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LATIN AMERICAN COMPETITION FORUM

Session I - Structural Issues in the Groceries Sector: Merger and Regulatory Issues

-- Contribution from Chile --

23-24 September 2015, Montego Bay, Jamaica

The attached document from Chile (FNE and TDLC) is circulated to the Latin American Competition Forum FOR DISCUSSION under Session I at its forthcoming meeting to be held on 23-24 September 2015 in Jamaica.

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Session I - Structural Issues in the Groceries Sector: Merger and Regulatory Issues

MERGERS IN THE CHILEAN SUPERMARKET SECTOR

-- CONTRIBUTION FROM CHILE (FNE AND TDLC)--

1. Introduction

1. Up until 2006, the Chilean supermarket market comprised of two large chains, D&S (now Walmart Chile) and Cencosud, which had both attained a share of 34% and 29% respectively. Unimarc followed behind them with just 3% of domestic sales. In 2007, this situation changed radically with the acquisition of the Unimarc chain (which, in 2006, boasted 3% of domestic sales in the sector) by the SMU¹ Group. From then until 2011, the Group undertook a series of acquisitions of regional chains, which gave rise to further consolidation in the sector and a narrowing of the gap between Unimarc, which by 2011 was achieving 26% of domestic sales, and the two major players. The growing importance of the sector, as well as the relationship between the leading chains and their suppliers, have resulted in numerous investigations by the Fiscalía Nacional Económica (FNE), the Chilean competition agency, and judgements by the Tribunal de Defensa de la Libre Competencia (TDLC), the Chilean competition regulator. The following pertinent cases represent the most important milestones in investigations of this type within the sector.

2. Relationship between supermarkets and suppliers

2. In early 2002, the Chilean Supplier Industries Trade Association (AGIP) brought two separate consultations before the Central Preventive Commission, the predecessor to the TDLC: the first was against D&S and the second targeted the nation's principal supermarkets, with both focusing on the relationship between said supermarkets and their suppliers. Both cases were settled jointly by the newly established TDLC in 2004². This body condemned the supermarkets' behaviour and attempted in the first instance to establish a merger monitoring mechanism within the sector, ordering that any proposed mergers

¹ SMU came into being during that year via the purchase of the Unimarc, Deca and Bryc supermarket chains by part of CorpGroup.

² Judgement No. 9-2004: http://www.tdlc.cl/DocumentosMultiples/Sentencia_09_2004.pdf.

in the market be henceforth evaluated via a consultation with the TDLC beforehand. The TDLC's decision was subsequently challenged by the leading supermarkets in Chile's Supreme Court, which upheld the appeal, rendering null and void Article 3 of the Resolution concerning the consultation process for proposed mergers³. It should be noted that in its judgement the TDLC provided – for the first time – an important definition of this market, one that is still used today⁴.

3. In 2006, the FNE filed a complaint against the D&S and Cencosud supermarket chains at the TDLC, alleging anti-competitive practices via aggressive growth strategies, which materialised through the acquisition of smaller competitors and land well-suited for supermarket construction. This increase in market power, according to the FNE, was reflected in the relationship between the chains and their providers, which was characterised by the imposition of subjective, discriminatory, and unexpected terms and conditions. Shortly after the filing of the complaint, D&S decided to negotiate with the FNE, which resulted in a TDLC-approved settlement⁵. In the settlement, D&S committed to drawing up General Terms and Conditions of Supply and adopting a series of measures related to supplier charges and fees. In addition, D&S was ordered to inform the FNE of any proposed high-profile mergers in the future. As for Cencosud, the TDLC partially upheld the complaint and ordered the company to engage in a consultation process for any planned mergers⁶. The FNE appealed the TDLC's ruling in the Supreme Court and eventually reached a settlement with Cencosud⁷. This agreement regulated Cencosud's relationship with its suppliers and maintained the obligation established by the TDLC in its Judgement No. 65-2008 related to consultations prior to each attempted merger.

2.1 D&S/Alvi:

4. In 2010, D&S informed the FNE, as part of its TDLC-approved settlement, of its intention to acquire all of the property belonging to wholesaler Alvi. According to the two parties, the transaction would have no effect on competition, given that D&S operated in the retailing sector through various types of supermarket and Alvi was focused on wholesaling. The FNE launched an investigation that concluded with a hearing before the TDLC in September of that same year⁸.

5. The FNE's review centred on two different areas: first, the justification for the existence of an overlap between the business activities of both companies, and second, a quantification of the likely effects of the transaction.

³ Supreme Court Judgement:

http://www.tdlc.cl/DocumentosMultiples/Sentencia_09_Corte_Suprema.pdf

⁴ According to the definition set by the TDLC, the market is defined as “*the provision, by wholesale suppliers and distributors, of food products and everyday non-food consumer items, to supermarkets, for retail distribution to end consumers.*”

⁵ Settlement between the FNE and D&S:

<http://www.tdlc.cl/DocumentosMultiples/Avenimiento%20FNE%20y%20DYS.pdf>

⁶ Judgement No. 65/2008: http://www.tdlc.cl/DocumentosMultiples/Sentencia_65_2008.pdf

⁷ Settlement between the FNE and Cencosud:

http://www.tdlc.cl/DocumentosMultiples/Avenimiento_Corte%20Suprema.pdf

⁸ Judgement No. 383-10:

<http://www.tdlc.cl/DocumentosMultiples/28%2009%202010%20%20%20Consulta%20de%20%20FNE%20sobre%20toma%20de%20control%20de%20Alvi%20Supermercados%20Mayoristas%20S.A.%20por%20Distribuci%C3%B3n%20y%20Servicio%20D&S%20S.A..pdf>

6. During the consultation, the FNE pointed out that there was an overlap between Alvi's self-service wholesalers and D&S' retail supermarkets, using three key arguments to justify this supposition:

1. The high number of end consumers making up Alvi's total sales – the FNE reached this conclusion with the help of a market research study carried out by TNS Chile, which revealed that end consumers represented some 48% of the total sales of Alvi's self-service wholesaler outlets. According to the study, a large majority (82%) of Alvi's retail sales stemmed from consumers with the lowest socio-economic status (C3-D), a feature shared by D&S' discount stores, Ekono and Bodega aCuenta.
2. Moreover, the FNE confirmed certain similarities between a typical basket of food and non-food products sold by Alvi and by the retail chains, and emphasised that Alvi had announced changes to its sales strategy, which entailed reducing the minimum units required to benefit from a discount, including product lines with a strong consumer focus (such as bakery goods and grocery items) and relaxing the requirements necessary for joining loyalty schemes.
3. Finally, the FNE noted that the premises, especially those used by the Alvi supermarkets and D&S' discount stores (Ekono and Bodega aCuenta), also shared similar features, such as the size of the shop floors, and the number of checkout counters and parking spaces.

7. For all of the above reasons, the FNE determined that there was indeed a convergence between how Alvi and certain supermarkets carried out their business, concluding that the transaction could result in a decrease in the intense competition prevalent in the market.

8. As regards risk, the FNE's analysis focused mainly on unilateral downstream risk. This type of risk was quantified using two distinct reduced-form econometric models, with cross-sectional monthly data relating to the various D&S outlets in Santiago⁹. Both models used the price index per D&S outlet for a basket of goods pertaining to 48 different categories as a dependent variable¹⁰. In the first model, the independent variables consisted of the following: the presence of an Alvi supermarket within a five-, 10- and 15-minute drive, the number of other competitors within those radiuses, and the category of supermarket (Superstores, Express or Basic). In the second model, the number of competitors was replaced by the concentration ratio.

9. To estimate Alvi's areas of influence and to determine the overlap between their outlets and those belonging to D&S, the FNE engaged the services of Mapcity, which estimated isochrones of five, 10 and 15 minutes and pinpointed competitors and their corresponding number of outlets that were located within the isochrone of each Alvi outlet. When calculating the isochrones, they took into consideration variables such as, among others, speed limits per type of street (lane, motorway, avenue, etc.), traffic congestion, zoning restrictions, and traffic lights.

⁹ For more information, see the FNE's economic report by Francisco Caravia R. and Francisco Rojas V., "Merger of D&S and Alvi: Impact of the transaction on D&S prices":

<http://www.tdlc.cl/DocumentosMultiples/Informe%20Econ%C3%B3mico%20FNE%20Alvi%20DS.pdf>

¹⁰ The price per category was calculated as the average price per SKU pertaining to that category, weighted by the relative weight of the SKU in sales at each outlet. In turn, to analyse the weight of each category in the basket, three different weightings were used: i) CPI basket consumption patterns, published by the National Statistics Institute, ii) the weight of each category in D&S' total sales, and iii) the weight of each category in supermarkets aimed at consumers with a low socio-economic status.

10. The results of this exercise indicated that Alvi's presence tended to exert competitive pressure on D&S' prices, particularly in low-income areas, and that the concentration ratios might explain the different price-setting strategies among outlets belonging to the same chain. In March 2011, the FNE brought its consultation to an end following both parties' decision to abandon the transaction.

2.2 *D&S/Falabella merger:*

11. Quite possibly the most high-profile case related to supermarket mergers to appear before the TDLC corresponds to Resolution 24/2008¹¹, which settled the question surrounding the merger of S.A.C.I. Falabella (hereinafter referred to as "Falabella") and D&S. Although this case was resolved eight years ago, it is well worth mentioning, as the analysis involved extended beyond the boundaries of the supermarket sector.

12. In this case, at the time of the consultation, Falabella enjoyed a presence in the following sectors: supermarkets (through Tottus, which had a low market share), department stores (Falabella), DIY stores (Sodimac), credit (the non-banking CMR credit card), shopping malls and power centres (Mall Plaza and Sociedad de Rentas Falabella), and banks (Banco Falabella). D&S, meanwhile, was involved in supermarkets (through their Líder, Ekono and Bodega aCuenta brands), credit (the non-banking Presto credit card), and shopping malls and power centres (via the Saitec subsidiary).

13. The TDLC took into consideration general changes observed in the retail sector in recent years, during which time companies have "*developed a business model that has become known as integrated retail, through which they blend businesses such as supermarkets, department stores, DIY stores, credit card services, banking, complementary real estate project development, and various additional services like general insurance, travel agencies and moving services, among others.*" In other words, the integrated retail model is "*one which covers a substantial part of regular consumer needs in large retail stores and its corresponding financing.*" Therefore, it was considered inappropriate to (i) analyse this merger as a straightforward concentration of supermarkets and (ii) restrict the analysis to each one of the businesses involved in the merger.

14. To analyse the merger in question, the TDLC looked at it from the perspective of the integrated retail concept, considering the complementarities and synergies between all markets in which the companies in question operated. In addition, and as a complement to the aforementioned analysis, each of the businesses mentioned was evaluated individually.

15. As regards the supermarket sector, the TDLC looked at the situation to date from the point of view of barriers to entry, concluding that the established companies' cost advantages hindered the arrival of new supermarket chains, given the level of concentration prior to the proposed merger, and of supplier relationships, concluding that, if the merger were to be approved, the risk of an abuse of purchasing power would increase, especially in terms of small and medium sized suppliers.

16. The TDLC concluded that, given the diminutive nature of the Chilean economy and the importance of existing barriers to entry into areas of business that make up integrated retail, it was very unlikely, in the event of a new operator joining the market and competing with the duopoly that would have emerged from the merger, that the appearance of said newcomer would have been sufficient to apply competitive pressure within a reasonable period.

¹¹ Resolution No. 24/2008: http://www.tdlc.cl/DocumentosMultiples/Resolucion_24_2008.pdf.

2.3 *SMU/SDS merger:*

17. In December 2012, the TDLC ruled on a consultation filed the previous year¹², in which the supermarket operator SMU S.A. queried the effects that the merger between it and Supermercados del Sur S.A. (SDS) would have on free competition, proposing mitigating measures consisting mainly of the sale of certain outlets, as well as the submission on the part of the merged company to contract terms similar to D&S' General Terms and Conditions. This consultation took place once the companies had already merged.

18. The TDLC analysed this consultation with pre-merger market conditions in mind, so as to seek mitigation measures that would maintain that level of competition. In doing so, they identified unilateral risk and a risk of coordination, given the number of supermarkets with a national presence in Chile.

19. The relevant market definition in this case followed the one given by the TDLC in various cases in the same category: "the regular provision, usually on a weekly, fortnightly or monthly basis, in a self-service manner, by large shops specifically designed for the purpose known as supermarkets, of food products and non-food items intended for household consumption, to end consumers". In addition, they analysed related markets – wholesale, convenience stores and online sales – in which the merged companies also had a presence.

20. In this particular case, the relevant geographical market was determined to be municipalities, except in the case of larger cities, in which smaller areas – that is, areas of influence within a 5-minute distance – were considered. Given that the two supermarket chains involved in the merger had outlets in various municipalities across the country, and given that in each municipality they faced a different level of competition from other existing Chilean chains, the Upward Pricing Pressure Index (UPPI) methodology was used to determine which of these municipalities would see an increase in the risk of anti-competitive practices after the merger.

21. The TDLC approved the merger between SMU and SDS, subject to a range of conditions. The first condition stated that the merged companies had to sell outlets in 17 geographical zones, as well as three distribution centres belonging to SDS and one of the trademarks used by SDS. All of these assets had to be sold as a single economic entity, and they could not be purchased by anyone associated with the merged companies, nor by any chain with a national market share greater than 25%. The merged companies were granted eight months to meet this condition. The second condition stipulated that, during the time period set aside for the sale of the above-mentioned assets, the merged entity had to keep its outlets running and ensure that the prices in those outlets matched the prices of the closest town with sufficient competitive conditions. Thirdly, the merged entity was instructed to sell its shares (amounting to 40%) in the Montserrat supermarket chain, which had a presence in the Metropolitan Region, within eight months. In addition, the merged entity had to draw up General Terms of Sale similar to the General Terms and Conditions of Supply established by D&S.

22. In 2014, the FNE launched an action against SMU for breaching the aforementioned first, second and third conditions. To date, this action has yet to be settled by the TDLC.

¹² Resolution No. 43/2012: http://www.tdlc.cl/DocumentosMultiples/Resolucion_43_2012.pdf.