

**Safeway plc and Asda Group Limited (owned
by Wal-Mart Stores Inc);
Wm Morrison Supermarkets PLC;
J Sainsbury plc; and Tesco plc**

A report on the mergers in contemplation



COMPETITION COMMISSION

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Asda Group Limited (owned
by Wal-Mart Stores Inc);
Wm Morrison Supermarkets
PLC; J Sainsbury plc; and
Tesco plc**

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**Presented to Parliament by the Secretary of State for
Trade and Industry by Command of Her Majesty
September 2003**

Members of the Competition Commission as at 18 August 2003

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Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which she considers would not be in the public interest to disclose and which, in her opinion, would seriously and prejudicially affect certain interests.

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Part I

Summary and Conclusions

1 Summary

Introduction

1.1. On 19 March 2003, the Secretary of State for Trade and Industry made four references to us under the merger provisions of the Fair Trading Act 1973 (the Act) (see Appendix 1.1). These concerned the proposed acquisition of Safeway plc (Safeway) by each of Asda Group Limited (owned by Wal-Mart Stores Inc (Wal-Mart) (Asda); Wm Morrison Supermarkets PLC (Morrison's); J Sainsbury plc (Sainsbury's); and Tesco plc (Tesco) (together referred to in this chapter as 'the main parties'). In a Department of Trade and Industry press notice issued with the reference, the Secretary of State said she had concluded that, in the cases of Tesco, Sainsbury's and Asda, there was a significant prospect that those mergers might be expected to result in a substantial lessening of competition, and, in the case of Morrison's, that there were reasonable grounds for believing that such would be the outcome. We were asked to report by 12 August 2003. On 12 August, we obtained a six-day extension to 18 August.

Safeway

1.2. Safeway is the fourth largest grocery retailer in the UK, measured by reported turnover. As at 31 March 2003, it had 481 grocery stores across the UK, ranging from large supermarkets to small convenience stores. The heaviest concentrations of its stores are in south-east England and Scotland. Safeway also operates 184 petrol filling stations and has a 50 per cent interest in a joint venture with BP, which operates forecourt food stores in some of BP's petrol stations. In the five years to 31 March 2003, Safeway reported a 23 per cent increase in turnover, from £7.0 billion to £8.6 billion, but its operating profit decreased by 15 per cent from £410 million to £347 million over this period.

Asda

1.3. Asda was acquired by the US corporation Wal-Mart in June 1999. Wal-Mart is the world's largest retailer (based on turnover), with worldwide operations and a total store portfolio of around 4,400. Since being acquired by Wal-Mart, Asda has become the UK's third largest grocery retailer, as measured by reported turnover. Asda had 258 stores in the UK as at 31 December 2002, these being on average about 4,200 sq metres in size. Asda's turnover increased by [%] per cent in the two years to 31 December 2002, from £9.7 billion to £[%] billion. Operating profits during that period increased [%] per cent, from £503 million to £[%] million. Much of the recent growth in Asda's turnover is attributable to sales of non-food items such as clothing and home and leisure products.

Morrison's

1.4. Morrison's is the sixth largest grocery retailer in the UK (after Asda, Sainsbury's, Tesco, Safeway and Somerfield plc (Somerfield)), measured by reported turnover. Its stores are concentrated very largely in the North of England and across Yorkshire and the Midlands. It

had 119 stores in January 2003, with an average store size of about 3,300 sq metres. Morrisons is unusual among the larger UK grocery retailers in that some of its operations, involving the buying and packing of fruit and vegetables, the manufacture and supply of some fresh food products and the processing and supply of some fresh meat products, are vertically integrated. Morrisons' turnover in the five years to January 2003 increased by 87 per cent, from £2.3 billion to £4.3 billion, and operating profit by 76 per cent, from £149 million to £263 million, over the period.

Sainsbury's

1.5. Sainsbury's is the second largest grocery retailer in the UK, measured on the basis of reported turnover. It has 498 stores in the UK, with an average sales area of about 2,800 sq metres. However, while Asda and Morrisons have mostly stores over 1,400 sq metres in size, Sainsbury's has a more varied store portfolio with many smaller stores as well. Its UK businesses include property development and banking services. Sainsbury's also operates overseas. Sainsbury's UK turnover in the five years to March 2003 increased by 23 per cent, from £11.6 billion to £14.3 billion, whilst operating profit [X] from £[X] million to £[X] million, over the period.

Tesco

1.6. Tesco is the largest grocery retailer in the UK, measured by reported turnover, and has 779 stores (excluding a number of small stores recently acquired from T&S stores) with an average sales area of about 2,800 sq metres. Tesco has operations in ten countries across Europe (including the UK) and Asia, producing worldwide group turnover of over £26 billion in its most recently reported year. The UK remains Tesco's core market, however, accounting for 82 per cent of its total turnover and 86 per cent of its underlying operating profits. Total UK turnover in the year to end-February 2003 was £21.6 billion and UK operating profit nearly £1.3 billion. Over the past five years, Tesco's UK turnover has increased by 44 per cent and UK operating profit by 48 per cent.

Background

1.7. On 9 January 2003 Morrisons announced that it had agreed terms to merge with Safeway, and made an offer to Safeway's shareholders, which the Safeway directors recommended that they should accept. On 13 January, Sainsbury's announced its proposal to make an offer for Safeway. On 14 January, Wal-Mart announced its proposal to acquire Safeway by way of a public offer by Asda Stores Limited or another company in the Wal-Mart group. On 22 January, Tesco announced that it might make an offer for Safeway. On 28 January, Trackdean, an investment company owned by Mr Philip Green and his family, announced that it had requested certain information from Safeway for the purposes of evaluating a potential offer. On 23 January 2003, Safeway announced that, in light of the potential counter-offers from other parties, it had decided to withdraw its recommendation for the Morrisons merger. On 19 March, the mergers in contemplation between Safeway and each of Morrisons, Asda, Sainsbury's and Tesco were referred by the Secretary of State for Trade and Industry to the CC and, in accordance with the Takeover Code, Morrisons' offer lapsed.

Relevant markets

1.8. We concluded that one-stop shopping in grocery stores of 1,400 sq metres and above is a relevant market for the purposes of these merger inquiries, because most consumers visit such

stores to carry out their main weekly shop. The market for one-stop shopping is essentially local, because most consumers are prepared to travel only a limited distance for their main grocery shop. We also considered the effect of these mergers on convenience stores, which are stores below 280 sq metres, and on stores between 280 and 1,400 sq metres, which provide for 'secondary' or 'top-up' shopping. We recognized that some one-stop shopping also takes place in stores smaller than 1,400 sq metres. We decided to consider issues relating to buyer power in the context of the supply of groceries to supermarkets with a share of 8 per cent or more of groceries purchased for resale from their stores in the UK.

The issues

1.9. We identified three main issues arising from these potential mergers: the current and prospective competitive position of Safeway; the effect of each acquisition on competition and choice in one-stop and other types of grocery shopping, both at the national and the local levels; and buyer power and supplier issues.

1.10. On the first issue, Safeway is currently performing relatively poorly on a number of standard dimensions of competition, relying to a significant degree on a selective promotional strategy which has not been entirely successful, and on the convenience which proximity of its stores offers some of its customers. To that extent it is a relatively weak competitive presence in the one-stop grocery market at the present time. Similarly, whilst it potentially represents a national competitor for sites for new stores, its recent record on new store openings indicates that it is relatively weak in this respect. We do not, however, regard Safeway as a failing firm. It has a sound financial position and continues to exert some competitive pressure in the market. Its loss would potentially, therefore, be of some significance in one-stop shopping. In addition, in recent years it has been a relatively easy target for price-cutting competition by others, and this would also be lost following its acquisition by another player. In the light of these factors, the removal of Safeway from one-stop shopping is likely to be significant in terms of the changed market structure and competition dynamics which would result.

1.11. We now turn to the second issue referred to in paragraph 1.9. We first note that competition is a process of rivalry, in which individual firms are the sources of diverse competitive strategies. Any merger reduces the number of such firms, but where there are a sufficient number of firms or low barriers to entry, the effect of this is likely to be negligible. Where, however, the number of firms is low, and there are significant barriers to entry, this effect is potentially damaging to the sources of competitive activity. In relation to one-stop shopping, we have found there to be significant barriers to entry, arising from the scale economies obtained by existing national players, and as a result of the planning regime's effect on new store development. In addition, there are currently only four national players through whom different strategies could have a rapid and widespread effect on consumers. The proposed acquisitions by Asda, Sainsbury's and Tesco would all reduce this number to three.

1.12. However, of more significance, in sufficiently concentrated markets, competitive dynamics can give way to a recognition by the participating firms of the interdependence of their prices and sales, and that they have a clear common interest in avoiding mutually destructive rivalry, in particular, price cuts, where the response of rivals in each case would render the price cut unprofitable for the participants. Recognition of their common interests in such circumstances may be sufficient to deter price cuts. Moreover, price increases might prove profitable because an implicit understanding of firms' interdependence could result in firms tending to match each others' prices at a higher level than would be sustained in a competitive market. Other aspects of their offering could also be affected by this recognition of common interests, for example the quality of products or service, or levels of innovation. Such behaviour requires neither active collusion between firms nor even any contact between them, since it

arises purely from firms' perceptions of their interdependence, with the benefits of such behaviour accruing to all the firms in the market. As a result, the effects of such behaviour are termed 'coordinated effects'. Such behaviour represents a weakening of competitive pressures on prices and other features of a grocery retailer's offer and is likely to be detrimental to both consumers and levels of competitiveness in the market.

1.13. We found that a number of conditions existing in the one-stop grocery market (set out in paragraphs 1.14 and 1.15) which are particularly conducive to such coordinated behaviour would be intensified by the acquisition of Safeway by Asda, Sainsbury's or Tesco. Some of these market conditions would also be conducive to unilateral effects, where one firm has the ability to exercise market power independently of competitors, suppliers or customers—for example, by setting prices higher than they would otherwise be or maintaining quality, choice, innovation or service at levels lower than they would otherwise be—and hence has the ability to act without the need to anticipate the strategies of other firms in the market. Other conditions, however, would tend to reduce the scope for such unilateral effects.

1.14. With regard to these conditions, first, we have found high levels of concentration in the one-stop grocery market which would be intensified following the acquisition of Safeway by any of Asda, Morrisons, Sainsbury's and Tesco and which would facilitate unilateral or coordinated effects. Allowing for current trends in performance, the acquisition of Safeway by Asda would see Asda and Tesco having very substantial market shares, with Sainsbury's considerably behind and Morrisons remaining very much smaller and only regionally based. The acquisition of Safeway by Morrisons would largely preserve the current structure of national players, but would consolidate the position of the fourth player, and remove any regional-sized player. The acquisition of Safeway by Sainsbury's would consolidate the position of the three largest players, with no fourth national player; whilst an acquisition by Tesco would give it a market share approaching the size of the next three players taken together.

1.15. Second, there is a sufficient degree of comparability between many individual grocery products as to enable the multiple grocery retailers to make price comparisons between their own and their competitors' grocery baskets; and high levels of monitoring of both price and non-price factors are indeed carried out by the multiple grocery retailers themselves and by market research firms, who can also monitor volume changes of the parties. These activities favour coordinated effects and, with the loss of a national player following the acquisition of Safeway by Asda, Sainsbury's or Tesco, would create even greater ease of comparison as the number of competitors needing to be monitored was reduced. Third, demand and costs in the market are stable and innovation generally low-key and continuous. These features favour coordinated effects and, with the loss of a national player following the acquisition of Safeway by Asda, Sainsbury's or Tesco, the possibility of disruptive innovation in the market would be less likely than it is now. Fourth, the parties have the ability to change price quickly, in response to each other, and do so. Fifth, they have a long-term financial commitment to the sector. Both these features increase the likelihood of lower profits for firms which choose to ignore their interdependence and its consequences. Sixth, as regards conditions conducive to withstanding competitive threats, there are, as noted above, high barriers to entry brought about by two main factors: the scale of the largest multiple retailers; and entry barriers which derive from the planning system. Each of these is conducive to both coordinated and unilateral effects. Seventh, there is a lack of effective grocery retailers outside the main parties who would be capable of exerting serious constraints on them; this would make coordination easier to sustain. Finally, but crucially, each of the acquisitions of Safeway except that by Morrisons would reduce the number of multiple grocery retailers with national coverage from four to three, intensifying each of the previous conditions.

1.16. At the national level, we found that the change in market dynamics brought about by the acquisition of Safeway by any of Asda, Sainsbury's or Tesco might be expected, given the

conditions facilitating coordinated behaviour, over time to lead to such coordinated behaviour as we describe in paragraph 1.12. We do not, therefore, expect that, following the acquisition of Safeway by any of these grocery retailers, effective competition would be maintained and promoted in the UK one-stop shopping market. Asda said that it would not be profitable for it to depart from the current policy of aggressive price cutting. However, we consider that Asda's price-reducing strategy could only be sustainable through increasing market share and thus further increasing concentration, which would in turn further reinforce the incentives for coordination to occur. In addition, the merger would significantly shorten the length of time that Asda would find it profitable to continue cutting its prices, if indeed it would still find it profitable to continue cutting prices at all. Sainsbury's said that it was sufficiently differentiated from Asda and Tesco as to preclude coordinated behaviour. However, we anticipate that an acquisition by Sainsbury's would generate a fairly stable hierarchy of three companies, even if Sainsbury's maintained a price and quality differential, and this would be relatively immune to external competitive pressures. Tesco said that the issue critically depended on how many national players were thought necessary to maintain competition, but that if a reduction from four to three was consistent with this, then Tesco was well placed to provide the benefits which the acquisition of Safeway could bring. As noted, however, we do not consider such a reduction in numbers of national players to be consistent with maintaining competition in one-stop shopping. In all three cases, therefore, we expect the profit incentive inherent in coordinated effects to weaken competition in one-stop shopping.

1.17. At the national level, we do not expect the acquisition of Safeway by Morrisons to reduce the number of national players or to exacerbate the conditions in which coordinated effects are likely to occur. Thus, we do not expect that, following the merger, effective price and non-price competition would be reduced in the UK one-stop grocery market. First, we take the view that, in so far as a Morrisons/Safeway entity would result in four substantial multiple grocery retailers of broadly similar scale, with a significant presence in every region of the UK, this may not be expected to reduce the sorts of competitive rivalry that have been a feature of the market in the past decade. Established as a fourth national player, our expectation is that Morrisons would seek to challenge its three main rivals on price and non-price aspects of competition. Second, with four national players, there is far less likelihood of coordination since the greater the number of parties involved, the more difficult coordination becomes in this context. Four national players may be expected to pose considerably less of a threat of coordinated behaviour than three. We find that although the merger would increase concentration, we do not expect it to reduce opportunities for entry or expansion within the one-stop grocery market. Indeed, in some respects we think it will enhance them. Morrisons is currently an ineffective competitor in some regions of the UK because it does not have the incentive to enter areas where it cannot readily benefit from store density and hence lower distribution and other operating costs. Finally, following the acquisition of Safeway, we believe that Morrisons would become a more potent entry threat throughout the UK. The acquisition of Safeway will already give it a presence in regions where currently it is only sparsely represented. By gaining stores in these new regions, Morrisons will have more incentive both to expand in those regions, and to move out into further new areas, in order to exploit its supply network; it will therefore have the incentive to bid for sites that become available in those areas.

1.18. Turning to competition at the local level, we carried out an analysis of competition and choice in all local areas where Safeway currently has stores of 1,400 sq metres or above. We conclude that the acquisition of Safeway by any of Asda, Morrisons, Sainsbury's or Tesco would have an adverse effect in a number of particular local areas, specified in our report, in terms of a reduction in the number of different one-stop shop fascias, and hence on competition in those areas, and on the choice of one-stop shops available to consumers within those areas.

1.19. We also carried out an analysis of competition and choice in all local areas where Safeway currently has stores below 1,400 sq metres. We conclude that the acquisition of Safeway by any of Asda, Morrisons, Sainsbury's or Tesco would have an adverse effect on

particular local areas, specified in our report, in terms of a reduction in the number of different smaller store fascias and hence on competition in those local areas and on the choice of smaller store fascias available to consumers within those local areas.

1.20. Turning to the third issue, buyer power, we find that the acquisition of Safeway by any of Asda, Morrisons, Sainsbury's or Tesco may be expected to aggravate further the imbalance in the respective bargaining positions of that party and its suppliers. As a result, we would not expect competitive prices to emerge. The consequences of uncompetitive prices may include 'waterbed' effects (where suppliers seek to recoup the lower prices they receive from large retailers through higher prices to smaller grocery retailers) or a further general weakening of some suppliers' bargaining positions, with the result that some grocery manufacturers are likely to find investment in new products or innovative manufacturing techniques more difficult or no longer possible. The imbalance in the respective bargaining positions of Asda, Sainsbury's and Tesco and their respective suppliers will be especially exacerbated by the acquisition of Safeway by any of those three grocery retailers because, generally speaking, suppliers are likely to secure less disadvantageous terms with four national grocery retailers than they would with three. In addition, as a consequence of our finding that the one-stop market is expected to become less competitive following the acquisition of Safeway by any of Asda, Sainsbury's or Tesco, we do not expect that any purchasing cost savings derived from the increased buyer power that will result from this acquisition would be passed fully on to consumers in the form of lower prices.

1.21. We find that the acquisition of Safeway by Morrisons may also be expected to aggravate the imbalance in the respective bargaining positions of Morrisons and its suppliers, but not to such a significant degree. This is because suppliers are, generally speaking, less likely to have disadvantageous conditions and prices with four national grocery retailers than with three. Suppliers benefit from having four broadly equal-sized grocery retailers because these can more readily be played off against each other than three even larger ones. Furthermore, as we do not expect that price and non-price competition in the one-stop grocery market would be reduced following this merger, we expect any cost savings to be passed on to consumers in the form of lower prices.

1.22. The particular adverse effects we have identified as flowing from the acquisition of Safeway by any of Asda, Sainsbury's or Tesco are that:

- (a) As a result of the lessening of competition brought about by the reduction in the number of national multiple grocery retailers, prices in the one-stop grocery market will over time be higher than would otherwise have been the case.
- (b) As a result of the reduction in competition and choice in local markets, prices for groceries will over time be higher than would otherwise have been the case.
- (c) As a result of the reduction in the number of national multiple grocery retailers, there will be a reduction in the intensity of competition for new sites and a reduction in the competitive threat of entry into all those areas where Safeway is not currently represented, thereby further intensifying the conditions favourable to coordinated effects.
- (d) As a result of the further imbalance in the respective bargaining positions of Asda, Sainsbury's or Tesco and its suppliers, there will be a further general weakening of some suppliers' positions. In some cases, levels of investment in new products or manufacturing techniques will tend to be lower or slower than would otherwise have been the case, with adverse effects on product innovation and diversity.

1.23. We find that the acquisition of Safeway by Morrisons may not be expected to exacerbate the conditions in which coordinated effects are likely to occur. Thus, we do not expect that, following the merger, effective price and non-price competition would be reduced in this manner in the UK one-stop shopping market.

1.24. The acquisition of Safeway by Morrisons may, however, be expected to have adverse effects in particular local areas in terms of a reduction in the number of different one-stop, and smaller store, fascias and hence on competition in the local areas and on the choice of one-stop shops available to consumers within that local area, with the result that prices will over time be higher than would otherwise be the case.

1.25. In addition, the acquisition of Safeway by Morrisons may be expected to have a limited adverse effect as a result of the increased imbalance in its bargaining power vis-à-vis suppliers, with similar but more limited effects to those described in paragraph 1.22(d).

Countervailing benefits

1.26. We found that there would be some cost savings following the acquisition of Safeway by Asda, Sainsbury's and Tesco that would be achieved within a short period of time and would be a consequence of each of these mergers. However, we conclude that they are not sufficient to outweigh the adverse effects identified. This is primarily because, first, we regard the long-term loss of competition, and the attendant effects, as a result of each of the three mergers to be a significant detriment to consumers; second, because of the relatively small scale of the benefits; and third, because the expected loss of competition will reduce the extent to which any cost reductions achieved are, over time, passed on to consumers.

1.27. We found that there would be some reduction in central costs as a result of the acquisition of Safeway by Morrisons. Because of our expectation that the one-stop shop market would not become less competitive following the merger between Morrisons and Safeway, we expect these savings to be passed on to customers. There will also be reductions in purchasing costs. On balance, we consider that these benefits may reasonably be set against the limited detriments we have identified as resulting from the increase in buyer power identified above.

Recommendations

1.28. We find that, whilst a sufficiently large programme of divestments of stores in areas of overlap created by the acquisition of Safeway by any of Asda, Sainsbury's or Tesco would be appropriate action that could be taken for the purposes of remedying or preventing the local adverse effects of these mergers, such divestments would not address our concerns at the national level. In the event of the acquisition of Safeway by any of Asda, Sainsbury's or Tesco, a very large number of stores would have to be divested to meet our requirements for maintaining local choice. However, even large-scale divestment would not meet our concerns about competition at the national level. No reasonable divestment programme would adequately restore a fourth national competitor. We are not satisfied that Morrisons would purchase enough divested stores to alleviate our concerns about the scope for coordinated effects among the three largest players, combined with only a weak threat of new entry in most regions of the UK. Furthermore, it is likely that some of the divestments that we might require in order to restore local choice and competition could not be made to another one-stop grocery retailer and would have to be open to Asda, Tesco or Sainsbury's as the case may be. This strengthening of the two other national parties in each case would reinforce the national detriments that we have identified. Finally, whilst a large-scale divestment programme might somewhat reduce any public interest concerns caused by the merger, it would also reduce the cost savings.

1.29. In the light of the foregoing analysis and findings, we recommend that Asda, Sainsbury's and Tesco be prohibited from acquiring the whole or any part of Safeway, other than Safeway stores that are divested to remedy the adverse effects specified in the case of the merger in contemplation between Morrisons and Safeway and subject to the conditions specified in relation to divestment following a Morrisons acquisition of Safeway.

1.30. We conclude that divestment would be appropriate action that could be taken for the purposes of remedying or preventing the local adverse effects that would result from the acquisition of Safeway by Morrisons. We recommend that Morrisons divest one-stop grocery stores in the 48 localities in which adverse effects of the merger have been identified in our analysis of local markets in order to remedy those adverse effects. We recommend that it also divest five smaller stores where adverse effects would result from the merger. We set out our detailed divestment rules in the event of an acquisition of Safeway by Morrisons in Appendix 2.3.