



A response

to the invitation to comment on the Tesco / Booker merger – Phase 2 Investigation

OVERVIEW

The following submission to the CMA’s Phase 2 investigation of the Tesco / Booker merger focuses on the potential lessening of competition as a result of buyer power. It is made by the British Brands Group, a trade organisation representing brand manufacturers.

Input from members has been sought and is reflected in our input. [redacted]

We assess the significance of the merger, differences in trade terms (broadly), the potential for waterbed effects and the potential impact of harmonisation of terms on investments in innovation, quality, choice and reputation. We highlight that GSCOP provides no protection when suppliers are negotiating trade terms and that it is unclear the extent to which GSCOP would cover the merged firm on matters that do fall within its scope.

We raise in particular the “double agent” role of retailers and its impact on innovation, stating that this merger would place a sharper and significantly more powerful spotlight on this anomaly in the interpretation of competition policy.

1	<p>INTRODUCTION</p> <p>The British Brands Group [redacted] provides the voice for the suppliers of branded products and has a mission to build a climate in the UK where brands can best deliver value and choice to consumers, [redacted]. We have focussed below on [redacted] issues raised by our members [redacted].</p>
2	[redacted]
3	<p>While acknowledging these concerns, our input [redacted] focuses on the potential lessening of competition as a result of buyer power (Theory of harm 5). We consider the environment for innovation, the provision of high quality, reputable products for shoppers and choice and the efficacy of remedies available were buyer power to be abused.</p>

4	<p>BUYER POWER</p> <p>The theory of harm in the Issues Statement suggests the merged firm <u>may</u> enjoy greater buyer power than the merger firms could exert individually. Meanwhile, the Reference Decision states that:</p> <p style="padding-left: 40px;">The Parties estimated that, post-Merger, the Parties could benefit from significant procurement synergies as a result of harmonising purchasing terms. Estimates ranged between public and internal estimates, [redacted]. The scale of these procurement synergies may indicate that <u>the merged entity's increased buyer power could be significant</u>.</p> <p>[Emphasis added]</p>
5	<p>Previous Competition Commission grocery market investigations have concluded that the UK grocery market is already concentrated and that buyer power exists. Most (but not all) members inform us that this merger would increase buyer power, most notably for those who currently supply both Tesco and Booker.</p>
6	<p>Closely inter-related to the increase in buyer power would be the increased strength of the merged business' gatekeeper role, combining as it would the UK's leading grocery retailer and wholesaler, raising the prospect of joint purchasing and stocking decisions. The merged business would control suppliers' access to their own stores, their symbol groups, independent retailers and, ultimately, a significant percentage of shoppers and consumers. This access to shoppers and consumers would not be easily replaced by other routes were the merged business to delist or refuse to list. In other words, the merged entity risks becoming a 'must have' trading partner. For smaller suppliers, failure to achieve listings on acceptable commercial terms could have serious implications for their viability.</p>
7	<p>The branded business model is vulnerable to restrictions on distribution. Most branded grocery producers require scale through wide distribution to achieve the necessary economies to deliver competitive prices while covering the significant up-front costs of innovation, brand creation, ongoing marketing support and other reputational costs. Were a significant part of the UK retail and wholesale market to be foreclosed to a branded supplier, future investments in innovation, reputation, quality and choice become less viable. We would be happy to provide more information on the brand business model and its susceptibility to distribution losses, should this be helpful.</p>
8	<p>The proposed merger would occur in a market where suppliers' margins are already under pressure, arising from deflation, exchange rate pressures and an inability to feed through price increases into the market due to the already strong gatekeeper role and buyer power of grocery retailers. The OC&C Grocer Index 2016 describes supplier margins being close to historic lows, with the top 150 suppliers demonstrating margins flat at 5.3%, well below the 6.4% long term average and hovering near the low of 5% not seen since the mid-1980s. It reports that large branded suppliers are cutting investment by 8.8% and that return on capital employed has fallen to its lowest level for 30 years at 12.4%.</p>
9	<p>Members' views</p> <p>We have sought the views of members [redacted]. We received input from [redacted], focussing on issues concerning the impact the merger may have on the environment for branded products (as distinct from the impact on their individual companies). The implications of a harmonisation of trade terms between Tesco and Booker was considered one of the</p>

	greatest threats, with [X] members considering this a risk to brands and a further [X] a strong risk ([X] considered it neither a benefit or a risk. [X] considered it a benefit).
10	[X], the Group consulted [X] to explore the potential implications of a harmonisation of trade terms on a range of factors (we did not ask which enjoyed the most competitive terms, Tesco or Booker). [X] members responded, ranging in size (in terms of annual turnover) from <£50 million ([X] members) and £50 million to £250 million ([X] members).
11	The views of members were polarised on the potential <u>impact</u> of any harmonisation of terms on their business: [X] considered the impact would be significant, [X] marginal and [X] negligible. When asked the current scale of differences in terms, [X] stated a differential less than 5%, [X] stated 5-10% and [X] stated 20-30%. [X].
12	On the likelihood of any improvement in terms for either Tesco or Booker being <u>passed onto shoppers</u> , on a five-point scale, [X] members considered this very unlikely and [X] unlikely, though [X] considered it possible (none thought it likely or very likely). [X] stated it was not applicable [X] and [X] did not answer this question. This indicates strong scepticism among most members that shoppers would see any benefit from an improvement in terms.
13	Members were asked about the potential impact on <u>promotional investments</u> . [X] considered it very unlikely and [X] unlikely that they would be less able to invest in promotions. However, [X] considered it possible, [X] likely and [X] very likely that such investments would be threatened, raising the prospect of higher prices to consumers.
14	Waterbed effects [X]
15	The [X] member information-gathering considered whether, as a result of harmonisation of terms, the pressure might result in internal decisions to raise prices to other retailers or wholesalers to compensate. [X] thought this very unlikely and [X] unlikely. However, [X] members considered this possible and [X] likely ([X] thought it very likely), suggesting that waterbed effects cannot be ruled out. Any deterioration in suppliers' willingness to offer wholesalers better terms would damage the competitiveness of the independent retail sector.
16	Abuses of buyer power The Groceries Supply Code of Practice (GSCOP) monitored and enforced by the Adjudicator (GCA) has proved effective in constraining a number of abuses of buyer power, notably in relation to delays in payment, lump sum payments and retrospective changes to supply agreements. GSCOP however has no bearing on the negotiation of trade prices. Suppliers' discussions with the merged business on the harmonisation of trade prices would not be covered.
17	The fair dealing provision (Clause 2) states that dealing must be fair and conducted without duress. However, the GCA has made it clear that this is not a standalone provision but adds clarity to the other provisions. This is an interpretation the Group supports. The implication is however that, when suppliers are negotiating new agreements, including trade terms, they are unprotected. GSCOP is of no help. With the increased buyer power of

	<p>the merged party and its significant gatekeeper role, suppliers' ability to negotiate would be more vulnerable. It is therefore credible that the merged business's drive to harmonisation terms will, depending on the supplier, result in [§].</p>
18	<p>In our review of member concerns [§], potential abuses of buyer power by the merged firm were of concern to several members, with [§] considering it a risk and [§] a strong risk ([§] considered it neither a benefit or a risk and [§] considered it a benefit).</p>
19	<p>To help allay this concern, were the merger to proceed, GSCOP will require amendment, or at least clarification. Currently only retailers are covered but so are any subsidiaries of a designated retailer. It is unclear therefore whether Booker would or would not be designated under the GSCOP Order. If not, would Tesco be free to purchase via Booker, thereby circumventing GSCOP? If it is covered, it would create an anomaly between Booker and other wholesalers.</p>
20	<p>Were the merger to proceed and were the GSCOP Order to require amendment, we urge that the opportunity is seized to make designation of retailers of grocery products automatic as soon as the £1 billion annual grocery turnover is reached. This is a more objective, proportionate and predictable approach than leaving designation to the discretion of the CMA.</p>
21	<p>INNOVATION</p> <p>We noted the CMA's observation in its Referral Decision that:</p> <p style="padding-left: 40px;">“Given the lack of third party concerns on the basis of reduced innovation at the supplier level, the CMA focused its assessment on the possibility of waterbed effects, in relation to which a number of third parties raised concerns” (paragraph 216).</p> <p>[§] we disagree. Around 80% of innovations in 75 grocery categories in the top five UK grocery retailers are brought to market by branded suppliers, indicating that such suppliers drive innovation in UK grocery (see the <i>Access to Brands</i> report, drawing on Kantar Worldpanel, GfK and Europanel data, attached at Annex 1). There is no doubt that the climate for innovation in grocery is deteriorating, with the <i>Access to Brands</i> report revealing that three of the top five retailers reduced their listing of new branded products in the last three years. It is incumbent on the CMA to ensure that the merger will not have an adverse effect on the climate for innovation, whether through the growth of private label or more generally through a deterioration in support for new branded products (see also our comments below on the double agent role and innovation more widely).</p>
22	<p>The climate for innovation</p> <p>There is further evidence that the environment for innovation in the UK is deteriorating. Currently, 19% of the new products can get listed in only one retailer. Maximum weighted distribution at the top five retailers of new branded products is 44% (2015), a number much below the market share of the top five retailers (70%) (source: <i>Access to brands</i>).</p>
23	<p>This picture is confirmed by IRI that states that the number of new branded grocery items decreased by 8.4% last year, a decline that started in 2013 and which has been falling steadily ever since. Range rationalisation by retailers such as Tesco is believed to be a major factor constraining NPD success, making it harder for new products to gain distribution and potentially giving new products less time in which to prove themselves.</p>

24	<p>Were Tesco's range rationalisation to extend to Booker or were the merged business not to list innovative products to the extent they do at present, the climate for innovation in UK grocery overall would deteriorate markedly. Given the scale of the merged entity, any reduction in its support for new products would make it much harder for branded suppliers to obtain the depth of distribution and the volume of sales required to earn a return on the significant up-front costs required to develop and advertise new products.</p>
25	<p>Double agent role</p> <p>[§<] concern of the 'double agent' role retailers enjoy both as customers and direct product competitors of branded suppliers via their private label ranges. Retailers require that brand manufacturers (the leading innovators) must share their innovation plans with retailers to secure distribution and support but that same information can then be used freely by retailers to inform their competing private label formulations and strategies. Such sharing of confidential commercial information between horizontal competitors is usually a <i>per se</i> competition offence. Despite private label copycat products often being the strongest competitor to a branded product, there has to date been an absence of focus on addressing this apparent anomaly in interpretation of the rules on information sharing between competitors.</p>
26	<p>Misuse of confidential information on competitors' innovations by retailers in relation to their private label products is damaging to the climate of innovation:</p> <ul style="list-style-type: none"> - Competitive uncertainty is significantly reduced for the private label competitor (the retailer); - The private label competitor (the retailer) can use the market research and consumer insights of the brand owner in developing its competing offer without incurring the cost; - The private label competitor (the retailer) can time its product launch and arrange its in-store presentation (in terms of product facings, shelf position and in-store communication) to enable its private label alternative to benefit from the brand's advertising and promotional efforts, again without incurring the cost; - Competition from private label products, armed as they are with confidential commercial information in advance of the market overall, foreshortens the period in which brands can recoup the cost of the innovation, discouraging future innovation. Were the branded innovation to be delisted altogether to be replaced by a private label alternative, returns would fall further.
27	<p>The proposed merger would place a new and significant spotlight on this anomaly. Tesco's near perfect information of most competing brand owners' future innovation plans could be leveraged not only across its own private label ranges but those of Booker. The same or similar private label products may be sold under one or a number of trade names, whether or not store-related. [§<]</p>
28	<p>We see no justification for why retailers should be able to use supplier confidential information with impunity. We would expect the CMA to be concerned to ensure that competition is not harmed more generally as a result of this anomaly. Given the increased size and hence influence that the merged entity would have, the CMA will wish to be satisfied that the double agent role is not exploited to the detriment of suppliers and ultimately consumers.</p>

29	<p>Members' views</p> <p>Our members have provided views on whether harmonisation of trade terms would affect the ability to <u>invest in innovation</u> and new products. [X] considered it very likely, [X] likely and [X] possible that they would be less able to invest in innovation. All [X] had annual turnovers below £50 million. The other [X] respondents ([X] being larger and [X] smaller suppliers) indicated that it was unlikely or very unlikely that their ability to invest would be affected.</p>
30	<p>CHOICE, QUALITY AND REPUTATION</p> <p>Members were also asked whether any harmonisation of trade prices would affect their ability to invest in the <u>quality</u> of their products. [X] members considered it unlikely or very unlikely that their ability to invest would be affected, either because any harmonisation of terms would have a negligible or small effect or because their products were produced internationally. However, [X] felt it likely that they would be less able to invest in quality.</p>
31	<p>Members were also invited to indicate whether their ability to support the <u>range</u> of products they offered. While [X] considered it unlikely or very unlikely their ability to support the range of products offered would be affected, [X] considered it possible, [X] likely and [X] very likely that there would be an effect.</p>
32	<p>One member commented: [X]</p>
33	<p>While most members consider that they would <u>continue to supply</u> the merged business were trade prices to harmonise to the lower level, [X] considered it very likely and [X] almost certain that they would have to cease supply to either Tesco or Booker. As one of these members put it: [X]</p> <p>A deterioration in the choice offered by Booker to its retail customers would potentially harm the competitiveness of those retailers. More broadly, we would expect the CMA to be concerned were the merger likely to result in a reduction of choice, quality and innovation, all of which would be detrimental to end consumers. Understandably, the risks are likely to be greater for smaller branded suppliers whose businesses may be less resilient than others, but whose continued existence is essential for UK consumers to continue to enjoy a wide variety of new, innovative and quality branded products.</p>