

Grand Theft Antitrust: Lessons from the GAME/Gamestation transaction

In January 2008, the UK Competition Commission cleared the completed acquisition of Gamestation Limited (Gamestation) by GAME Group PLC (GAME), creating the largest retailer of video games in the UK through the combination of the only two national specialist retailers.¹ The merger was approved unconditionally by the Commission, albeit with two of the panel members expressing a dissenting opinion. This Brief examines the source of the differences of opinion amongst the panel members and in so doing highlights two important considerations for the practical assessment of horizontal mergers, namely:

- the extent to which product differentiation affects the market definition and indeed what role market definition has to play in the competitive assessment; and
- how to determine the closeness of competition between merging parties in practice.

Overview of the industry and the case

GAME and Gamestation (the parties) were the only two national specialist retailers of video games in the UK, selling both new ('mint') and previously owned ('pre-owned') games. Both retailers allowed customers to trade-in their pre-owned games in return for credit on purchases in-store. However, there were numerous retailers of mint games: these included internet suppliers (e.g. Amazon, Play); supermarkets; high street retailers (Woolworths, Argos, HMV, and Zavvi) and small independent retailers that also offered pre-owned games.

It was apparent that both GAME and Gamestation faced significant competition in the retailing of mint games. Indeed, one of the most significant developments in the UK video games industry in recent years has been the growth of the online and supermarket sales channels. Both on-line and supermarket retailers compete aggressively in terms of price and high street retailers have responded to such competitive pressures by inter alia engaging in extensive promotional activity and by bundling gaming and non-gaming products.

The parties, as specialist video games retailers, had sought to meet this competition in two ways: first, by offering an effective discount on purchases of mint games through trade-in (i.e. consumers trade-in for credit on the next purchase); and second, by offering pre-owned games for sale at a discount to the identical mint product. The trade-in opportunity is doubly important since it not only represents an effective discount but also the source of supply by which specialist retailers are able to offer an attractive range of pre-owned games. Further, the parties stocked a wide range of games that differentiated their offering from that of the supermarkets (but not the internet). In short, as in many other retailing markets, high street retailers have responded to increased competition from supermarket and internet retailers in a number of different ways in order to remain competitive.

The Commission evaluated whether a substantial lessening of competition (SLC) was likely to arise in the retailing of mint games, the retailing of pre-owned games and in the trade-in terms offered to customers. The Commission concluded that an SLC in mint games was unlikely. It also found that pre-owned games were part of the same relevant market as mint games and that since no SLC would arise in the retailing of mint games, mint games would continue to constrain pre-owned games. Further, the Commission considered that trade-in was intrinsically linked to the parties' retail activities since it provides customers with an effective discount off purchases, and is vital as a source of pre-owned stock. Reducing trade-in terms would therefore have a sufficiently adverse knock-on effect on the parties' overall competitiveness in selling mint and pre-owned games to render such a strategy unprofitable.

¹ The impact of internet and supermarket retailing on specialist (and other) retailers has been observed in many retailing markets. See, *inter alia*, the UK Competition Commission's report on the merger of two specialist bookstores (HMV Group plc and Ottakar's plc: Proposed acquisition of Ottakar's plc by HMV Group plc through Waterstone's Booksellers Ltd, 12 May 2006, *Waterstone's/Ottakar's*).

The role of market definition in assessing closeness of competition

The hypothetical monopolist test (also referred to as the SSNIP-test) provides the analytical framework for defining relevant markets in which the responses of consumers (and suppliers) to small but significant non-transitory changes in relative prices is assessed. Defining relevant markets according to these fundamental principles allows one to identify the producers that constrain most effectively the pre-merger behaviour of the merging parties. This is relevant not only for market definition, but also for any assessment of the competitive effects of the transaction. The point here is not that markets must always be defined in theory, rather that *in practice* the discipline of defining markets, i.e. correctly identifying demand and supply side substitutes, is a critical part of the competitive assessment.

A distinction must be made between differences in price *levels* (a factor which is consistent with product differentiation) and how consumers and suppliers respond to price changes (the issue at hand under the SSNIP-test). For example, consider the proposition that specialists not only have similar characteristics but also have similar prices and therefore must constrain each other more closely than internet and supermarket retailers – perhaps even to such a degree that puts them in a separate market.

This proposition is an incorrect application of the SSNIP-test because it fails to consider how consumers respond to changes in relative prices. Even though specialists look alike, a hypothetical monopolist of specialist stores may not profitably sustain higher prices because the change in relative prices would induce a sufficient share of customers to switch to supermarket or online retailers.

So while product differentiation may have the effect of insulating certain firms from competition, differentiation may also arise as a competitive response when firms are not in the position to compete viably through offering an identical product or service to that offered by rivals. By differentiation they hence seek to compete effectively in other ways where they hold a comparative advantage in terms of their attractiveness to the consumer. In short, specialists may face the greatest competition from firms with different business models. The fact that firms have similar characteristics does not necessarily imply that they are particularly close or closest competitors.

Closeness of competition

The extent to which two firms are close competitors is something that must be assessed by looking beyond a comparison of characteristics to a more rigorous examination of relevant empirical evidence. A ‘close’ competitor is one that poses a strong constraint on the firm in question’s pricing (or other strategic) decisions, so in the context of a horizontal merger assessment, the closer the merging parties are as competitors and the more ‘distant’ are the parties’ rivals, the more likely that the merger would give rise to an SLC.² This is potentially a very important issue since it can often be unclear *a priori* as to the extent to which the merging parties are close competitors and the extent to which the merging parties would remain effectively constrained by other competitors post-merger.³ In particular, market shares may often be misleading where firms offer differentiated products. High combined shares are not likely to be a cause for concern when the parties are distant competitors, while relatively low combined shares are not necessarily a safe harbour if the merging firms are close competitors.

The Commission considered closeness of competition in detail during its assessment of whether or not an SLC was likely in the retailing of mint games, ultimately coming to the view that an SLC was unlikely. The Commission was able to draw upon numerous surveys conducted by the parties which showed consumers to be price-focussed, informed and purchasing from a wide range of channels (whether internet, supermarkets or other

² Supply side responses such as new entry and product repositioning must also be taken into account. New entrants or existing competitors may be well placed to introduce a new product or service that is very ‘close’ to that of the merged firm.

³ This is a topic which is addressed in more detail in RBB Brief 14, *Assessing Unilateral Effects in Practice: Lessons from GE/Instrumentarium*

4

Further, the parties argued that existing retailers faced low barriers to growth. This is particularly true of internet retailers but also for entertainment specialists (which had responded to lower margins on DVDs and CDs by switching shelf space to video games). While supermarkets focussed on chart titles only, such titles account for the majority of video game sales revenues such that having a narrower range did not substantially hamper the ability of supermarkets to win sales from retailers offering a wider range of titles.

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RBB advised Waterstone's and Ottakar's at both the OFT and Commission stages. The merger was cleared unconditionally.

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The Commission argued that this correlation could be explained by pre-owned and mint games having similar life cycles but being in separate markets and did not accept the argument that the reason why life cycles were similar was precisely because the games were so closely substitutable (i.e. the pre-owned price had to follow the mint price in order to remain competitive). However, the latter is the most likely explanation, especially given that the large majority of those who buy pre-owned games also buy mint games and that the majority of mint games sold by both parties have a pre-owned equivalent – it is hard to believe that the similarity of life cycles is just a coincidence.

bricks & mortar). Specifically, consumers consistently highlighted price as the most important reason for their choice of retailer and a substantial share carried out research before purchasing their games. This indicated that any attempt by the merged firm to sustain higher prices would be unlikely to be profitable since consumers would switch to a wide range of alternative retailers, a view that was also supported by the fact that GAME and Gamestation had lost sales (especially on a like for like basis that controls for store openings by Gamestation) to internet and supermarket retailers.⁴

The Commission found that despite GAME and Gamestation being specialist retailers of games, they still faced considerable competition from a wide range of different retail channels throughout the UK. This is consistent with its findings in *Waterstone's/Ottakar's* (2006) where the merging parties (specialist bookstores) were also subject to increasing competition from supermarkets and online retailers.⁵ Indeed, the Commission's findings have broad applicability to mergers in retail markets where competitors actively seek to differentiate themselves from one another, and not only those where more traditional retailers have come under increasing competitive pressure from new sales channels.

Assessment of Evidence – Pre-owned games

The Commission's principal concern related to pre-owned games since the parties were the two main high street players in this segment – indeed, a crucial question was whether the prices of mint games posed a strong competitive constraint on the prices of pre-owned games. If pre-owned games were in a separate market from mint games, the relatively high combined shares of the parties might indicate scope to increase prices especially if entry to this segment was unattractive for mint retailers.

The parties argued that mint games were a strong constraint on pre-owned games. Firstly, while there may be a perceived quality differential in terms of packaging, pre-owned software is functionally equivalent to the new product. Indeed, pre-owned games were offered as a competitive pricing strategy to compete with the lower mint prices typically found in supermarkets and the internet.

Secondly, surveys conducted on behalf of both the merging parties and the Commission indicated that the main reason for purchasing pre-owned games instead of a mint game was the price. For example, the Commission's own survey indicated that 78% of consumers who bought pre-owned instead of mint did so because it was cheaper. Survey evidence and loyalty card data also demonstrated that a very high share of consumers who purchase pre-owned games also buy mint games. These facts established there was no distinct group of 'pre-owned buyers' that could profitably be exploited by the merged firm, and indicated that a large majority of pre-owned buyers are likely to be 'marginal consumers' willing to switch between mint and pre-owned games in response to relative changes in price.

Thirdly, the parties put forward other evidence to support their claim that mint and pre-owned games compete in the same relevant market. The parties provided several examples of the significant negative effects of mint promotions on pre-owned volumes. The Commission found similar examples but argued that since the promotional price changes were sometimes large (above 5–10%), this evidence in itself was not necessarily indicative of a strong constraint. This was a valid assessment of that particular piece of evidence when considered in isolation but the results were nonetheless indicative of clear substitutability between mint and pre-owned games.

Fourthly, the parties explained that pre-owned prices were set at a discount to mint prices. If the parties reduced the mint price of a given title, they would also lower the pre-owned price of the same title to maintain a competitive differential. As evidence of this pricing behaviour, the parties presented the existence of very high correlation between pre-owned and mint prices.⁶

Finally, the Commission received evidence from third parties. In this regard, all evidence received was consistent with mint and pre-owned titles competing in the same relevant market. Indeed the Commission noted that of the third parties to comment 'none argued that these were distinct economic markets'.⁷

The Commission ultimately concluded that mint and pre-owned games were part of the same relevant product market though two of the panel members disagreed. The concerns of these members amounted to the view that mint games were not a sufficient constraint on pre-owned games. They argued that pre-owned prices in specialist stores were sometimes higher than mint prices in supermarket and internet retailers. However, as discussed above, it is an incorrect application of the SSNIP-test to define separate relevant markets on the basis of absolute price levels, but rather the key issue in market definition is how consumers react to changes in relative prices. Further, pre-owned prices were on average lower than supermarket and internet mint prices and on those minority of occasions where pre-owned prices were found to be higher than mint prices, this would typically be due to the mint title being heavily promoted. In such cases, pre-owned volumes would be likely to fall (as both the Commission and the parties found in relation to a selection of top selling titles).

The dissenting members also pointed out that it is not necessary to define a relevant market for pre-owned games in order to find an SLC. However, this is an empty statement. First, the very large majority of evidence supports the view that mint and pre-owned games compete. Second, no credible evidence was put forward in support of an SLC irrespective of whether or not pre-owned games are part of a broader relevant market including mint games. Put differently, the claimed SLC was little more than speculation.

Conclusion

In merger assessment it is all too easy to assume that firms with common characteristics will be close competitors and that the more differentiated firms' offerings become (in terms of characteristics), the weaker the constraint between them. However, the Commission correctly avoided relying on a characteristics based approach with respect to mint and pre-owned games, drawing on several pieces of evidence on consumer behaviour which indicated that the merging specialist retailers of games faced substantial constraints from other retail channels, including the internet and supermarkets. Such evidence on how consumers (would) respond to price changes sheds light both on the relevant market as well as the competitive effects of the merger.

In coming to its view, the Commission correctly required the parties' evidence to meet a high standard. Indeed, there is rarely a single piece of evidence that, in its own right, is so compelling as to determine a relevant market or the strength of a particular competitive constraint. Nonetheless, in this case the balance of evidence weighs strongly in favour of the merging parties' views. So it is hard to justify the dissenting opinion – especially because it is not supported by evidence that would meet the same high standard required of the merging parties.