cent of those in Ottakar's non-overlap stores; and 54 per cent of those in Waterstone's non-overlap stores.

<sup>58</sup>[With the exception of [§]; a small amount of discounting of regional titles; and some local discretion in relation to the sale of dead stock.]

which it is sold. Competition in book retailing at the local level between existing stores, therefore, is concentrated on two non-price factors: range of titles in stock and quality of in-store service. In order to assess the extent of local competition we looked in more detail at various non-price factors to see if we could identify any substantial differences between Waterstone's and Ottakar's stores in overlap and non-overlap locations.

- 5.36 We note that our customer survey showed that Waterstone's and Ottakar's are each other's closest competitors in overlap areas<sup>59</sup> but showed no difference in customers' satisfaction between overlap and non-overlap locations.

#### *Range*

- 5.37 Appendix D sets out our understanding of Waterstone's and Ottakar's stock management systems. There are strong similarities between the two companies in their approach to issues such as the management of new titles, range management and promotions. Both companies have strong central controls, particularly in relation to new titles which are expected to sell well.
- 5.38 Local managers have regard to centrally determined guidelines when deciding on the range of books that they stock. Nevertheless, both HMV and Ottakar's have said that local managers had autonomy over some aspects of their stores, for example the layout of the stock, the selection of staff and some of their range. This will allow some degree of differentiation between stores, and hence competition, at the local level.

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<sup>59</sup>Our survey respondents said that 53 per cent of books bought at Ottakar's overlap locations would, if Ottakar's was not available, have been bought at Waterstone's and 44 per cent of books bought at Waterstone's overlap locations would, if Waterstone's was not available, have been bought at Ottakar's (see Annex 1 of Appendix C). HMV argued that our survey exaggerated the extent to which customers in overlap locations view Ottakar's and Waterstone's as closest alternatives because the respondents had just made a purchase in Ottakar's or Waterstone's. HMV provided us with an analysis of purchases by 429 members of the TNS panel living in the overlap areas. This showed that Waterstone's accounted for only about [3] per cent of spend by Ottakar's customers on books at stores other than Ottakar's, and vice versa. We do not consider that these results call into question the validity of our survey results on next best alternatives because HMV's analysis covered all purchases by members of the TNS panel living in overlap areas (not just purchases at the local store) and because it is not necessarily the case that all stores at which a customer buys books are equally close alternatives.

- 5.39 This degree of centralization in the choice of range at Ottakar's, and the degree of local flexibility in range at Waterstone's, ran contrary to public perception. The Publishers Association, for example, said that 'Ottakar's ... aims to offer a ... localised buying policy and more flexible promotion selection. Waterstone's, by comparison, focuses on larger stores with central buying and promotional policies'. Many other third parties submitted similar evidence. HMV pointed out that, despite these comments, the publishers invested in teams of sales representatives who visited their local stores to discuss stocking and promotion of new titles, underlining the fact that many decisions on range were taken locally.
- 5.40 Given the evidence that we received about Waterstone's and Ottakar's buying decisions, we concluded that the parties were broadly similar in the extent to which decisions about overall range and new title selection were made centrally. Contrary to public perception, the Phoenix v9 system appeared to us to give Waterstone's local managers the capacity and flexibility to make well-informed judgements about the range of titles stocked. The central system could then convey to other Waterstone's stores any specific successes occurring locally.
- 5.41 We analysed whether there was a difference in range at Ottakar's or Waterstone's stores in overlap locations as compared with non-overlap locations. The parties submitted research concluding that neither Waterstone's nor Ottakar's store range was affected by the presence of the other store. We concluded that the presence of a competing Waterstone's or Ottakar's store made no difference to range. As might be expected, size of store was the most significant factor influencing range (see Appendix F for more details).
- 5.42 Both Waterstone's and Ottakar's make particular arrangements for the Scottish market, and, in the case of Waterstone's, for Wales and Northern Ireland. Both firms

operate a Scottish Core Range of similar size [X] of specifically Scottish interest, set by Head Office on the basis of sales made in Scottish stores. Waterstone's also provides specific range management grades for both Scotland and Ireland. In both firms local managers throughout the country have the ability to select books of regional or local interest. They can choose to promote them by non-price means, although in both firms price promotions are implemented only by the central teams. More details of these arrangements are provided in Appendix D.

#### *Choice of store sites*

- 5.43 Competition between retailers in the longer term also encompasses decisions on store size and location. We note that the proportion of competitive openings (ie openings by Ottakar's where there was already a Waterstone's or vice versa) increased from the late 1990s. In the last two to three years, this is principally due to Waterstone's opening stores in areas where Ottakar's was already present. We found that total floorspace (Waterstone's plus Ottakar's) was generally higher in overlap locations which could be consistent with a larger range of titles being stocked than would otherwise be the case. We consider the impact of the proposed merger on these longer-term aspects of competition in paragraphs 5.94 to 5.96.

#### *Service quality*

- 5.44 In our view, it would be surprising if two Waterstone's and Ottakar's stores located close to each other did not compete on service quality to some extent. Service quality is, however, difficult to measure. We considered various aspects of service to see if we could identify any quantifiable difference in service levels between overlap and non-overlap areas. Based on the available quantifiable and comparable data from Waterstone's and Ottakar's, we looked at the number of staff; the level of staff experience; book signings; store opening hours; and the number and timing of refurbishments relative to competitor store openings. Although not exhaustive, we

considered that the analysis of this data gave a reasonable indication of the extent of any local competition.

5.45 We found a measurable difference between overlap and non-overlap stores in only two areas—book signings and store refurbishments. Both parties argued that book signings were a relatively unimportant aspect of customer service. HMV pointed out that book signings ranked low in importance (19<sup>th</sup> out of 22 categories) in Waterstone’s Brand Health Monitor.<sup>60</sup> Moreover, the parties argued that publishers, and the authors themselves, were responsible in large part for deciding where signings would take place, so it was not a factor that stores could easily control and use to their competitive advantage. Although stores sometimes request book signings, this is only one factor in determining an author’s itinerary. Our analysis showed that the number of book signings at Ottakar’s was greater in overlap than non-overlap locations, suggesting some rivalry at the local level between Waterstone’s and Ottakar’s seeking to win customers.<sup>61</sup> Ottakar’s agreed that it sometimes encouraged book signings in overlap stores in response to a new store opening nearby, but recognized that the effects were short term.

5.46 We looked at store refurbishments as an indicator of quality of the store environment. Ottakar’s said that store refurbishments were generally undertaken as a condition of the lease, and not as a response to local competition. However, Ottakar’s also said that, in response to competitor store openings, the overlap store sometimes carried out a ‘mini refit’.

5.47 HMV said that it had not brought forward any refurbishment following the opening of an Ottakar’s store, although we noted that Waterstone’s management accounts

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<sup>60</sup>Research carried out in June 2005 for Waterstone’s by Researchcraft (a telephone survey of 1,000 ABC1 adults who had bought a book in the previous six months).

<sup>61</sup>However, in the case of Waterstone’s overlap stores, we did not find a significant difference in the levels of book signings compared with non-overlap stores.

describe some refurbishments as ‘anti-competitor works’. We also considered data on refurbishments of Waterstone’s stores which showed some correlation between general (but not partial) refits and the opening of a nearby Ottakar’s store (see Appendix F). Refurbishment in response to competitor openings needs to be seen in context: refurbishment is only one aspect affecting the quality of customers’ experience and we note that customers did not consider the quality of the environment as key to their decision about where to buy a book (see paragraphs 5.68 and 5.69).

5.48 We looked at the data provided to us on numbers of staff and levels of experience in overlap and non-overlap stores (see Appendix F). The OFT found weak evidence of a higher number of staff at Ottakar’s stores in overlap areas, although no evidence that there were more staff at Waterstone’s stores in overlap areas. The parties argued that the results of the OFT’s analysis were highly sensitive to assumptions and that there was no robust evidence of any differences in staff levels. We found levels of staffing in overlap stores to be comparable to non-overlap stores, adjusting for store size.

5.49 We were also provided with data on the level of staff experience for Waterstone’s stores. The data showed that there was a higher proportion of more experienced staff in overlap areas. However, once the data had been adjusted for size of store (as the overlap stores are on average smaller than the non-overlap stores), we found no significant difference between the level of staff experience in the overlap and non-overlap areas. Ottakar’s provided us with data which showed no significant difference in the length of staff service between overlap and non-overlap areas.

5.50 We found store opening hours to be very similar for both Waterstone’s and Ottakar’s stores, with the differences apparently related primarily to the standard opening

hours within the relevant shopping location. There was no evidence of any systematic change in store opening hours at Waterstone's stores when an Ottakar's store opened nearby (see Appendix F).

#### *Conclusions on local competition*

- 5.51 We concluded that there was no systematic and substantial difference in range or service quality in overlap stores compared with non-overlap stores. We identified some differences between overlap and non-overlap stores on book signings and refurbishments. However, we did not consider book signings to be a key competitive variable, since they are not central to a bookshop's offer for most customers. On refurbishments, although Waterstone's and Ottakar's may have used these to compete at a local level to a limited extent, we did not consider this to be significant. According to our survey, customers did not consider store environment to be a particularly important feature of book stores. There was no evidence of any difference in customer satisfaction between overlap and non-overlap areas.

#### *National competition*

- 5.52 We considered the characteristics of the key competitors in the UK market. We then considered the extent to which there was intra-market rivalry in terms of both price and non-price factors.

#### *Competitors*

- 5.53 Table 3 summarizes the key characteristics of the national competitors in book retailing (see also paragraphs 5.3 to 5.15). We have been told by several third parties that the specialist bricks and mortar books retailers compete directly with one another, in particular because of the browsing experience that they offer. The Society of Authors said that Waterstone's, Ottakar's, and Borders in particular formed part of

the same 'strategic group' within which there was strong competition, and that competition between members of this group and other retailers was not as strong.

TABLE 3 Comparison of book retailers

Retailer	Type	Typical location	Number of stores (UK)*	Typical range	Geographical overlap†	
					Waterstone's	Ottakar's
Waterstone's	Bricks and mortar	City and town centres	190	30,000–40,000	N/A	Medium
Ottakar's	Bricks and mortar	Market towns	141	20,000–30,000	Low	N/A
WH Smith	Bricks and mortar	City and town centres including smaller towns; travel stores	545 (high street); 127 (travel stores)	High street: 350 stores at 5,000–10,000; remainder 10,000–20,000	High	High
Borders/Books etc	Bricks and mortar	City centres and retail parks	Borders: 36 Books etc: 33	Borders: 50,000–80,000 Books etc: 20,000–30,000	Medium	Low
Other chains and independents	Bricks and mortar	Secondary and tertiary locations		Small to very large	High	High
Supermarkets	Bricks and mortar	Town centres, retail parks and dedicated out-of-town sites		1,000 or less	High	High
Internet	Distance			Very large	High	High
Other distance‡	Distance				High	High

Source: CC.

\*As at end 2005.

†The figures in the Waterstone's/(Ottakar's) column show the CC assessment of the percentage of Waterstone's/(Ottakar's) sales accounted for by those of its stores that have competition from the retailer in that row of the table.

‡Includes mail order, book clubs, direct sellers (eg The Book People).

Note: N/A = not applicable.

5.54 We have been told that there is some difference in market positioning even among bricks and mortar specialist retailers. Several third parties told us that Waterstone's tended to be the most 'literary'; that it was more metropolitan than Ottakar's; and had a larger average store size. We found that Waterstone's obtained a larger proportion of its sales from deep-range titles than Ottakar's, even in stores of similar size. Ottakar's, on the other hand, tended to be based in market towns; had on average smaller stores; was seen as child-friendly and had a particular strength in children's books.

5.55 Table 3 shows that Waterstone's and Ottakar's geographic overlap with each other is not high: Waterstone's stores overlapping with Ottakar's account for a low proportion

[X] of Waterstone's total sales and Ottakar's stores overlapping with Waterstone's account for a medium proportion [X] of Ottakar's total sales. The level of geographic overlap with Borders is also not high, especially for Ottakar's. Both Waterstone's and Ottakar's have a much higher geographic overlap with WH Smith and the supermarkets. Distance sellers, including Amazon, offer full national coverage.

5.56 National market shares are summarized in Table 1. Two other indicators of the level of existing competition between different book retailers are:

- (a) residual spend data (from TNS); and
- (b) data from our survey of Waterstone's and Ottakar's customers.

5.57 Evidence from the TNS survey, provided to us by HMV, showed the proportion of Waterstone's (Ottakar's) customers' total book spending that was spent at other retailers, compared with those retailers' national market shares (relative residual spend). If Waterstone's customers spend a higher proportion of their non-Waterstone's book spending at Ottakar's than would be expected according to national market shares, this may suggest that Ottakar's is a relatively close competitor to Waterstone's.

5.58 Table 4 summarizes the evidence on relative residual spend. The highest relative residual spend of Waterstone's customers is at Borders, other specialist bookshops and on the Internet. Ottakar's customers have their highest relative residual spend at other specialist bookshops and on the Internet. Waterstone's customers' share of residual spend at Ottakar's is in line with its national market share, while the residual spend share of Ottakar's customers at Waterstone's is slightly below its national market share. This is likely to reflect the offsetting effects of low geographic overlap between their outlets and the relative similarity in their market positioning. Based on this data we might conclude that market shares are broadly reflective of the

significance at national level of competition between Waterstone's and Ottakar's. However, we note that this evidence should be treated with caution, since customers might use different retailers for different types of book purchase.

TABLE 4 Relative residual spend of Waterstone's and Ottakar's customers

	<i>Waterstone's relative residual spend*</i>	<i>Ottakar's relative residual spend*</i>
Waterstone's		
Ottakar's		
WH Smith		
Borders		
Other specialist		
Tesco		
Asda		
Internet retailers		
Other distance		

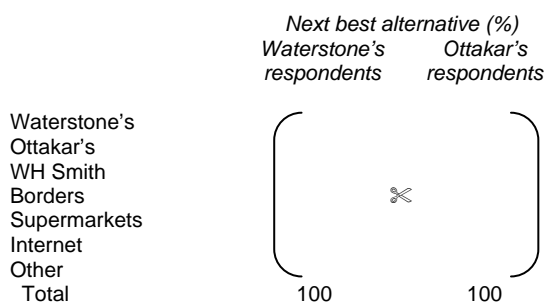
Source: HMV from TNS data.

\*Above 100 represents a relatively close competitor and below 100 represents a relatively distant competitor. Based on year to January 2005.

Note: N/A = not applicable.

5.59 Table 5 summarizes evidence from our survey on the next best alternative booksellers to Waterstone's and Ottakar's in the locations that we surveyed. WH Smith is stated to be the next best alternative by more Waterstone's and Ottakar's customers than any other retailer. The next most frequent choices in the case of Waterstone's customers are Internet retailers, closely followed by Borders and Ottakar's. In the case of Ottakar's customers, WH Smith is closely followed by Waterstone's, with Internet retailers and especially Borders being less popular as the nearest alternative. Evidence from our survey suggested that supermarkets were not particularly close competitors, perhaps because they focused on a relatively small number of titles.

TABLE 5 Next best alternative booksellers used if Waterstone's/Ottakar's not available



Source: CC estimated weighted average of overlap and non-overlap responses to CC survey (see Appendix C, Annex 1).

Note: N/A = not applicable.

5.60 In summary, we found there to be a range of competitors to Waterstone's and Ottakar's offering full national coverage. Whilst they have different characteristics, they all compete with one another. Supermarkets appear at present to be a less close competitor to Waterstone's and Ottakar's than are WH Smith, Borders and the Internet retailers, partly because they focus on a relatively small number of titles. Nevertheless, as shown in Appendix C the market share of supermarkets has increased and we expect supermarkets to continue to increase their range of titles and market share as they expand the proportion of their floorspace devoted to non-food items.

*Price competition*

5.61 We considered national competition in terms of both price and non-price factors. Waterstone's and Ottakar's have primarily uniform national prices. We found that there was heavy discounting off RRP for best-sellers, with the supermarkets and Internet retailers charging the lowest prices. Discounts off RRP offered by Waterstone's, Ottakar's, WH Smith and Borders have increased in recent years as they have sought to prevent erosion of market share by supermarkets and Internet retailers offering books at lower prices (see Appendix C, Figure 3).

- 5.62 The reduction in prices by the high street chains on deep-range titles is much less marked than for best-sellers. Deep-range prices for Waterstone's, Ottakar's and Borders are, on average, about [X] per cent below RRP and for WH Smith almost [X] per cent below RRP. Discounts off RRP on deep-range titles are on average greater for supermarkets and Internet retailers, although supermarkets have a small share of deep-range titles.
- 5.63 HMV said that Waterstone's faced strong and growing price competition on best-sellers, in particular from WH Smith and the supermarkets. It compared the volumes of two heavily advertised groups of titles it sold in the run-up to Christmas 2005. The first group of six titles was price-discounted whilst the second group of eight titles was not. The reduced price titles showed substantial gains in volume relative to the non-discounted group. We noted, however, that this evidence was restricted to a specific group of titles in a particular time period. Without knowing the source of Waterstone's additional volume it was inconclusive, and furthermore the volume gains varied substantially among the individual discounted titles (see Appendix C).<sup>62</sup>
- 5.64 We looked at some other examples covering a longer period of time (see Appendix C). We show the prices for *The Da Vinci Code* (the second-best-selling title in 2005) in 2005 as an example.<sup>63</sup> The lowest prices were charged by Asda and Tesco, followed by Internet retailers and the other supermarkets. Prices at Waterstone's, WH Smith and Borders fluctuated, each of them being reduced significantly at different times. Ottakar's prices remained constant (at a smaller discount off RRP) throughout the year. We found that price reductions generated substantial volume increases but these volume increases did not appear to be won at the expense of a direct loss of volume of this title by other retailers.

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<sup>62</sup>Volume increases for each title varied from [X] per cent (compared with the average for non-price-reduced books).

<sup>63</sup>*The Da Vinci Code*, Dan Brown, 2004, published by Corgi Books Limited.

- 5.65 Price cuts on a particular best-selling title may also affect sales of other titles by attracting customers into the store who then buy books they would not otherwise have purchased. A study by HMV (for a week during the Christmas 2005 period) showed that, on average, [redacted] books were bought in transactions including the purchase of a half-price book, compared with an average of [redacted] books bought in other transactions. We note, however, that this could equally be explained by customers already in store being prompted to purchase an extra discounted title. The results of our survey showed that 62 per cent of respondents had bought all their books at full price; only 15 per cent bought some at full price and some discounted, and 23 per cent bought all their books at discounted prices.
- 5.66 Competition between retailers results in the most popular titles being sold at a discount to RRP, both through 3 for 2 offers and similar promotions and deeper discounts on specific best-selling titles. Price competition on best-sellers has intensified in the past few years. Thus Waterstone's average discounts on the best-selling 5,000 titles in the year has increased from less than [redacted] per cent on average in 2001 to more than [redacted] per cent in 2005. Ottakar's average discount has also increased to some extent during the same period.
- 5.67 There is much less price competition on deep-range titles. The parties told us that they sold the vast majority of deep-range titles at RRP. HMV said that in 2005 Waterstone's discounted only [redacted] per cent of its deep-range titles, although we noted that its discounted titles account for a sufficiently large proportion of its deep-range sales that the value of its discounts averages [redacted] per cent of its deep-range sales value at RRP (see paragraph 5.62). A larger proportion of deep-range titles is discounted by Internet retailers, where discounts across all deep-range titles average over [redacted] per cent off RRP (albeit, for some Internet purchasers, the value of discounts may be partly or fully offset by the cost of postage). Across all retailers

deep-range discounts average about 10 per cent off RRP sales value. This figure is likely to have increased over the last five years due to the increased market share taken by Internet retailers.

#### *Non-price competition*

- 5.68 Non-price competition encompasses principally competition on range and service. Results from our survey suggested that range and convenience of location were the most important factors to customers when choosing a bookshop. Value for money, quality of service and a pleasant environment were also taken into account but were considered by respondents to be less important.
- 5.69 Market research carried out for HMV suggests Waterstone's customers regarded the most important attributes of a book retailer to be: a wide range of books (which [X] per cent considered extremely important in a book retailer); having the book you want [X]; friendly, approachable staff [X]; and a good layout making it easy to find the book you want [X]. All were rated ahead of value for money [X]. The next most highly-rated attributes were knowledgeable staff [X]; helpful, efficient customer service [X]; and an appealing children's book department [X].<sup>64</sup>
- 5.70 HMV said that Waterstone's competed with lower priced retailers by offering a wider range and a higher level of service. HMV's market research showed that both Waterstone's and Ottakar's were rated highly on range and service attributes. Results from our survey were consistent with this in that survey respondents rated Waterstone's and Ottakar's stores better on range, quality of the store environment and quality of service than the next best alternative, but slightly worse or no different on the price of books. The survey asked customers whether they would shop elsewhere if conditions were worse. A higher proportion of respondents said that they

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<sup>64</sup>Research carried out in June 2005 for Waterstone's by Researchcraft (a telephone survey of 1,000 ABC1 adults who had bought a book in the previous six months).

would shop elsewhere if range were reduced than the proportion who said that they would if the store environment or levels of customer service were reduced. We discuss the impact of the proposed merger on national non-price factors in paragraph 5.104.

### *Promotions*

- 5.71 Both Waterstone's and Ottakar's have central units which decide, ahead of publication, which titles will be price-promoted at the front of stores. We understand that the choice of titles for promotional slots is the result of negotiation between publishers and retailers. The publishers have a list of titles they would like a particular retailer to promote, but the retailer may choose to promote different titles. The final choice of promotional titles is decided on the basis of negotiations with publishers about the commercial terms for each title. The stocking and pricing of potential best-sellers in both Waterstone's and Ottakar's are centrally controlled. Price promotions are not, however, restricted to new titles (see Appendix D). In addition, local managers can decide on non-price promotions, such as giving books additional or more prominent display space. We were told that locally decided non-price promotions took up a large proportion (nearly 80 per cent) of promotional table space in the average Waterstone's store. However, there is no scope in either company for local determination of price promotions. To the extent that there are different price-promotional arrangements for different geographic areas (eg Scotland), these are determined centrally both by Waterstone's and Ottakar's.
- 5.72 Publishers suggested that promotions by retailers were particularly important or effective compared with other methods of getting new books noticed (see paragraph 5.29). This included not only price promotions (such as charts and 3 for 2 offers), but also the way the titles were displayed, for example. The figures submitted by several

large publishers showed that their marketing spend with retailers (excluding spend on promotional discounts) accounted for 25 to 40 per cent of total marketing budgets.<sup>65</sup>

- 5.73 The Publishers Association suggested there were three types of best-seller:
- (a) immediate successes which could be predicted in advance and were in effect guaranteed by publishers investing large sums of money in the book (for example, television tie-ins and established novelists to whom large advances were paid);
  - (b) long build-up successes, which occurred as a result of a publisher supporting an author over a long period of time: in these cases, the breakthrough for an author might come only after publishing a number of less successful books;
  - (c) surprise successes, which were few and far between, did not involve significant investment and were often achieved by word of mouth.

The Publishers Association said that promotions by retailers such as Waterstone's and Ottakar's were particularly important for the long build-up successes, which, over time, constituted the largest number of best-sellers.

- 5.74 We considered that retailers' promotion and grading of new titles was an important means by which publishers competed to make their books and authors successful. Publishers were likely to wish to have their books promoted by as many retailers as practicable and to seek to negotiate promotional terms on any book with as many retailers as possible.

- 5.75 In considering whether the promotion and grading of new titles was a significant feature of competition between retailers we noted that information on weekly sales by title rapidly becomes available after publication. Nielsen Bookscan data, showing the top 5,000 titles for the previous week, is available by 3 pm the following Tuesday.

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<sup>65</sup>One publisher [redacted] told us that its marketing contribution to retailers, including promotional discounts, was more than 80 per cent of total marketing spend.

Retailers told us that they also obtained useful information on what was selling well from Amazon's list of 100 best-selling titles. Thus retailers can rapidly pick up successes launched by competitors.

5.76 Furthermore, book retailers do not appear to seek exclusivity on the promotion of new titles, suggesting that this is not an important competitive variable. We were told that exclusive promotional deals would harm a retailer's sales of future successful titles on which rivals had gained exclusivity, which suggests that the identity of the retailer selling a new title is not decisive in determining its success.

5.77 It was not clear to us that retailers regarded the selection of titles to price-promote as a significant element of competition. In particular, the competitive advantage of a successful price promotion to the retailer was limited, given the rapid availability of sales information which allowed other retailers to identify and promote titles successfully launched elsewhere.

5.78 At present there is some difference between Waterstone's and Ottakar's decisions on which books to promote, although they overlap on the majority of their price promotions. We looked in particular at pre-publication price promotions for new titles. The Publishers Association suggested there were several hundred new titles promoted by Ottakar's but not by Waterstone's in a particular year. Analysis provided by the parties suggested that this might have amounted to over 500 titles in 2005, or half of Ottakar's price promotions of new titles, although Waterstone's emphasized that the vast majority of these titles were also available, albeit not price-promoted, in Waterstone's stores. We received no evidence to suggest that the choices made by Waterstone's or Ottakar's about which titles to price-promote pre-publication were influenced by each other's decisions.

5.79 We consider in paragraphs 5.106 and 5.107 whether the loss of such promotional opportunities might be considered to constitute an SLC.

*Bargaining strength of retailers and publishers*

5.80 As discussed in paragraph 2.10, publishers and retailers negotiate buying terms individually. Retailers are able to obtain different terms because other retailers do not observe directly the outcome of these negotiations. Retailers might have bargaining strength in negotiations with a publisher if they account for a significant proportion of that publisher's sales and can credibly threaten not to stock some, or all, of the publisher's titles (or could buy them from a wholesaler, albeit at lower discounts). However, we noted that the size of discounts provided by publishers to retailers might not be strictly related to sales volumes but might also reflect, for example, distribution costs and other factors.

5.81 Publishers will have some bargaining power with retailers because they control the copyright to each title and hence control the supply of that title. This is particularly important for 'must stock' titles, but matters for all titles to the extent that readers do not regard one title as a good substitute for another. In addition, as set out in paragraph 2.7, concentration among publishers is increasing.

*Conclusions on national competition*

5.82 At the national level, competition encompasses a variety of retailers with different characteristics. WH Smith appears to be the most important single competitor to both Waterstone's and Ottakar's. Retailers compete on both price and non-price factors. Customers of Waterstone's and Ottakar's regard range as a particularly important element of non-price competition. The selection of titles to price-promote was emphasized by publishers but it was not clear to us that this was a significant element of competition between retailers. Price competition is stronger on best-

sellers than deep-range titles. The extent of discounting against RRP has increased in recent years because those retailers selling at discounted prices, such as the supermarkets and Internet retailers, have increased their market share, and because other retailers, including Waterstone's and Ottakar's, have responded by increasing their discounts.

### ***Counterfactual***

5.83 In deciding whether the proposed merger would be likely to give rise to an SLC we need to compare the competitive situation that we expect following the proposed merger to that which would be expected to prevail without the proposed merger (the counterfactual).

5.84 We considered two possible counterfactual situations:

- (a) Ottakar's remains independent; or
- (b) Ottakar's is acquired by another third party.

5.85 As set out in paragraphs 3.1 to 3.4, an MBO team made an offer for Ottakar's on 26 August 2005, and HMV made a higher offer on 8 September. If no new offer were received, Ottakar's would continue as an independent public company.

5.86 We considered whether a third party would be likely to acquire Ottakar's in the foreseeable future in the absence of the proposed merger. We were told that there were other interested parties at the time of the MBO and the HMV offer, including [X]. However, we could not form an expectation that, in the absence of the proposed merger, another third party would acquire Ottakar's.

5.87 We therefore concluded that Ottakar's would remain independent—either as a public company or under MBO ownership. We did not think it necessary to determine which

of these two events would have occurred given that both would produce materially the same result in competition terms.

5.88 We then considered the likely characteristics of an independent Ottakar's. We note that competition in book retailing has been particularly intense since September 2005. Discounting by other retailers increased during the Christmas 2005 season.<sup>66</sup> Management will need to respond to the changing competitive environment which is resulting in declining sales and profitability. [REDACTED]

5.89 [REDACTED] The financial position of the company and [REDACTED] are discussed in detail in Appendix G. However, we note that management has already reduced stock levels by 9 per cent compared with the previous year, despite 5 per cent extra floorspace. In the absence of the proposed merger, we expect that Ottakar's would introduce a number of further measures, including the implementation of an improved stock management system and a reduction in costs. [REDACTED]

5.90 We therefore conclude that our counterfactual should be that of an independent Ottakar's as envisaged in paragraph 5.89 and Appendix G.

### ***Effects of the proposed merger***

5.91 In this section we discuss the effects of the proposed merger on local and national competition, as well as possible vertical effects. We estimated that the market share of the merged entity was around 24 per cent of the UK market in 2005 and a somewhat higher proportion ([REDACTED] per cent) of the deep-range segment. The market share of the four largest retailers would increase from 45 to 50 per cent as a result of the proposed merger (55 to 63 per cent of the deep-range segment). Retailing of

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<sup>66</sup>Ottakar's like-for-like sales have declined by 3 per cent in the financial year ended 31 January 2006 which is a [REDACTED] per cent fall against budget. Ottakar's has budgeted a like-for-like sales [REDACTED] per cent for 2006/07. Like-for-like sales for the eight weeks to 25 March 2006 were down by 8.1 per cent on the previous year, and [REDACTED] than budgeted for the period.

deep-range titles would be moderately concentrated as a result of the proposed merger.<sup>67</sup>

### *Local competition*

5.92 Paragraphs 5.30 to 5.51 set out the evidence that we received about the extent to which Waterstone's and Ottakar's compete currently at the local level. We concluded that there was little evidence of Waterstone's or Ottakar's systematically altering any significant non-price competitive variables in response to each other's presence at the local level. We considered whether the merged entity would have the incentive to depart from national pricing by increasing prices in the overlap areas. However, it would continue to face local competition from, among others, WH Smith, the supermarkets, and the Internet retailers in the overlap areas, just as it does in non-overlap areas. We concluded that, given this level of competition, the merged entity would not have an incentive to depart from national pricing by reducing discounts in overlap areas.

5.93 We considered whether the proposed merger would be likely to have an effect on range at the local level. HMV argued that the proposed merger would lead to a positive uplift in range at Ottakar's stores once Waterstone's Phoenix v9 stock management system was introduced. This was based on the experience to date of introducing Phoenix v9 in Waterstone's stores, which Waterstone's estimated had increased range by an average of 7 to 10 per cent in its stores. Our analysis, based on comparing the existing range at 20 Ottakar's stores with that at Waterstone's stores, suggested a similar increase might be expected at Ottakar's stores. HMV later claimed that the increase might be as high as 30 per cent on average, and that the uplift in relevant titles would be even larger. We also considered that Waterstone's would have no incentive significantly to worsen range as it is an

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<sup>67</sup>The HHI of the market as a whole would increase from 700 to 900, with the HHI of the deep-range segment increasing from 1,000 to 1,400 as a result of the proposed merger.

important distinguishing feature of its stores (see paragraph 5.104). In the short term, given that we did not believe that range was affected by the presence of an Ottakar's/Waterstone's in the area, we did not believe that the proposed merger would result in an SLC in relation to range.

5.94 In the longer term we considered whether the proposed merger might be expected to lead to some store closures in overlap areas (see paragraph 3.5) and a consequent reduction in total store size and range in overlap areas compared with the range that would be stocked in the absence of the proposed merger. Both HMV and Ottakar's also told us that there were significant costs associated with store closure. These would include the continuing cost of the lease (unless it could be reassigned), the write-off of any assets, and other closure costs such as staff redundancy costs.

5.95 We did not, however, consider that store closures would lead to an SLC for the following reasons:

(a) Reducing the number of stores in a locality from two to one would have only a modest impact on the combined range, as the two stores are likely to stock similar titles. In the existing areas where Waterstone's has more than one store, the combined range is on average about 20 per cent greater than the range of the largest single store. The reduction in range we expect in overlap areas where a store is closed needs to be set against our expectation of an increased range at other Ottakar's stores due to the introduction of Phoenix v9 (see paragraph 5.93). Moreover, even in the overlap areas where a store is closed, if the closed store is a Waterstone's store, some offsetting increase in range is to be expected from the introduction of Phoenix v9 at the Ottakar's store, whether or not an improved stock management system were to be implemented as referred to in paragraph 5.89.

- (b) The number of titles lost would be likely to account for a small proportion of sales. There would therefore be only a limited impact on customers.
- (c) Customers would continue to be able to purchase all titles from Internet retailers as well as, to a varying extent, at competing bricks and mortar stores.
- (d) Moreover, the closure of a store by the merged entity could create an opportunity for entry by other retailers offering a wide range of books. We discuss local entry more generally in paragraphs 5.16 to 5.18.

5.96 We also considered that in the absence of the merger there was some likelihood of Waterstone's opening new stores in areas where Ottakar's was already present. However, for the reasons set out in paragraph 5.95 (a) to (d), we did not expect that this aspect of the proposed merger would lead to an SLC.

5.97 We found no evidence that competition at the local level had a significant effect on service quality, and, reinforced by our counterfactual, we concluded that the proposed merger would not result in an SLC at the local level.

5.98 Considerable concern has been expressed about the impact of the proposed merger in Scotland, centred on the possible adverse effects of the proposed merger on Scottish authors and publishers. We were told that the Scottish publishing industry consisted mainly of small and medium-sized enterprises and was therefore vulnerable to the exercise of market power by the merged entity, particularly in relation to demands for promotional discounts. We were also told that in Scotland, 26 of the 31 stores selling a wide selection of deep-range titles would be part of the merged entity, and the merged entity would have a market share of over 30 per cent. We note that the overlap stores were in most of the major conurbations.

5.99 However, Borders has stores at three of the five Scottish overlap locations, compared to two out of 28 overlap locations in England and Wales. Our survey showed that Borders was a significant competitive constraint to Waterstone's and Ottakar's in the Scottish overlap locations.<sup>68</sup> Following the proposed merger, the merged entity would continue to be constrained by similar factors in Scotland to those elsewhere in the UK, in particular competition from Internet retailers and the merged entity's policy of uniform national pricing. We were unable to conclude that Scotland forms a separate geographic market, nor that the competitive situation in Scotland was substantially different from that in the rest of the UK. We therefore did not find an SLC as a result of the proposed merger in Scotland or any other geographical area of the UK.

#### *National competition*

5.100 We considered four possible effects of the proposed merger at the national level:

- (a) a reduction in discounts off RRP leading to an increase in the price of best-sellers;
- (b) a reduction in discounts off RRP leading to an increase in the price of deep-range titles;
- (c) a reduction in nationally determined range or quality of service; and
- (d) a reduction in the number of promotional slots by retailers leading to a reduction in innovation by publishers in new titles (number or variety).

5.101 As regards pricing of best-sellers, we noted in paragraph 5.61 that the prices relative to RRP charged by Waterstone's and Ottakar's had fallen but this was likely to be attributable to strong and increasing price competition from lower-priced retailers, in particular the supermarkets. We found no evidence of significant direct price competition on best-sellers between Waterstone's and Ottakar's. We note that

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<sup>68</sup>18 per cent of respondents at Scottish overlap stores said that Borders was their next best alternative bookseller, compared with 2 per cent at overlap locations in England and Wales.

Ottakar's did not, for example, seek to match Waterstone's price cuts in the pre-Christmas period.

5.102 In terms of price competition on deep-range titles, the parties argued that nearly all their deep-range titles were sold at RRP, which is set by the publishers and acts as an effective price cap (see paragraphs 5.25 and 5.62). Discounts on deep-range titles might increase, but we were told that, if they did, this would be as a result of competition with lower-priced retailers, including Amazon in particular, rather than as a result of competition between Waterstone's and Ottakar's. As with best-sellers, we found no evidence of significant direct price competition on deep-range titles between Waterstone's and Ottakar's.

5.103 Many third parties told us that there was likely to be a decrease in range or diversity as a result of the proposed merger. This was, at least in part, due to their perception that Ottakar's was more decentralized in terms of selecting range. We did not find this to be the case in general (see paragraphs 5.37 to 5.40). In any case, given our counterfactual, we believed that Ottakar's would seek further to centralize decision-making and cut costs, whether or not the proposed merger went ahead. In addition, as set out in paragraph 5.40, Waterstone's Phoenix v9 allowed it to respond quickly to customer demand, even if a title were not well-stocked initially.

5.104 HMV told us that a reduction in range or service quality would not be profitable after the proposed merger because non-price attributes were an important part of the parties' response to price pressure from discount-oriented book retailers. It said that degrading its service post-merger, or particularly its range, would risk alienating a substantial share of the merged entity's customers. HMV told us that an extensive range and specialist staff were its principal means of differentiating Waterstone's from competitors such as WH Smith and the supermarkets. We noted above that

Waterstone's and Ottakar's have experienced declining like-for-like sales and this supports HMV's argument that both companies currently face competitive pressure from other book retailers. We did not consider it likely that the merged entity would willingly reduce nationally determined range or service quality.

5.105 The publishers told us that the proposed merger would be likely to lead to a reduction in the number of titles published. Some of the large publishers told us, however, that they had already reduced the number of titles that they published. Overall there was a very large number of titles published, and we did not believe that the incentives on publishers to publish new titles or authors to write new books would change as a result of the proposed merger. Given the existing trends in the market, and the apparent ease of entry into publishing, we had no reason to believe that the proposed merger would lead to a reduction in the number of titles published.

5.106 We also considered whether there might be an SLC arising from a reduction in the number of titles promoted. When we refer to promotion, although this could encompass both price and non-price promotion, we are particularly concerned with price promotion. This was an area of particular concern to many third parties. Following the proposed merger, Waterstone's might, in our view, be expected to reduce costs by eliminating duplication in head office activity which could lead to one central team deciding on all promotions for the merged company.<sup>69</sup> Books that are not promoted by the merged company but which would previously have been promoted by Ottakar's might be less likely to succeed. As set out in paragraph 5.78, in 2005 this might have amounted to a reduction of over 500 promotional slots, although the number of promotional slots is a commercial decision which can vary for a number of reasons. However, publishers have alternative ways of promoting books

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<sup>69</sup>The central team also issues recommendations or gradings to local stores on which new titles to stock, although local store managers make the decision.

(see paragraph 5.29), and any titles not promoted by the merged entity following the proposed merger could still be promoted by other retailers or by other methods.

5.107 We were not persuaded that a decline in the number of promotional opportunities was likely to result in an SLC since, as noted in paragraphs 5.77 and 5.78, we do not believe that competition for promotions is significant between retailers, nor between Waterstone's and Ottakar's in particular. We therefore do not consider that the merged entity would seek to, or be able to, exploit its market position by reducing promotions.

### *Vertical effects*

5.108 In paragraphs 5.80 and 5.81 we discussed the relative bargaining power of retailers and publishers. We considered the likely effect of the proposed merger on Waterstone's bargaining strength. HMV told us that Waterstone's expected to be able to [✂]. The Publishers Association told us that it did not think that the publishers would necessarily 'end up paying more discount to a combined Waterstone's/Ottakar's chain on average than [is paid] to Waterstone's at present'.

5.109 There is likely to be some difference in the relative bargaining strength of large and small publishers and hence the impact of the proposed merger might differ by size of publisher. Smaller publishers might find it more difficult to resist demands for higher discounts, although we note that in general discounts offered by smaller publishers are lower than discounts from larger publishers. In any case, Waterstone's generally obtains its titles from many smaller publishers via a wholesaler.

5.110 We thought it more likely than not that there would be a small improvement in Waterstone's buying terms as a result of the proposed merger. We were told that, in response, publishers might increase RRP or reduce their discounts to other retailers.

5.111 Publishers told us that the level of RRP depended primarily on what the consumer was willing to pay (see paragraph 5.24). If publishers chose to increase RRP, the size of the increase would depend on several factors: the level of the merged entity's increased discount, the merged entity's proportion of sales with the publisher in question, and the responsiveness of consumer demand to a change in price. The parties argued that if publishers were able to increase RRP, they could have done so equally well before the proposed merger. We did not think that publishers would be likely to be able to increase RRPs purely as a result of the proposed merger.

5.112 Third parties told us that if publishers reduced the discounts that they gave to other retailers this would be most likely to affect the discounts offered to independents, given the independents' relative lack of bargaining power. However, we received no evidence to suggest that this would be the likely response of the publishers to an improvement in buying terms for the merged entity. It could be argued that if it was in the publishers' interests to reduce discounts to the independents, they would have done so already. In any case, to the extent that the competitive constraint from independents is not very strong, this would be unlikely to result in an SLC.

### ***Conclusions on SLC test***

5.113 We provisionally conclude that the proposed acquisition of Ottakar's by HMV through Waterstone's may not be expected to result in an SLC in the market for the retail sale of new books (best-sellers or deep-range titles) at a national, regional or local level in the UK.