The Merger Inquiry Group
Competition and Markets Authority
Victoria House
Southampton Row
London, WC1 4AD

3 August 2017

Dear Mr Polito and colleagues,

Proposed merger between Tesco PLC and Booker Group PLC

Tesco and Booker welcome this opportunity to engage with the CMA on our proposed merger.

Our respective businesses and markets have been analysed several times by the CMA and its predecessors, and have always been found to be dynamic, intensely competitive and customer-focused. Indeed, since the last time you looked at the market, competition has increased further via the growth of discounters, the rapid evolution of technological solutions, the rapid expansion of convenience shopping and as a result of recent M&A activity.

Our merger represents a combination of two complementary businesses. We operate in distinct market sectors (wholesale and retail) and do not compete with each other.

The rationale for our merger is anchored in our focus on the customer. Lifestyles, attitudes and habits are changing, eating out is growing considerably and the merger allows us to improve the choice, quality, value and service for customers wherever they choose to buy their food.

We recognise that whilst the catering and food service market is our core growth rationale the CMA will be focused on the impact of the merger in the independent / convenience retail sector.

It has been suggested that the merged business might try to "divert" sales from one part of the business to another, by artificially "deteriorating" the offer in either Tesco stores or to Booker retail customers. We have absolutely no intention to do this.

We believe you will conclude that the operational, financial and reputational risks from such a strategy makes no commercial or operational sense. The markets we operate in are too competitive, transparent and dynamic even to contemplate such a possibility. We would be punished by our customers and they would simply switch to one of our many respective competitors.

It has also been suggested that our merger may undermine the commercial options of our suppliers. However strong partnerships with suppliers are crucial to our business and allow us to give consumers the mix of household brand names, innovation and fresh produce that they want. We believe that suppliers will support the proposed merger – and the opportunities it brings for them, in terms of growth and additional revenue and / or in terms of efficiency and reduced cost.

Our merger will only be successful if we improve the quality, range, cost and service for caterers and restaurants, for small businesses and for convenience retailers. These improvements will in turn create benefits for consumers, for our suppliers and for the local communities in which all of these businesses are located. If we fail, experience shows us that customers will exercise their right to choose and decide to take their business to one of our many competitors and our business will shrink.

We very much look forward to discussing these points with you further.

Yours sincerely,

Dave Lewis (Tesco)	Charles Wilson (Booker)

PROPOSED MERGER BETWEEN TESCO PLC AND BOOKER GROUP PLC

INITIAL SUBMISSION TO THE COMPETITION AND MARKETS AUTHORITY FOR PHASE 2 REVIEW

1. Introduction

1.1 Tesco and Booker welcome the opportunity to engage with the Inquiry Group and wider CMA team on why their proposed merger (the ***Merger***) will enhance the dynamism and efficiency of the UK retail and wholesale groceries markets and not result in any substantial lessening of competition in either market.

1.2 While the rationale for the Merger outlined in the CEOs letter is a positive one, Tesco and Booker nevertheless recognise that the CMA has identified some concerns in its Phase 1 decision (the ***Decision***). These concerns are primarily based around whether the merged entity would have the ability and the incentive to worsen Booker's wholesale offering or Tesco's retail offering, or harm its supplier base.

1.3 This submission focuses on the following areas which Tesco and Booker consider to be key when assessing the Merger and explaining why the theories of harm set out in the Decision are not plausible in practice:

(a) **Section 2** provides a description of the parties and where they fit in the UK food sector. This section shows that Booker and Tesco operate at different levels of the supply chain and that this is a vertical merger.

(b) **Section 3** provides a description of the relevant markets in which Booker and Tesco operate, namely the wholesale groceries market and the retail groceries market. In line with conclusions of the CMA and its predecessors in previous investigations, this section illustrates that these markets are highly competitive and dynamic (and have become even more competitive in recent years).

(c) **Section 4** provides an assessment of the competitive effects arising from this vertical Merger. This section demonstrates that:

(i) the merged entity would not have the ability or incentive to deteriorate Booker's wholesale offering or Tesco's retail offering post-merger. As well as directly cutting across the strategic rationale for the Merger, any strategy based around deteriorating Booker's or Tesco's offer in a small number of targeted local areas is highly theoretical, would not be profitable and risks significant commercial and reputational damage (see **Sections 4A and 4B**);

(ii) there is no realistic prospect that the Merger could have a negative impact on competition in the wholesale groceries market (see **Section 4C**); and

(iii) Tesco and Booker will have no ability or incentive to harm their supplier base (see **Section 4D**).

2. The food sector and where Tesco and Booker fit

2.1 The UK food sector is a large part of the UK economy. It supports multiple business models connecting the food supply base (the producers of fresh, branded and own-brand products) with customers and ultimately with end consumers. The food sector is constantly evolving as consumers change where and how they eat in and out of the home, and from which channels they choose to purchase and consume their food. Independent retailers, caterers and small businesses purchase food products from a variety of sources, including directly from growers and manufacturers, from third party logistics suppliers and from wholesalers.

2.2 Tesco and Booker operate in different markets and at different levels of this supply chain. Tesco is a retailer and Booker is a wholesaler. They do not share the same customer base: while Tesco supplies products directly to end consumers through its network of owned retail stores, Booker is not itself a retailer and has no relationship with end consumers.[1] Booker's customers are predominantly small businesses, including caterers and independent retailers. This means Booker is only indirectly connected to the retail groceries market through its retailer customers. This fundamentally affects the competitive dynamics arising from the Merger.

2.3 As such, the transaction is essentially a vertical merger between two complementary businesses. As today's letter from our CEOs makes clear, there is substantial scope for Tesco and Booker to achieve efficiencies from combining the complementary business activities of Tesco's retail business and Booker's wholesale business, in particular the supply chain and distribution operations of the two businesses. Tesco and Booker are also aiming to achieve significant revenue synergies by utilising the merged entity's skill and expertise to offer improved choice, price and service to Booker's customers.[2]

A. Booker is a wholesaler

2.4 Booker is a **wholesaler** operating cash & carry and delivered services for business customers, rather than end consumers. It is predominantly engaged in the wholesale supply of food and non-food products to a range of catering, retailer and other small businesses.

2.5 Booker operates in a highly competitive and low margin wholesale sector. The diversity of wholesale competitors means that the boundaries of the wholesale market cannot easily be defined. Therefore, Booker runs its business on the basis that all its customers have access to a large number of alternative supply options. This is why Booker has a long established and successful strategy of ✂. This means that Booker's entire corporate strategy, as well as its management infrastructure, is set up to improve continuously choice, price and service to all its customers.

2.6 A ✂ proportion of Booker's customers operate in the catering and small business sector, representing c.✂% to ✂% of Booker's profits. Booker's retailer customers represent the remaining c.✂% to ✂% of Booker's profit. The vast majority of these

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1 With the exception of ✂ Budgens stores owned by Booker and ✂ Budgens store that is operated, but not owned, by Booker. ✂.

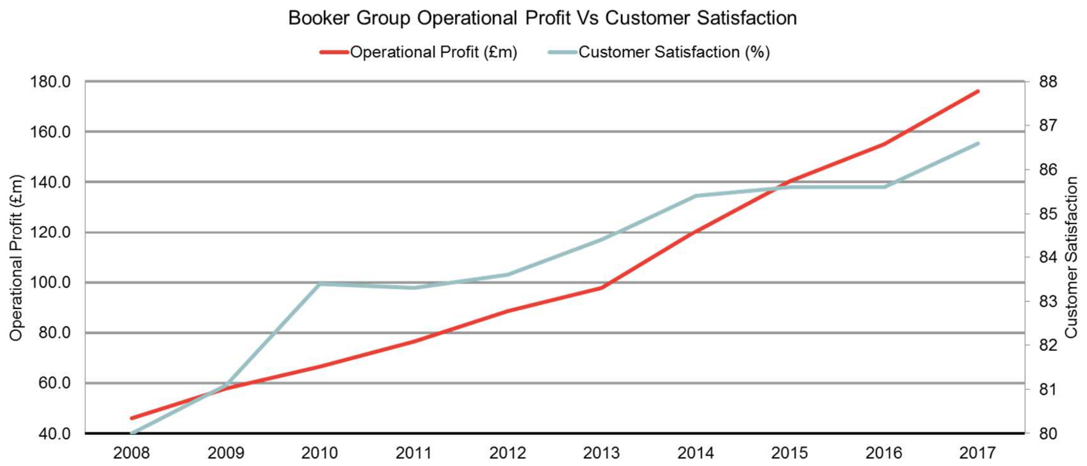
2 These efficiencies and revenue synergies are set out in the Rule 2.7 announcement.

retailer customers are independently owned businesses, with some choosing to operate as members of one of Booker's symbol groups (i.e. Premier, Londis, Family Shopper and Budgens), which together amount to just under 5,500 stores and represent around 50% of Booker's total sales to retailer customers.

2.7 Booker's symbol group offering has grown over time and evolved to become highly flexible. Booker has a history of growing with its symbol group customers. After the acquisition of the Musgrave business in 2015, Booker took a number of measures to loosen the requirements for Budgens symbol stores. Similarly, Booker loosened the requirements initially placed on its Family Shopper customers, as soon as it became evident that giving its symbol group customers greater flexibility allowed them to cater better to the demands of their consumers. Booker aims to retain customers through an attractive wholesale and symbol group services offering, rather than by imposing contractual restrictions on its customer base.

2.8 Booker has grown with its customers. By improving choice, prices and service to its customers, Booker has grown its sales from c.£3 billion in 2007 to c.£5.36 billion in 2017, which has driven its operating profit from c.£46.1 million in 2008 to c.£176.1 million in 2017. This has increased shareholder value by c.£3.5 billion and is testament to serving all customers well.

Figure 1: growth in Booker's operational profit and customer satisfaction since 2008



Source: Booker's annual reports

B. Tesco is a retailer

2.9 Tesco is primarily a UK food **retailer**[3] and also supplies a range of non-food grocery items (e.g. household and health & beauty), as well as general merchandise, clothing and petrol. It supplies its products directly to UK consumers, with the aim of "*serving Britain's shoppers a little better every day*".

2.10 Tesco operates a portfolio of owned grocery stores in different sizes and formats (i.e. Express, Metro, Superstore, Extra and One Stop) and also has a thriving online business. Tesco's retail stores are generally very different to the retailer customers

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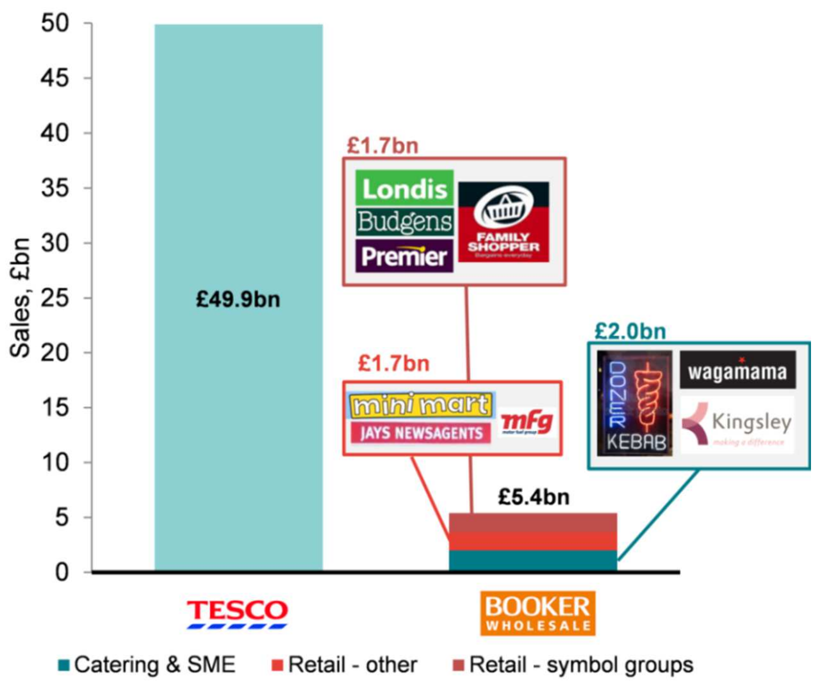
3 Details of Tesco's business outside the UK are provided at paragraph 2.2 of the Merger Notice. Tesco also owns: (i) Tesco Bank; (ii) Tesco Mobile; and (iii) dunnhumby. For an overview and brief history of the Tesco group, please see Tesco PLC's website (in particular, https://www.tescoplc.com/about-us/history/).

served by Booker. These retailer customers are not close competitors of Tesco, as evidenced by Tesco's own competitor tracking which does not feature Booker's symbol group customers.

2.11 Tesco also has a very small franchise business, with c.160 of its One Stop stores (around 15% of One Stop stores) operated by independent retailers. This franchise business is *de minimis* in the context of Tesco's UK activities.[4]

2.12 In the early 2010s, Tesco came under huge pressure from structural changes and was punished by consumers. A new management team was appointed in 2014 and has been focused on implementing a turnaround strategy. This strategy aims to re-focus the Tesco business on what matters for consumers in order to regain competitiveness and rebuild trust, as well as to simplify and improve how Tesco works with its suppliers. Tesco is seeing positive results from this turnaround strategy, including better service, record availability and clearer, lower and more stable prices, as well as improved relationships with suppliers.

Figure 2: Tesco and Booker sales breakdown



Source: Frontier analysis based on Booker's final results for FY 16/17 and Tesco's group sales (excluding VAT and fuel) for FY 16/17. Note: tobacco accounts for a substantial proportion of Booker's total sales (around 30%), of which ✂ comprises excise duty (c.✂% of Booker's tobacco sales). Excluding tobacco, Booker's sales are £✂ to caterers and small businesses, £✂ to symbol retailers and £✂ to other retailers.

4 The CMA concluded during Phase 1 that Tesco's One Stop franchise business poses a very limited constraint on Booker's symbol group offering and as such has ruled out any concerns in relation to this immaterial overlap.

3. The relevant markets in which Tesco and Booker operate

A. A highly competitive wholesale groceries sector

3.1 The UK wholesale groceries sector is dynamic, fragmented and highly competitive.[5] Wholesalers operate a number of different business models, including cash & carry operators, delivered wholesalers, symbol group providers, specialist wholesalers and buying groups. They also serve a broad mix of business customers, including catering businesses, independent retailers, on-trade businesses, small companies and offices.

3.2 The highly competitive nature of the wholesale groceries sector was recognised by the Competition Commission (***CC***) in *Booker / Makro*, where the CC concluded that the merger of Booker and Makro would not lead to a substantial lessening of competition because the merged entity would face sufficient alternatives in the form of national and regional cash & carry operators and delivered operators. The CC's market test in that case confirmed that customers multi-sourced, price was the main driver of demand and customer loyalty was low.

3.3 The CMA has also examined in detail the supply of symbol group services in its *Booker / Musgrave* and *P&H / Costcutter* decisions. There again, the CMA found the market to be competitive and characterised by customers who multi-sourced and would not simply pass through a price rise, but would be prepared to switch to alternatives in the face of any deterioration in the wholesale offer.

3.4 These findings still stand and, if anything, the wholesale sector has become even more competitive since then. For example, IGD's UK grocery & foodservice wholesaling 2017 report states that there has been "*intensifying price competition,* [and] *delivered foodservice wholesalers have continued to focus on narrowing the price/value gap with cash & carry, helping switch customers back to that segment*". Booker faces strong competition from a wide range of players, including cash & carry operators, delivered operators, symbol group providers, specialist regional and local wholesalers, buying groups, third party logistics firms, online operators and manufacturers. The CC noted in its *Booker / Makro* decision that "*delivered operators are likely to be effective alternatives in the wholesale market for most customers in most areas*".[6] Many retailers source their supplies from a mix of cash & carry operators and delivered operators. There is today no such thing as a narrow "cash & carry" market.

3.5 **Figure 3** below provides an overview of the larger UK wholesale competitors, including Bestway, Spar, Nisa, Palmer & Harvey, Costco, Brakes, 3663, Dhamecha and Conviviality. Morrisons has recently announced a long-term wholesale supply arrangement with McColls across the UK, which means it will also provide wholesale services to retailers on a national basis.[7] In addition, given the dynamic and fragmented nature of the wholesale market, there are a large number of regional, local

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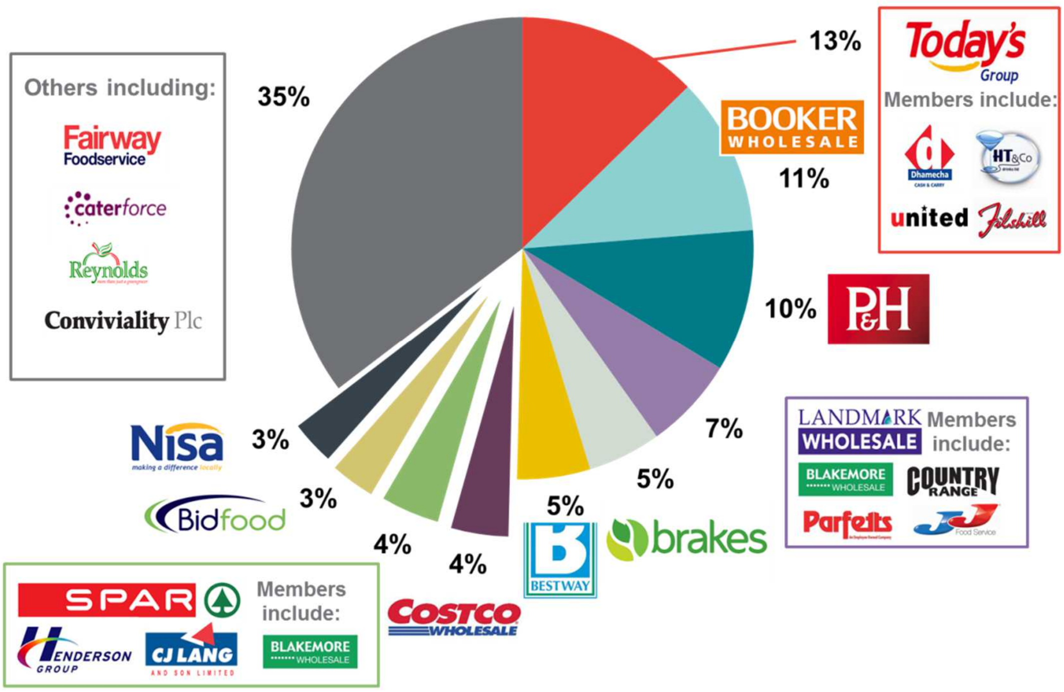
5 As a result of the highly fragmented and differentiated nature of the UK wholesale market and the blurred lines between the various different segments it encompasses, it is difficult to estimate the true size of the UK wholesale market, with estimates varying between approximately £30bn (IGD) and £90bn (UK Government, ONS). One reason for the size of this diverse marketplace often being underestimated is the presence of numerous specialist providers (which are sometimes not reflected in official statistics).

6 See paragraph 8.29 of the final report.

7 http://hsprod.investis.com/ir/mrw/ir.jsp?page=news-item&item=2847848932573184

and specialist wholesalers that are strong and effective competitors and serve a considerable number of wholesale customers. Many of these smaller wholesalers are part of large buying groups, such as Landmark and Today's, which enable them to source products from suppliers on very competitive terms. Distinctions between the different types of wholesale providers are blurred, meaning that overly narrow frames of references (e.g. a frame of reference confined to "wholesale symbol group operators" or "cash & carry wholesalers") do not reflect the true competitive dynamics in the wholesale groceries sector. Therefore, any effective competitor set should include the wide range of strong and credible wholesale players across both the cash & carry and delivered channels,

Figure 3: estimated market shares for larger wholesaler players



Source: Frontier analysis based on IGD and annual reports. Based on a total wholesale market size of £44.9 billion. Note: Spar, Landmark Wholesale and Today's Group are buying / marketing groups and consist of a number of member wholesalers.

3.6 Caterers, retailers and small businesses are typically highly informed, price sensitive and professional buyers. They are business owners whose livelihoods depend on how and what they buy. They multi-source from a wide range of wholesale suppliers across different channels and are willing to travel considerable distances and utilise delivery services to benefit from the best wholesale terms.

3.7 This approach to purchasing is driven by the fact that wholesale customers operate in highly competitive downstream markets, in particular in catering and retail. With the convenience market growing ever more competitive, independent retailers remain as focused as ever on price. Not only do they demand more competitive prices, they also want better fresh product lines, more choice and improved delivery services from their wholesalers, and will switch wholesalers to get it. These customers can be fully expected to react and seek a more competitive source of supply if the merged entity were to deteriorate Booker's offer.

Supply of symbol group services

3.8 There are a variety of business models available to independent retailers seeking competitive wholesale supply arrangements. These range from operating under a more centrally controlled franchise model, affiliating with a symbol group[8] or operating as an unaffiliated independent retailer. Under each business model, retail grocery stores are owned and operated by independent retailers:

(a) A franchise model (such as the model adopted by One Stop and WHSmith) is typically less flexible than a symbol group model, with the franchisor exercising greater control over the overall retail proposition of the independent retailer (for example, specified store layouts, higher levels of capital investment and higher purchasing commitments). This is primarily to ensure that franchisees provide a consistent shopping experience and standard of service to their consumers to protect the relevant brand. A tighter franchise model often appeals to independent retailers that would prefer a greater degree of central oversight to minimise the administrative burdens in running their businesses.

(b) In contrast, a symbol group model is considerably more flexible. Symbol group retailers typically remain free to determine their own commercial strategy and overall retail proposition. This flexibility is, in large part, a result of the historical development of the symbol group model. Symbol groups have evolved from a variety of backgrounds. For example, Premier grew from its origins as a cash & carry wholesaler, whilst other symbol groups were initially established as buying groups for independent retailers (e.g. Nisa). Others entered the UK through international expansion, notably Spar and 7-Eleven. There is, therefore, no single symbol group model and no clearly defined standalone symbol group market. Symbol group retailers source a considerable proportion of their purchases from competing wholesalers. As confirmed by the CMA in its review of the *Booker / Musgrave* transaction, Booker operates a highly flexible symbol group model in which its c.3,300 Premier retailers and c.1,850 Londis retailers have a high degree of autonomy and control in how they run their businesses. Since then, Booker's customers have benefited from even more flexibility and this has been welcomed by customers, driving growth for them and for Booker.[9]

3.9 As recognised by the CMA in *Booker / Musgrave*,[10] there is strong competition for the supply of symbol group services among a wide range of players. There are several wholesalers offering symbol group services on a national basis (e.g. Nisa, Best-One,

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8 Symbol groups offer retailers the ability to retain their independence, whilst receiving additional support through nationally / regionally recognised fascia, promotional packages that would have been difficult to obtain as an individual retailer and supporting services. The fascia, marketing materials and (end consumer) promotional packages that symbol group retailers receive broaden their ability to reach new consumers.

9 The history and size of Budgens symbol stores means they used to operate on a tighter model (dating from their time as part of Musgrave). Since the acquisition of the Budgens business, Booker has sought to improve the Budgens model by providing Budgens retailers with greater freedom and flexibility, thereby creating a far simpler proposition than the former highly controlled Musgrave franchise model.

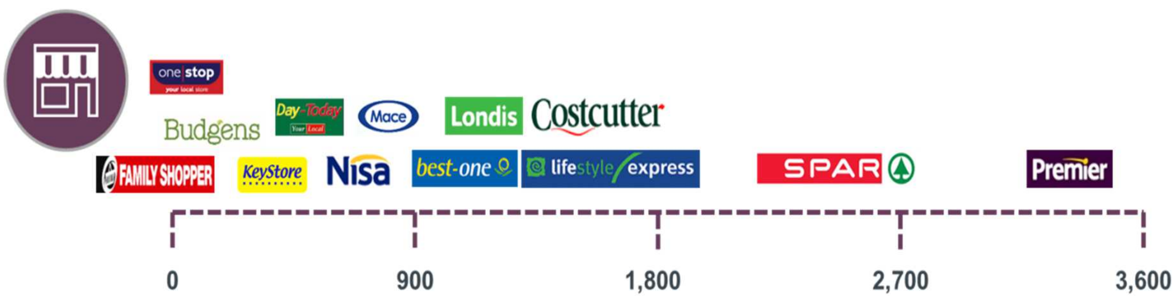
10 See paragraphs 54 to 56 of the CMA's *Booker / Musgrave* Phase 1 decision.

Costcutter, Spar and Lifestyle Express) and many other wholesalers offering symbol group services on a regional basis (e.g. Today's and Key Store). All independent retailers therefore have multiple options should they wish to be part of a symbol group (see **Figure 4** below), with rival providers operating in all regions of the UK.

3.10 The CMA concluded in its Phase 1 decision that four of these providers (Costcutter, Spar, Nisa and Best-one) would qualify as "effective competitors".[11] It excluded Lifestyle Express, Today's and Key Store from the effective competitor set on a conservative basis.[12] We disagree with this approach and consider that all of these providers are strong and viable alternatives for symbol group retailers. In addition, any analysis of competitive dynamics has to take into account that symbol group retailers do not depend on the provision of these symbol group services. Retailers can (and frequently do) decide to run their stores without affiliating to a symbol group.

3.11 More importantly, ✂% of Booker's symbol group customers are located within 30 miles of *at least five* other competing symbol group stores – and ✂% are within this distance for *at least three* alternatives to Booker. This implies that <u>all</u> of Booker's symbol group customers have the option of switching to multiple symbol group providers. Given the availability of these alternatives, it is not surprising that the CMA concluded in its Phase I market test that: "*the majority of symbol group retailers indicated that, if faced with a 5% price increase, they would switch fascia*".[13] Against this backdrop, the Decision's filtering approach is excessively conservative, as it does not adequately recognise the competitive dynamics of the market. Indeed, for the reasons set out below, Tesco and Booker do not consider that <u>any</u> filtering exercise is appropriate in this case.

Figure 4: comparison of symbol group and franchise fascia by store numbers



Source: Frontier analysis

B. A highly competitive retail groceries sector

3.12 The total size of the UK retail groceries (food) sector is estimated to be worth £179 billion.[14] The sector is highly competitive: a multitude of players with different strengths and business models are active both nationally and locally. The multiples, including Tesco, have come under significant pressure in recent years, particularly from Aldi and Lidl, who have more than doubled their combined market share since

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11 See paragraph 89 of the Decision.

12 See paragraphs 90 to 91 of the Decision.

13 See paragraph 154 of the Decision.

14 IGD.

2010. Meanwhile some of the fastest growth has come from smaller players and newer models, including online players (such as Amazon and Ocado).

3.13 Consumer habits are changing. Growth has shifted away from big baskets and one-stop shops in large stores and towards an increasingly fragmented mix of alternatives. This has driven growth in the convenience segment and other formats (e.g. online and discounters), whilst supermarket sales have remained flat. The share of the UK retail groceries sector accounted for by large stores is expected to fall to almost half by 2021, down from 67% in 2010.

3.14 The convenience segment is growing. Made up of a diverse range of players, including multiples, co-operatives, discounters, independents, symbol stores and petrol forecourts, there has been an overall rise in convenience missions, as well as strong growth of 'food to go' and 'top up' missions. The convenience segment has grown at over 4.5% per year since 2010 and this growth is expected to continue, with a 17.7% increase in spending at convenience stores over the next five years.[15]

3.15 In response to these trends, a number of players have significantly expanded:

(a) the Co-operative Group has acquired or opened a number of convenience stores over the last three years and now owns the highest number of convenience stores in the UK (more than Tesco), with nearly 3,000 stores;

(b) McColls has significantly increased its number of convenience stores (now operating over 1,000 convenience stores). As a result, the CMA has accepted that it is an "effective competitor";[16]

(c) Spar's UK retail sales have grown by 8.5% over the last year and it is now the largest forecourt retailer in the UK, with over 1,000 petrol forecourts;

(d) an influx of investment in petrol forecourt 'dealers' has resulted in petrol forecourt stores expanding their convenience offer to drive profitable growth. Petrol forecourt sites are now an attractive proposition for convenience retailers, as evidenced by the wide range of players expanding in this space (e.g. the Co-operative Group, M&S, Waitrose and Sainsbury's);

(e) online has been the fastest growing channel since 2010 and is widely forecast to continue as such up to 2021. It is projected that online players will comprise 9% of the UK retail groceries sector in 2021, up from 2.6% in 2010.[17] This channel has seen a multitude of new entrants (e.g. Amazon and Hello Fresh), facilitated by a growth in the use of digital devices for grocery shopping. Amazon, for example, is looking to open grocery stores in the UK to complement its online offering and has recently announced that it will be acquiring Whole Foods (which has nine stores in the UK); and

(f) non-food retailers, such as B&M, Wilkinsons and Poundland, are increasingly active in the sale of grocery products to consumers. For example, B&M has

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[15] The Grocer, *Discounter-driven revolution will see grocery grow 15% by 2022 says IGD*, 6 June 2017.

[16] See paragraph 86 of the Decision.

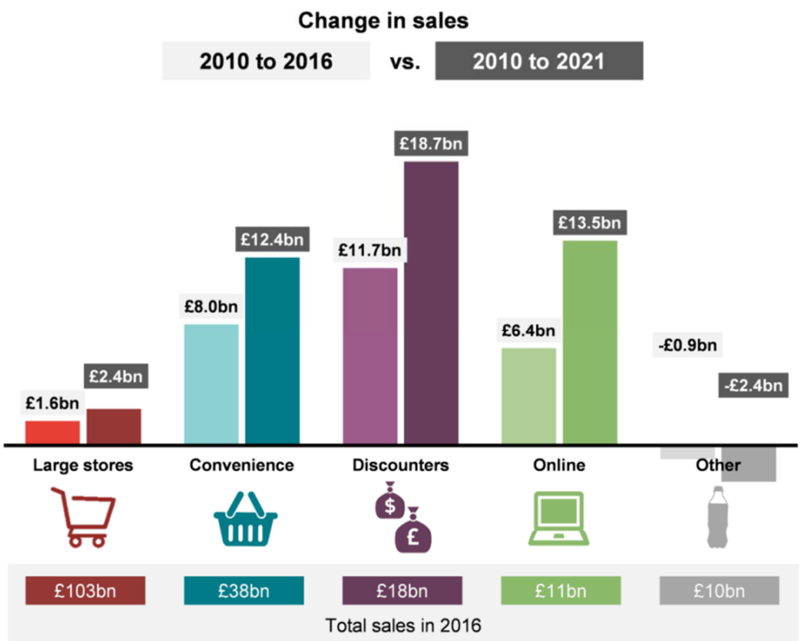
[17] IGD.

recently announced it is acquiring Heron Foods,[18] which is a convenience groceries retailer with a significant presence in the North of England (i.e. over 250 stores with plans to open 10 to 20 stores per year).

3.16 The most transformative development in recent years has been the rise of discounters, in particular Aldi and Lidl. Aldi is now the fifth largest supermarket in the UK, whilst Lidl is shortly expected to overtake Waitrose to become the seventh largest. It is reported that over 70% of consumers now shop at discounters (equivalent to over 20 million households). Retailers across the sector have experienced significant losses in consumers to the discounters. This strong competitive pressure has resulted in the multiples significantly changing their offering to consumers: for example, Tesco introduced its Farm Brands range in direct response to discounter growth. As well as having a significant impact on large retailers, Aldi and Lidl are also adapting their offering to compete more directly with players in the convenience segment.

3.17 The growth of discounters is forecast to continue: Discounters are projected to account for one in every £7 being spent by 2021 and their share of the UK retail groceries sector is expected to reach 13% by 2021.[19] Aldi and Lidl have identified the UK as a priority growth market, with Aldi's UK and Ireland CEO recently stating "*with absolute assurance*" that Aldi "*will be at 1,000 stores well in time for 2022*".[20] Similarly, Lidl's CEO recently commented that Lidl envisages opening 50 to 60 stores every year and is investing £650 million this year and £800 million next year.[21]

Figure 5: growth in the UK grocery market by channel



Source: IGD, UK Country Presentations for 2015 and 2016

[18] http://www.bandmretail.com/~/media/Files/B/BM-Stores/documents/bm-heron-food-acquisition.pdf

[19] The Grocer, *Discounter-driven revolution will see grocery grow 15% by 2022 says IGD*, 6 June 2017.

[20] The Grocer, *Aldi: 'massive opportunity' to quadruple store number*, 11 May 2017. Aldi's CEO for the UK and Ireland also stated that he sees no reason why Aldi could not expand its store estate to around 2,600 stores.

[21] The Grocer, *The big interview: Christian Hartnagel*, 8 July 2017.

3.18 Given the very significant impact that the discounters have had on the business models, PQRS and competitive strategies of retailers across the groceries sector, Tesco and Booker were surprised by the Decision's finding that the discounters should not be considered as "effective competitors". We consider that there is strong evidence (and industry recognition) that Aldi and Lidl (and Iceland which was also excluded) are effective competitors in the UK retail groceries sector and provide a strong and credible offering across all customer missions, including convenience missions.[22]

C. Procurement in the retail and wholesale groceries sectors

3.19 In the groceries sector, procurement is normally organised according to the different product categories offered by the retailer or wholesaler. In most categories, the range will have a mix of branded and own brand products, but the split varies significantly between categories, with packaged categories having a much greater presence of branded goods than fresh, where the majority of products tend to be own brand.

3.20 Supplier structures differ between the various product categories. Within packaged groceries, impulse and drinks categories, there is typically a mix of: (i) large international suppliers offering household brands; (ii) smaller (often national) suppliers offering local, more premium or different types of products; and (iii) own brand suppliers. This mix is key to offering an attractive and diverse range to attract a wide array of customers.

3.21 Within fresh categories, brands have a much more limited presence. Products are typically developed jointly by retailers and suppliers to meet retailer-specific specifications, with range choices largely driven by retailers and innovation driven jointly by retailers and suppliers. For some products, such as dairy, own brand ranges are supported by products of credible branded suppliers. For other products, such as meat and produce, there are fewer credible branded suppliers.

Booker is more focused on the procurement of branded goods

3.22 Booker's sales are weighted towards branded goods in the drinks, impulse and tobacco categories, which are predominantly supplied by globally powerful suppliers. It has more limited fresh sales (especially to its retailer customers).

3.23 As such, when it comes to procurement, Booker is focused on achieving the most efficient sourcing (i.e. finding the products with the best quality/price ratio and which meet the specifications of its catering/on-trade and retail customers). Since Booker is a wholesaler, it cannot guarantee that ranges which its retailer customers choose to stock and support in their stores and as such there are limits as to the level of investment Booker is prepared to make in the upstream supply chain.

Tesco is equally focused on fresh and own brand products

3.24 While it naturally sources a significant volume of branded goods, Tesco's procurement is equally focused on fresh and own brand products, with own brand products representing over half of its food sales. One of the cornerstones of Tesco's

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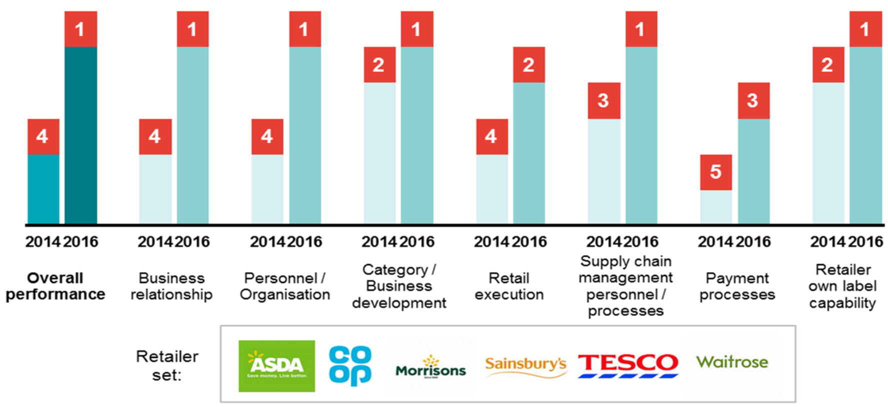
[22] For example, the procurement activities of Aldi, Lidl and Iceland are governed by the Groceries Supply Code of Practice.

commercial strategy is the "customer value equation", which is built around a price guarantee for branded products and a unique offering of fresh and own brand products.[23] Tesco's superior fresh and own brand offering is its key differentiating factor as a retailer (whereas branded goods are available everywhere).

3.25 What this means in practice is that, as well as engaging with branded suppliers, Tesco is as focused on building close and enduring partnerships with primary producers in order to offer an attractive fresh proposition to its consumers. These long-term partnerships achieve this through innovation and increased end-to-end supply chain efficiencies, ultimately to the benefit of Tesco's consumers. This creates a high degree of interdependence between Tesco's success and that of its suppliers. Indeed, relationships with suppliers are one of Tesco's Big 6 KPIs, which are central to assess the overall health of its business.

3.26 Tesco's relationships with its suppliers – which are governed by the Groceries Supply Code of Practice (***GSCOP***)[24] – have improved significantly. This has been an essential part of Tesco's turnaround strategy to regain overall competitiveness and trust, and deliver an improved offer to customers. Suppliers have also acknowledged the improvement: in the 2016 edition of the annual, independently run supplier survey by Advantage, Tesco was rated top overall retailer for the first time since 2011 (see **Figure 6** below).[25]

Figure 6: Tesco supplier relationship improvements - ranking compared to competitors (2014-2016)



Source: Advantage Supplier Survey 2016

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23 Value equation = brand guarantee + unique Tesco offering (page 63 of Tesco's interim results presentation dated 5 October 2016 (https://www.tescoplc.com/media/391670/interim-presentation-2016-17.pdf).

24 This was established with the aim of preventing large retailers from transferring excessive risks and unexpected costs to suppliers. Since her appointment in 2013, the Groceries Code Adjudicator (the ***GCA***) has been active to ensure compliance with GSCOP and has issued a significant body of guidance which further ensures that suppliers are protected against certain supply chain practices by retailers. GSCOP has reached a good level of maturity and is now embedded in Tesco's ways of working with suppliers. The GCA sponsored YouGov supplier survey 2017 shows that the proportion of suppliers who consider that Tesco complies with GSCOP consistently well or mostly is up to 92% (up from 70% in 2015).

25 Tesco ranked 1st in five out seven areas surveyed including 'own label capability', 'category development' and 'business relationship'.

3.27 Taken together, given the relevant markets in which Tesco and Booker operate, this Merger will have a positive impact on business customers, consumers and suppliers. As noted in today's letter from the Tesco and Booker CEOs and described in **Figure 7** below, we consider that they will all benefit from the Merger.

Figure 7: overview of the Merger's benefits for business customers, consumers and suppliers

4. Competitive effects of the Merger

4.1 We recognise that the CMA needs to consider a number of issues in order to assess the potential impact of the Merger on competition, and Tesco and Booker have been open about this throughout Phase 1. The issues have not changed. However, as the CMA accepted in its Phase 1 investigation, the Merger involves the combination of two businesses active at different levels of the supply chain (i.e. a vertical merger) and therefore requires a different approach than that which would apply in a typical "retail-to-retail" merger.

4.2 To address this, the CMA has assessed the extent to which a merged Tesco and Booker would have both the ability and incentive to deteriorate their respective offers in order to generate more profit following the Merger, and whether any such deterioration would have a detrimental effect on competition.

4.3 We agree that this is an appropriate frame of reference, but do not recognise the Decision's theories of harm. Concerns would normally arise only where competitors are foreclosed and this foreclosure itself results in a substantial lessening of competition. The conditions required for this to be a profitable strategy are rarely met in vertical mergers, and they are not in this case given the highly competitive wholesale and retail groceries markets.

4.4 When considering Tesco's and Booker's incentives, we urge the CMA not to lose sight of the rationale underpinning this Merger – which, as set out in today's CEOs' letter (above), is about improving the customer proposition and growing revenue across both the Tesco and Booker businesses. Tesco and Booker have no interest in transferring revenue from one part of the business to another or attempting to construct artificially a less compelling offer in certain local areas in the hope of gaining some hypothetical marginal benefit. Given what a negligible proportion (representing around ✂% of total sales and total operating profit) of the combined business is in the local areas identified as failing the Decision's filters,[26] it makes even less sense to take the huge operational and reputational risks involved in foreclosing the merged entity's own customers. In any event, pursuing such a strategy would be loss-making for the reasons described below.

A. Areas where Booker-supplied symbol stores and Tesco stores are both present

Deterioration of Booker's wholesale offering to symbol group customers

4.5 In respect of Booker, the CMA is required to assess whether there will be all of: (i) an ability to worsen Booker's wholesale offering to symbol group customers who, in turn, will worsen their retail offering in order to benefit Tesco's retail business; (ii) an incentive to do so; and (iii) whether this will result in an anti-competitive effect. These three questions are addressed in turn below, leading to the conclusion that the merged entity would not have the ability, incentive or effect of foreclosing Booker's symbol group customers as hypothesised by this theory of harm.

4.6 It should be stressed that Booker has a history of growing with its customers, reacting to improve customer satisfaction and facilitating customer choice. It is Booker's strategy of focusing on better choice, price and service for its customers that has resulted in increased profits for Booker and increased value for its shareholders. This will be the wholesale business model that the merged entity will continue to follow post-merger.

(i) Would it make commercial sense for the merged entity to adopt a novel strategy whereby it would seek to foreclose its own symbol group customers with a view to diverting sales to Tesco?

4.7 This theory of harm is based on an assumption that the merged entity would develop a novel wholesale strategy involving <u>all</u> of the following:

(a) identify certain areas where its customers: (i) have limited alternatives at the wholesale level; (ii) face limited competition at the retail level; and (iii) face a Tesco store which could attract a high number of consumers at Booker-supplied symbol stores;

(b) target a localised deterioration in Booker's offer to these customers only;

(c) ensure that Booker's symbol group customers would not simply choose to buy more elsewhere in response to deterioration of Booker's offering; and

(d) compel Booker's symbol group customers to pass-through this unilateral wholesale deterioration to end consumers.

4.8 Booker does not design its wholesale offer to target or flex according to local competitive conditions. This is not to say that Booker offers an entirely uniform national proposition across all of its cash & carry business centres. Indeed, no two Booker business centres are identical. These variations are focused on better serving the needs of local customers (with the aim of maximising customer satisfaction). This

[26] This is based on the areas identified by the CMA as failing the Decision's filters for Theories of Harm 1 to 3.

can vary across business centres, for example due to differences in the mix of caterer and retailer customers using the business centre. As such, customers might perceive differences in the configuration of individual business centres. However, the **vast majority of Booker's decisions on pricing, ranging and service are set nationally**.

4.9 Moreover, there are too many conditions that have to fall into place <u>at the same time</u> for this theory to support the "balance of probabilities" threshold at Phase 2. These conditions run counter to the evidence and would require the CMA to view the wholesale and retail groceries markets in a way that is contrary to all of its previous decisions. In particular:

(a) Booker's symbol group customers are independent retailers and it would not make commercial sense for the merged entity to seek to foreclose its own symbol group customers in a way that could cause material diversion of end consumers away from Booker-supplied symbol stores to competing retailers. In *Booker / Musgrave*, the CMA concluded that Booker does not have the ability to do so. This reflects the fact that **Booker does not generally exercise any meaningful degree of control over its symbol group retailers**. This is reflected in the ✂ placed on Premier customers and Booker's decision to move Londis and Budgens customers onto a more simplistic and flexible model (aligned with the Premier model) following the acquisition of those symbol group operations from Musgrave.[27]

(b) The theory of harm requires the merged entity to devise a novel and bespoke strategy to deteriorate Booker's offering in targeted local areas (i.e. to discriminate between Booker's symbol group customers and target only those customers identified at paragraph 4.7(a) above). This would involve a fundamental change to Booker's business model, be impractical and entail significant costs and investment in a strategy that would inevitably result in reputational damage to the merged entity.

4.10 Moreover, Booker's symbol group customers would easily be able to defeat any unilateral worsening of Booker's offering by switching at the wholesale level. Given the highly competitive nature of the wholesale groceries sector (see **Section 3A** above), Booker is significantly constrained by its symbol group customers' ability to shop around, both incrementally with other wholesalers (i.e. switching a proportion of wholesale purchases) and by switching fascia to a rival symbol group provider:

(a) The CMA's market test confirmed that the **majority of customers would switch symbol group provider** if faced with a price rise and any switching costs would be low.[28]

(b) Booker's customers have **several options to switch fascia**: as the CMA found in *Booker / Musgrave*, there is strong competition among a wide range of providers. For example, over ✂% of Booker's symbol group customers

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[27] The operation of Budgens stores has also been aligned with Booker's wider commercial strategic objectives insofar as the holding of leases is concerned. ✂

[28] See paragraphs 153 to 154 of the Decision. The fact that there has been limited switching away from Booker recently is a function of the success and attractiveness of Booker's offer. If this were to change, switching would increase.

identified as failing the Decision's excessively conservative filters in fact have three or more competing symbol stores located within ten miles and ✂ of them have at least one. This indicates that all of these Booker-supplied symbol stores would have alternative symbol group providers to which they could switch. Every region also has a number of delivered wholesalers available.

(c) There is extensive evidence that Booker's symbol group customers **multi-source from a wide range of wholesalers and frequently switch significant purchasing volumes between wholesalers** in order to obtain the most attractive wholesale offer (which is consistent with the CC's findings in *Booker / Makro*).[29] Even if the merged entity enforced minimum purchasing requirements, Booker's customers could source c.✂% to ✂% of their supplies from rival wholesalers, which is sufficient to discipline the merged entity.

(d) Booker's symbol group customers operate in highly competitive retail markets and face further pressures from a range of factors, including rent, utilities and the living wage. Their personal business success depends on their ability to source the best wholesale offering and remain competitive. Booker's symbol group customers would therefore have every incentive to source from other wholesalers if the merged entity unilaterally deteriorated Booker's offering.

4.11 In the already unlikely scenario where Booker's symbol group customers have accepted a worsened wholesale offer from Booker without looking for alternative wholesale suppliers, the theory of harm requires Booker's symbol group customers to pass-through the worsened wholesale offering to their end consumers. **Booker lacks the ability to require its customers to pass through a unilateral wholesale deterioration** and has no expectation that they will do so. Given the highly competitive nature of retail groceries markets, Booker's symbol group customers would likely do everything in their power to prevent losing consumers to competing retailers by not passing-through any unilateral wholesale deterioration.

4.12 Therefore, it would not make commercial sense for the merged entity to attempt to foreclose some of its own specific symbol group customers with a view to diverting retail sales to Tesco.

(ii) Would the merged entity have the incentive to deteriorate the retail offering of Booker's symbol group customers?

4.13 Booker's symbol group customers account for approximately ✂% of Booker's total sales to retailer customers and ✂% of Booker's overall profit. **The 369 local areas identified in the Decision (on the basis of excessively conservative filters) represent only ✂ of Booker's total sales and operating profit**, namely c.✂% of sales and c.✂% of operating profit. Even based on the highly unlikely hypothesis that a discriminatory deterioration of Booker's offering would result in 100% of consumers at the targeted symbol group customers diverting to Tesco, there would still be no incentive to pursue such a discriminatory strategy. In particular, it would be commercially unviable

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[29] See paragraphs 8.5, 8.11, 8.13 and 8.17 and Table 3 of the final report. The approach taken in the Decision risks materially contradicting the CC's findings in *Booker / Makro*.

(a) Booker's symbol group customers are commercially-minded retailers, so it would quickly become apparent that certain customers were being offered different terms based solely on their location and their local competitive environment. Indeed, Booker's customers often shop at different Booker cash & carry business centres and a number of them operate multiple premises or have friends and relatives who also operate symbol stores.

(b) A discriminatory strategy would therefore **fundamentally damage the trust and reputation that Booker has worked hard to establish over many years with its symbol group customers** and cause irreparable damage to the merged entity. Its impact would be much wider than the small group of customers targeted with any worsened offering and, at the very least, would present a real risk of a loss of profit in the long term.

(c) These significant risks (and the operational costs involved) would not be offset by the minimal theoretical gains of pursuing any such strategy, even if 100% of consumers diverted from Booker-supplied symbol stores to Tesco stores.

4.14 In any case, there would be no guarantee that end consumers would switch in sufficient volumes, nor that they would choose to switch to Tesco. There are a wide range of other retailers that they could switch to, including many not included in the CMA's unduly narrow "effective competitor" set (e.g. Aldi, Lidl, Iceland, unaffiliated independents, certain symbol stores and petrol forecourts). Moreover, consumers are likely to perceive that other symbol stores, petrol forecourt retailers and unaffiliated independents are closer alternatives to Booker-supplied symbol stores than are Tesco stores. Therefore, consumer diversion from Booker-supplied symbol stores to Tesco stores would likely be low.

(iii) Conclusion

4.15 Deteriorating Booker's offer would not be profitable and there would be no incentive to engage in such a strategy. The parties' economic analysis (i.e. the vertical GUPPI framework) demonstrates why any attempt to raise wholesale prices in order to recoup sales at the retail level would not be profitable.[30] This is a function of all the factors described above and shows that unfeasibly high diversion ratios (i.e. well above 100%) would be required to render any price rise profitable. As such, pursuing the discriminatory strategies envisaged by this theory of harm could never be profitable and would be commercially illogical.[31]

4.16 In contrast, the Decision has been able to identify a competitive concern – and even then only in a small number of areas – only by adopting highly conservative assumptions. These include assumptions that: (i) the merged entity would have the incentive to deteriorate Booker's wholesale offering in a small number of local areas; (ii) the catchment size for symbol group providers does not include all areas where they currently deliver symbol group services; (iii) Booker's symbol group customers

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[30] See Frontier's paper on post-merger pricing incentives in retail-to-wholesale mergers dated 7 March 2017. This was provided to the CMA at Appendix 9.A to the Merger Notice.

[31] This is based on a 10% GUPPI threshold, which Tesco and Booker consider to be the appropriate threshold for a Phase 2 inquiry (in line with previous CMA Phase 2 inquiries, such as *Ladbrokes plc / Gala Coral Group Limited*).

purchase 100% of their requirements from Booker (and do not frequently multi-source from a range of wholesalers); (iv) pass-through by Booker's symbol group customers is likely to be over 80%; and (v) the effective competitor set in the retail groceries sector does not include Aldi, Lidl and Iceland.[32]

4.17 We do not think that these assumptions reflect the market reality individually let alone collectively. Given this, and the fact that deteriorating Booker's offering goes entirely against how Booker has increased customer satisfaction and sales as well as the deal rationale, the concern is a hypothetical one only and there can be no substantial lessening of competition as a result of this theory of harm.

Deterioration of Tesco's retail offering

4.18 The CMA is required to assess whether the merged entity will have an ability and an incentive to worsen Tesco's retail offering in order to benefit Booker's wholesale business, and whether there could be a negative effect on competition. Similar questions arise as in relation to the previous theory of harm. Examining each in turn leads to the conclusion that the merged entity would not have the ability and incentive to deteriorate Tesco's retail offering and therefore there could be no substantial lessening of competition.

(i) What would the merged entity need to do to deteriorate Tesco's retail offer?

4.19 This theory of harm would require the merged entity to engage in bespoke strategies in targeted local areas where there is perceived to be "less" competition in order to drive switching to Booker-supplied symbol stores and increase Booker's wholesale sales. This is entirely at odds with Tesco's business model. The commercial reality is that the merged entity would not even consider engaging in such a strategy due to the likely loss of sales to Tesco's primary competitors (i.e. the multiples and discounters), the significant reputational risks involved and the fact that such a strategy would be loss-making in practice.

4.20 **Tesco determines its PQRS nationally** and there is no incentive to deviate from this:

(a) It would involve high operational complexity, significant costs and reputational risks. In particular, introducing local variations of sufficient magnitude to attempt to drive switching would undermine the Tesco brand and allow Tesco's primary competitors (i.e. the multiples and discounters) to target Tesco through price-led national advertising campaigns. It would expose Tesco to complaints from consumers that its offering is a "postcode lottery" and would damage Tesco's brand integrity. This would almost certainly outweigh any theoretical benefits: for example, Tesco's sales at its stores located in the 64 areas identified in the Decision (on the basis of excessively conservative filters) comprise only ✂% of its total retail sales and ✂% of its total operating profit.

(b) Tesco already operates in areas with varying levels of local competition and does not vary its offer locally. There is no reason to consider that this would differ post-merger.

[32] See paragraphs 137, 91, 116(a), 142 and 86(a) of the Decision for each of these assumptions.

(ii) Would the merged entity have an incentive to deteriorate Tesco's retail offer?

4.21 The merged entity would have an incentive to do this only if it would be profitable. This would require sufficient consumers to switch to Booker-supplied symbol stores and for these retailers to increase their wholesale purchases from Booker (as a result of the incremental sales from these customers). However, consumers would be more likely to switch to Tesco's primary competitors.

4.22 **Tesco's primary competitors are the multiples and discounters**, in particular ✂. These competitors exert a much greater competitive constraint on Tesco than do Booker-supplied symbol stores:

(a) Competition from Tesco's primary competitors is what influences Tesco's PQRS (which is determined nationally), and that will not change post-merger.

(b) The discounters have had a transformative impact on the retail groceries sector and continue to grow rapidly (see **Section 3B** above). Their strong competitive pressure has resulted in Tesco (and other retailers) significantly changing their offering to consumers.

(c) As such, the majority of any diverted sales would more likely be re-captured by other multiples and the discounters (rather than Booker-supplied symbol stores). Tesco stores and Booker-supplied symbol stores are not close competitors, so any consumer diversion from Tesco stores to Booker-supplied symbol stores would likely be very low.

4.23 Even in areas where no other retailer is present, this theory of harm makes no commercial sense, as **the merged entity would lose money overall**:

(a) Booker cannot guarantee it would receive any benefit as a result of this strategy. The primary beneficiary of any sales that divert to Booker-supplied symbol stores would be the independent retailers (which capture the retail margin on such sales), and not Booker (which only stands to gain a lower wholesale margin on such sales);

(b) even if retailers did increase their wholesale purchases, a material share of any sales diverting from Tesco to Booker-supplied symbol stores would not be captured by Booker. As noted above, Booker-supplied symbol stores purchase a considerable proportion of their purchases from other wholesalers; and

(c) even then, the loss of retail margin associated with diverted Tesco sales would be much higher than any theoretical gain of wholesale margin at the Booker wholesale level. Given the substantial fixed costs of running a retail store and the low variable margins earned, a loss of sales volume can make the difference between whether or not a store covers its fixed costs (i.e. whether or not the store is profitable) – this makes any strategy envisaged by this theory of harm even more commercially unviable.

4.24 All of this means that such a strategy would not be profitable: **the merged entity would be sacrificing Tesco's higher retail margin to re-capture diluted profits at Booker's much lower wholesale margin**. This is demonstrated by **Figure 8** below, which shows that such a strategy would not be profitable even if 100% of Tesco's consumers diverted to Booker-supplied symbol stores in a given area.[33]

Figure 8: illustration of why a Tesco deterioration would not be profitable even assuming 100% diversion ratios

✂

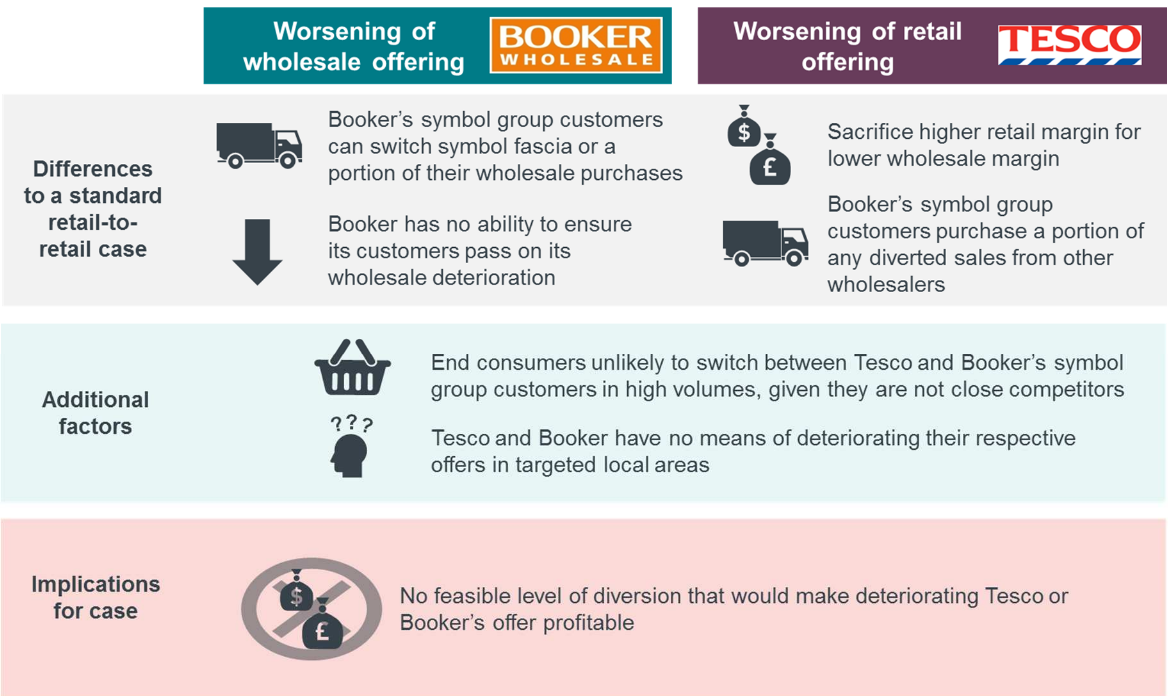
Source: Frontier analysis

(iii) Conclusion

4.25 The fundamental difference between this Merger and a retail-to-retail merger is that the merged entity does not have control over, or the ability to internalise, **all key elements of the equation necessary to make a deterioration profitable in the way that it hypothetically could in a retail-to-retail merger**. This is illustrated in **Figure 9** below.

4.26 Given the lack of ability and incentive to engage in local pricing, the lack of closeness of competition between Tesco stores and Booker-supplied symbol stores and the highly competitive nature of retail groceries markets, the merged entity would have at most limited ability and no incentive to deteriorate Tesco's retail offering. As such, there can be no substantial lessening of competition as a result of this theory of harm, and a local filtering exercise is not necessary.

Figure 9: summary of why this Merger is different from a standard retail-to-retail merger



[33] See Frontier's paper on post-merger pricing incentives in retail-to-wholesale mergers dated 7 March 2017. This was provided to the CMA at Appendix 9.A to the Merger Notice.

B. Booker also supplies independent customers active in the same areas as Booker-supplied symbol stores and Tesco stores

4.27 The Decision has raised the possibility of the Merger giving rise to competition concerns as a result of the foreclosure of independent retailers. However, this theory of harm is implausible, as the **merged entity lacks any ability to worsen the retail offering of independent retailers**. The reasons are similar to those set out for the theory of harm relating to a deterioration of Booker's offering to its symbol group customers, although the theory of harm is even more implausible because:

(a) Independent retailers widely multi-source and use Booker for only a small proportion of their purchases (c.✂% on average). Even the independent retailers identified under the Decision's excessively conservative filters purchase an insignificant proportion of their purchases from Booker (less than ✂% on average). Most independent retailers clearly have no dependence on Booker.

(b) Given the highly competitive nature of the wholesale groceries market (see **Section 3A** above), there are a plethora of alternative wholesale supply options for all independent retailers currently sourcing supplies from Booker. The CMA risks materially contradicting the CC's findings in *Booker / Makro* if it considers otherwise.

(c) The merged entity does not even have a hypothetical ability to exert more influence over the retail offering of independent retailers. There is no mechanism though which it could seek to do so.

4.28 Moreover, **the merged entity will have no incentive to deteriorate Booker's offering in order to foreclose independent retailer customers**:

(a) The merged entity has no incentive to price discriminate against independent retailers that use Booker's cash & carry business centres (as explained above and in line with the CC's findings in *Booker / Makro*).

(b) Nor would it make commercial sense. Even the independent retailers that are captured by the Decision's excessively conservative filters represent a negligible proportion of Booker's customer base and revenues (i.e. less than ✂% of its total annual revenue and less than ✂% of the individual C&C business centre revenue for more than ✂% of Booker's business centres). It would not make commercial sense and would be unprofitable to change Booker's business model and start varying Booker's offering locally in order to target minimal theoretical gains in a small number of local areas – this would be substantially outweighed by the significant costs and reputational damage involved.

(c) In any event, there is highly unlikely to be sufficient consumer diversion from independent retailers to Tesco stores to make any strategy envisaged by this theory of harm profitable. Consumers at independent retailers are likely to consider other independents (as well as symbol stores and petrol forecourts) as closer alternatives than Tesco stores. Given that there are in the region of c.28,000 unaffiliated independents and petrol forecourts located across all areas of the UK,[34] any consumer diversion to Tesco stores is likely to be very low.

C. Foreclosure of Palmer & Harvey

4.29 The Decision has raised the possibility of the Merger giving rise to a realistic prospect of a substantial lessening of competition in the delivered wholesale segment, due to Tesco's alleged ability and incentive to shift wholesale purchases away from Palmer & Harvey post-merger. Tesco considers that such a concern is speculative.

4.30 It is publicly known that P&H has been suffering financial issues for a number of years and has struggled for capital to keep afloat. It is clear that the business is facing a number of ongoing challenges.

4.31 Nonetheless, Tesco has had a long-standing relationship with P&H for the distribution of a variety of products to its stores and over the years P&H has gradually increased the scope of the services provided to Tesco (and One Stop). Tesco considers that P&H provides a good service, has a close relationship with the large tobacco majors[35] and is well placed to offer a combined package of services that Tesco values. As P&H's Managing Director, Martyn Ward, has stated, Tesco's merger with Booker is "*an opportunity rather than a limiter*" for P&H.[36]

4.32 In any event, Tesco considers that the evidence does not support a finding that the Merger could have a negative impact on competition in the wholesale groceries market. The wholesale groceries sector is highly competitive with a number of strong and credible players providing delivered services.

D. Impact of the Merger on suppliers

4.33 The fact that Tesco and Booker share some of the same suppliers and hope to be able to achieve procurement savings as a result of the Merger does not mean that the Merger will have a detrimental impact on the supply base, indirectly on consumers or ultimately on competition. In fact, the opposite is true for the three main reasons outlined below.

(i) Increased incentives to continue working collaboratively with suppliers

4.34 Given the competitiveness of the retail and wholesale groceries markets, Tesco's and Booker's success is intrinsically linked to having thriving suppliers. Having strong suppliers with a mix of household names and innovative and exciting new brands is key for a retailer to satisfy consumer demands.

4.35 Tesco and Booker enjoy good relationships with their suppliers. In particular, Tesco has experienced significant improvements in its relationship with suppliers in the recent past and this has been an essential component of Tesco's strategy to regain overall competitiveness. The Merger will reinforce this, as it will create significant opportunities and benefits for the supplier base through growth (in particular with the

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34 See page 8 of ACS's Local Shop Report 2016.

35 For example, it was announced in April 2016 that two tobacco manufacturers (Imperial Tobacco and JTI) agreed to be guarantors on a loan facility extended to P&H by a syndicate of banks. See: http://www.betterretailing.com/palmer-and-harvey-lending-deal/.

36 Retail News, *Tesco-Booker is a game changer says P&H boss*, 24 February 2017.

expansion into the foodservice segment of the market), improved end-to-end supply chain management and efficiencies. Tesco is therefore unsurprised by the finding in the Decision that suppliers are not concerned about any loss of innovation in grocery supply chains.[37]

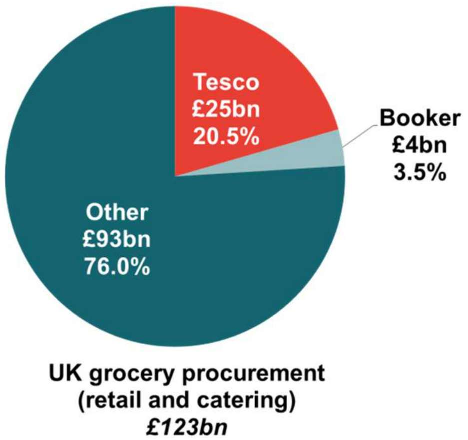
(ii) No substantial increase in buyer power

4.36 The combination of Tesco's and Booker's purchases will not lead to a significant increase in negotiating power vis-à-vis suppliers. The increment in purchases overall will be limited and, in the categories where the increments are larger, suppliers have strong bargaining power themselves.

4.37 One of the main elements of the procurement savings that Tesco and Booker expect to generate from the Merger relates to the ability to more closely align buying terms from suppliers that supply both Tesco and Booker (e.g. by seeking to extend the benefit of more competitive buying terms from one party to another). Given the negotiating power of branded suppliers, the merged entity will be able to achieve the projected procurement savings only by demonstrating to those suppliers that there is a justification for alignment of terms through genuine operational, ranging or logistical efficiencies generated by the Merger. In relation to fresh and grocery categories (and own label suppliers), given the minimal overlaps, the procurement synergies relate to sharing cost savings from working closely with suppliers to increase efficiency throughout the supply chain.

4.38 Tesco purchases approximately £25 billion worth of food and grocery in the UK, while Booker's purchases amount to £4 billion for the retail segment. Total UK grocery procurement amounts to c.£123 billion meaning that the Merger will result in a combined share of 24%, with an increment of 3.5%. The percentage increment is lower on a retail only basis (2.6%) and much lower if tobacco is also excluded (1.3%).

Figure 10: Tesco's and Booker's total purchases as a proportion of all UK grocery procurement (in the retail and catering segments including tobacco)



Source: Frontier analysis. Note: this is a conservative analysis as the source used for market size excludes some catering sales (e.g. alcohol that is not purchased with food).

[37] See paragraph 216 of the Decision.

4.39 A breakdown of the combined purchases into product categories demonstrates that where increments are higher than the total increment, this occurs in categories where suppliers are able to negotiate with retailers as equals:

(a) in fresh and grocery categories, Booker's retail COGS represent a very small increment to Tesco's purchases and no category will see an increment exceeding 3.5%; and

(b) Booker has a larger procurement share of the tobacco, drinks and impulse categories but, even in those categories, the combined procurement shares post-merger do not exceed 35% and only exceed 30% in relation to tobacco and spirits (the latter only when looking at the retail segment separately).

Figure 11: Tesco's and Booker's procurement market shares by product categories in the retail and non-retail segments (using Booker's retail and non-retail COGS)

✂

Source: Frontier analysis

(iii) No realistic prospect of a negative impact on suppliers or consumers

4.40 There is no realistic prospect of a negative impact on competition at the supplier level, as the vast majority of branded suppliers have strong negotiating power and many supply powerful brands which all retailers are expected to stock. Equally, Tesco and Booker will not have an incentive to harm suppliers, hinder innovation or reduce their volumes of purchases, as that would damage the competitive position of Tesco's and Booker's customers at the retail level, where competition is fierce.

4.41 The Merger will not lead to a reduction of competition at the retail level either. There is no credible risk of foreclosure of competing retailers or wholesalers due to the merged entity's hypothetical ability to negotiate more favourable terms from suppliers. The so called "waterbed effect" theory is based on unrealistic assumptions and abstract theories and, as the Competition Commission concluded in 2008, is not compatible with the features of the UK's groceries retail market.[38]

[38] See paragraphs 5.19 to 5.43 of the Competition Commission's Final Report on the Supply of Groceries in the UK market investigation dated 30 April 2008.

PROPOSED MERGER BETWEEN TESCO PLC AND BOOKER GROUP PLC

INITIAL SUBMISSION TO THE CMA FOR PHASE 2 REVIEW

ANNEX 1: RESPONSE TO THEORY OF HARM 1 ON WORSENING OF TESCO'S OR BOOKER'S RETAIL OFFERING IN AREAS WHERE THE PARTIES' OWNED AND OPERATED GROCERY STORES OVERLAP

1. Overview

1.1 Booker is primarily a wholesaler to independent business customers. It has only minimal operations at the retail level through ✂ mid-sized grocery stores and ✂ convenience grocery store owned or operated by Booker under the Budgens fascia.

1.2 These owned stores are legacy stores, which form part of ✂. Booker's business model is (and remains) focused on operating at the wholesale level, rather than owning and operating retail grocery stores. Therefore, there are no meaningful overlaps between Tesco and Booker at the retail level.

2. No competition concerns at a national level

2.1 The Merger will result in a negligible increase in Tesco's national market share for the retail supply of groceries in each of convenience stores and mid-sized stores, given that Booker owns or operates only ✂ convenience store and ✂ mid-sized stores.

2.2 In relation to the mid-size stores segment in particular, the merged entity will continue to face strong competition from major competitors who combined own around 4,000 mid-sized stores and 1,600 one-stop stores.[1] The total retail sales from the ✂ mid-sized Budgens stores were approximately £✂ in the previous 12 months, which equates to approximately ✂% of the total retail sales from all mid-sized and one-stop stores.[2] Therefore, there are no competition concerns at a national level.

3. No competition concerns at a local level under the CMA's standard framework for assessing overlaps between owned retail stores

3.1 The CMA imposed an Initial Enforcement Order (IEO) on 30 May 2017 that applies to the Budgens stores located in Arbury Road, Chingford and Honiton. ✂, the CMA has an established approach from previous decisions for assessing the impact on local competition of overlaps between owned stores in retail-to-retail grocery mergers (i.e. a filtering approach based on a post-merger reduction in fascia from four to three (or fewer)).[3] However, detailed scrutiny of the areas caught by these filters demonstrates that the Merger would not result in a substantial lessening of competition (see below).

3.2 Moreover, the Parties consider that the effective competitor set underpinning this approach should be updated to include Aldi, Lidl and Iceland (see **Annex 7** for further

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[1] This includes stores from Aldi, Asda, Booths, the Co-operative Group, Dunnes, Iceland, Lidl, M&S, Morrisons, Sainsbury's, Supervalu and Waitrose.

[2] This is based on IGD's definition of hypermarkets and supermarkets (as a proxy for the CMA's definition of one-stop stores and mid-sized stores), which reported total retail sales of £103.1 billion in 2016.

[3] For example, *Martin McColl Ltd / Co-operative Group Ltd* (ME/6632/16) and *Netto Limited / Co-operative Group Limited* (ME/6529-15).

detail).[4] In any event, the competitive constraint exerted by Aldi, Lidl and Iceland should be taken into account in any detailed "second stage" analysis of the conditions of competition in each local area.

3.3 According to the CMA's Phase 1 decision referring the Merger for a Phase 2 inquiry (the ***Decision***), only the Budgens stores in ✂ and ✂ fail the filtering approach used by the CMA (out of the ✂ owned Budgens stores overlapping with Tesco stores).[5] The CMA confirmed that there was no realistic prospect of a substantial lessening of competition in the local areas of the other ✂ Budgens stores.[6]

3.4 For the ✂ and ✂ stores, the Parties have set out below maps of the relevant areas and an explanation of why a closer examination of the local competitive dynamics demonstrates that the Merger would not result in a substantial lessening of competition in each of these areas.

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[4] The Decision already recognises that McColls should be included the effective competitor set (see paragraph 86).

[5] See paragraphs 95 and 101 of the Decision. The CMA has excluded a ✂ overlapping store on the basis that the appropriate counterfactual would be that the store would have exited.

[6] See paragraph 103 of the Decision.

Figure 1: ✂ (mid-sized Budgens store with one mile, five minute and ten minute catchments)

✂

3.5 The Budgens is a mid-sized store (***MSS***) in an urban area and as such is constrained by:

(a) other MSS within a 5 minute drive time; and

(b) one-stop stores (***OSS***) within a 10 minute drive time.[7]

3.6 There are two OSS Sainsbury's stores within a 10 minute drive time, as well as one OSS Asda store and two OSS Tesco stores.

3.7 When including Iceland and Aldi in the effective competitor set, the Budgens is further constrained by two further MSS within 5 minutes. As such, the Merger would result in a fascia reduction from 6 to 5 on the basis of an appropriate effective competitor set that includes Aldi, Lidl and Iceland.

3.8 The Aldi and the Iceland are adjacent to one another, providing customers with strong alternative options to the Budgens within close proximity. The Aldi, in particular, is large (approximately 16,000 square feet in total) with a strong fresh and ambient offer - approximately 40% of the Aldi is dedicated to fresh food and 60% to ambient groceries.[8] The Aldi has a large car park that can accommodate 35 to 40 cars, while the Iceland can accommodate 20 cars.[9] Therefore, the Aldi and Iceland stores have a strong offering and are effective competitors to the Budgens store.

Figure 2: Aldi and Iceland in ✂

✂

3.9 Moreover, there are several convenience stores located in close proximity to the Budgens store, including four Co-op stores, one of which is on the same road as the Budgens store. There are also two Mace stores and two Spar stores within 1 mile of the Budgens store.

3.10 This means that any consumer diversion between the Budgens store and the Tesco stores would not be sufficiently high to result in a substantial lessening of competition in this area.

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7 See paragraph 46 of the Decision.

8 Booker field research.

9 Booker field research.

Figure 3: ✂ (convenience Budgens with one mile, five minute and ten minute catchments)

✂

3.11 The Budgens in ✂ is a convenience store and is therefore constrained by other convenience stores, MSS and OSS.

3.12 Closer scrutiny of the local area demonstrates that the Budgens store would continue to face strong competition from at least five competing fascia (when including Aldi, Lidl and Iceland in the effective competitor set). In particular:

(a) the Budgens store is situated on the same high-street as a mid-sized Co-op and a mid-sized Iceland (which are likely to capture most of the diversion from the Budgens store given their proximity and size); and

(b) the overlapping Tesco Superstore is situated about a mile to the West of the town, with an Aldi, a Lidl and a Spar located nearby (on the same road as the Budgens store and closer than the Tesco Superstore). The Aldi and Lidl are both mid-sized stores with 25% of their space dedicated to fresh food and 60% to ambient groceries (similar to the Tesco). Both have car parks for 30 to 35 cars.[10] Owing to their proximity and size, these stores are strong competitors and will likely attract a greater proportion of any consumers diverting away from the Budgens store compared to the Tesco store.

3.13 It is highly implausible that:

(a) Tesco would risk revenue from a Tesco Superstore to drive sales to a small Budgens store, especially given that there is an Aldi and a Lidl much closer, which constrain the Tesco store and would capture the bulk of the diverted sales; and

(b) the smaller Budgens store could accommodate the increased demand from diverted sales from the Tesco Superstore given the volumes likely to be involved.

3.14 Therefore, any consumer diversion between the Budgens store and the Tesco store would not be sufficiently high to result in a substantial lessening of competition in this area.

Figure 4: Iceland, Aldi and Lidl in ✂

✂

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[10] Booker field research.

PROPOSED MERGER BETWEEN TESCO PLC AND BOOKER GROUP PLC

INITIAL SUBMISSION TO THE CMA FOR PHASE 2 REVIEW

ANNEX 2: RESPONSE TO THEORY OF HARM 2 ON WORSENING OF TESCO'S RETAIL OFFERING IN AREAS WHERE TESCO'S OWNED STORES OVERLAP WITH BOOKER'S SYMBOL GROUP STORES

1. Introduction and summary

1.1 As part of its Phase 1 assessment, the CMA examined local overlaps between around 3,500 Tesco stores and 5,500 Booker-supplied symbol stores. The CMA concluded in its Phase 1 decision referring the Merger for a Phase 2 inquiry (the ***Decision***) that there is a reasonable prospect that the merged entity will have the ability and incentive to worsen the Tesco retail offering in 64 local areas (accounting for less than 2% of Tesco's stores) with the effect of substantially lessening competition.[1]

1.2 The Parties consider that this theory of harm is counter-intuitive and would not be profitable to implement. This is for three main reasons.

1.3 First, the merged entity would have no incentive in any local area to deteriorate Tesco's retail offering in order to benefit the Booker wholesale business. Any such strategy would be loss-making due to the "double dilution" of any sales re-captured by Booker (see **Section 2** below):

(a) such a strategy involves sacrificing a higher retail gross margin (in the region of ✂) on Tesco's sales in favour of a significantly lower wholesale gross margin (in the region of ✂[2]) on Booker's sales; and

(b) only a proportion of sales diverting from Tesco to Booker-supplied symbol stores would be re-captured by Booker, given that Booker's symbol group customers purchase ✂ of their requirements from Booker (✂).[3]

The result of this "double dilution" is that there is no feasible level of consumer diversion from Tesco to Booker-supplied symbol stores at which the merged entity would have the incentive to deteriorate Tesco's retail offering. This is underpinned by the Parties' vertical GUPPI analysis,[4] which is robust to a range of reasonable assumptions and supports the conclusion that any strategy based on deteriorating Tesco's retail offering post-merger would not be profitable. In particular, the critical diversion ratios necessary to make such a strategy profitable are not plausible (i.e. they materially exceed 100%). This means that a local overlaps analysis is not required for this Merger, as no amount of factual investigation would be able to uncover problematic levels of diversion from Tesco stores to Booker-supplied symbol stores.

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[1] See paragraphs 120 and 121 of the Decision.

[2] ✂

[3] See Section 2C of **Annex 3** on the Parties' response to Theory of Harm 3.

[4] See **Annex 9.1** to the Merger Notice and **Appendix 9.A** to the Merger Notice for Frontier's technical paper on *Post-merger pricing incentives in retail-to-wholesale mergers* submitted to the CMA on 7 March 2017.

1.4 Second, the fact that Tesco stores are not close competitors to Booker-supplied symbol stores means that any consumer diversion from Tesco stores to Booker-supplied symbol stores is likely to be low (see **Section 3** below). In particular:

(a) Tesco's main competitors are the multiples and the discounters. If the merged entity deteriorates Tesco's retail offering, any consumers at Tesco stores that divert to competing retailers would divert primarily to Tesco's main competitors, including Aldi, Lidl and Iceland (which are not, but should be, included in the Decision's effective competitor set); and

(b) a proportion of consumers would likely divert to other retailers that are not included in the Decision's effective competitor set, such as certain symbol stores, petrol forecourt retailers and unaffiliated independents.

Therefore, it is implausible that consumer diversion from Tesco stores to Booker-supplied symbol stores could ever reach a level that would make it profitable for the merged entity to deteriorate Tesco's retail offering.

1.5 Third, the merged entity would have limited ability and no incentive to deviate from Tesco's nationally defined retail proposition (see **Section 4** below). The merged entity would need to devise a novel and bespoke localised strategy to exploit the hypothetical opportunities envisaged in the Decision. Such an approach would be a fundamental change to Tesco's strategy of determining its retail proposition nationally. Moreover, any theoretical gains would be minimal: the filtering approach in the Decision suggests (on an excessively conservative basis) that there are only 64 local areas where consumer diversion to Booker-supplied symbol stores might feasibly reach the high levels required for it to be profitable to worsen Tesco's retail offering. Tesco's sales at its stores located in these areas are ✂. Given that any bespoke localised strategy would entail significant costs and material commercial risks, it is inconceivable that the merged entity would depart from its effective strategy of determining its retail proposition nationally in the pursuit of illusory profits in a very small number of local areas.[5] The CMA recognised this point in its *Booker / Musgrave* merger inquiry.

1.6 Each of these overarching reasons is explored in greater detail below. The substantial evidence underpinning each of these reasons was not sufficiently taken into account in the Decision, with the result that the filtering approach set out in the Decision is theoretical and excessively conservative (see **Section 5** below). Indeed, the Parties consider that no local overlaps analysis - and therefore no filtering exercise - is required at all.

[5] See paragraphs 6 and 59 of the Phase 1 decision.

2. The merged entity has no incentive to deteriorate Tesco's retail offering due to the "double dilution" of any sales re-captured by Booker's wholesale business

2.1 Any sales diverted from a Tesco store to a Booker-supplied symbol store will predominately benefit the symbol store retailer, rather than Booker. In addition, other wholesalers would stand to benefit from any diverted sales.

2.2 Compared to a standard retail-to-retail merger, the incentive to deteriorate Tesco's offering is substantially weakened by two key factors:

(a) **Relative margins**: of those sales that Booker manages to re-capture at the wholesale level, the merged entity would have to sacrifice Tesco's higher retail margin in return for Booker's much lower wholesale margin (approximately ✂). The symbol group retailer would obtain the majority of Tesco's foregone retail margin – not Booker.

(b) **Wholesale sourcing:** the merged entity benefits from a deterioration of Tesco's retail offering only in circumstances where the Booker-supplied symbol store decides to increase (very significantly) its wholesale purchases from Booker. As Booker's symbol group customers typically purchase ✂ of their wholesale groceries requirements from Booker, any profits re-captured by Booker would be diluted further. The assumption used in the Decision that Booker's symbol group customers purchase 100% of their wholesale groceries supplies from Booker is incorrect and not supported by the evidence (see Section 2C of **Annex 3**).[6]

2.3 **Figure 1** below illustrates how sacrificing a nominal £100 of retail sales at a Tesco store could only ever be partially re-captured at the wholesale level by Booker. This is because the primary beneficiary of these diverted sales is the independent Booker-supplied symbol store (rather than Booker).

Figure 1: illustration of why a deterioration of Tesco's retail offering would not be profitable even assuming 100% diversion ratios

✂

Source: Frontier analysis

(a) ✂[7]

(b) ✂

(c) ✂

(d) ✂

2.4 Therefore, even if the CMA assumes that 100% of a Tesco store's sales are diverted to a Booker-supplied symbol store (which would be implausible), the merged entity would <u>lose almost ✂</u>. This demonstrates that this theory of harm is itself implausible,

[6] See paragraph 116(a) of the Decision.

[7] For information on margins, see **Appendix 9.A** to the Merger Notice: Frontier's technical paper on "Post-merger pricing incentives in retail-to-wholesale mergers" submitted to the CMA on 7 March 2017.

as there is no level of diversion from Tesco to Booker-supplied symbol stores that would make it profitable for the merged entity to deteriorate Tesco's retail offering.

2.5 This was explained in the Parties' submissions on its vertical GUPPI analysis during the Phase 1 process, in relation to which the Decision noted that "*a GUPPI framework can be a useful starting point for helping to consider the Parties' incentives*".[8] Critical diversion ratios are materially in excess of 100% (see **Figure 2** below),[9] which is robust to a range of reasonable assumptions and sensitivity checks.[10] This means that there is no feasible level of diversion from Tesco to Booker-supplied symbol stores that would give the merged entity an incentive to deteriorate Tesco's retail offering post-merger. The implication of this is that <u>a detailed local overlaps analysis is not required</u>, as no amount of factual investigation would be able to uncover problematic levels of diversion from Tesco stores to Booker-supplied symbol stores.

Figure 2: Critical diversion ratios from Tesco stores to Booker-supplied symbol stores based on a 10% GUPPI threshold

	Booker symbol group fascia			
To / From	**Premier**	**Family Shopper**	**Londis**	**Budgens**
Tesco	✂	✂	✂	✂

3. Any consumer diversion from Tesco to Booker-supplied symbol stores is likely to be low

3.1 Notwithstanding the above, any consumer diversion from Tesco stores to Booker-supplied symbol stores is likely to be low for the following reasons:

(a) it would be Tesco's main competitors at the retail level who would profit from a deterioration of Tesco's offer, rather than Booker's symbol group customers. For example, each of Aldi, Lidl and Iceland is a (materially) more effective competitor to Tesco than Booker-supplied symbol stores; and

(b) Tesco stores and Booker-supplied symbol stores are not close competitors.

3.2 This would also be the case in areas that fail the Decision's filter, as this filter does not take into account the competition faced by Tesco stores and Booker-supplied symbol stores from the following sources: (i) the Decision's effective competitor set excludes a wide range of grocery retail stores (including the discounters, Iceland, certain symbol stores, petrol forecourt retailers and unaffiliated independents); and (ii) the filtering approach in the Decision excludes larger stores located outside of the catchment for convenience stores.

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[8] See paragraph 116 of the Decision.

[9] The Parties consider that a GUPPI of 10% is the appropriate threshold for a Phase 2 inquiry. See, for example, the CMA's Phase 2 decision for *Ladbrokes plc / Gala Coral Group Limited* (footnote 118). See **Annex 9.1** to the Merger Notice for the reasonable sensitivity checks undertaken by the Parties.

[10] The Decision adopted excessively conservative assumptions when applying the vertical GUPPI framework. For example, the assumption that Booker's symbol group customers purchase 100% of their wholesale groceries supplies from Booker is incorrect (see paragraph 116(a) of the Decision).

3.3 If the CMA considers that consumers would divert from Tesco stores to Booker-supplied symbol stores, the CMA should also recognise that consumers would divert to other symbol stores, whether or not currently included in the CMA's effective competitor set, as well as petrol forecourt retailers and unaffiliated independents (which are not included in the CMA's effective competitor set). The presence of any such stores in the same local areas as Booker-supplied symbol stores will mean that any consumer diversion from Tesco stores to Booker-supplied symbol stores is likely to be low.

3.4 These points are explained in detail in **Annex 7**.

4. The merged entity has limited ability and no incentive to deviate from Tesco's nationally defined retail proposition

4.1 The Decision states that the ability of Tesco to worsen its retail offering is "*not in question as Tesco controls its owned Tesco and One Stop convenience stores*".[11] However, this conclusion is overly simplistic as Tesco would need to deteriorate its retail offering in targeted local areas for this theory of harm to be plausible. This would involve a fundamental change to Tesco's business model:

(a) Tesco currently determines its PQRS nationally by reference to its main competitors, namely the multiples and discounters. For example, ✂.

(b) The merged entity would have no incentive to undertake the significant investment required to adopt bespoke strategies in specific local areas due to the substantial commercial risks involved in pursuing such a strategy:

(i) Deteriorating Tesco's retail offering in a local area would undermine the Tesco brand by reducing consumers' trust in Tesco across the board. A Tesco store in one local area effectively operates as an advertisement for Tesco stores in other areas. "*Rebuilding trust by operating with transparency*" is one of three turnaround priorities which Tesco set out in October 2014 and which remain a key focus for the business.[12] To deteriorate Tesco's offer in particular local areas would expressly run counter to a strategy which Tesco has decided is essential for its business.

(ii) Introducing higher prices in some areas would allow competitors to run price-led national advertising campaigns. Competitors would highlight the higher price in a "deteriorated area" and compare it to their own national price. Price-led national advertising campaigns have previously had a major adverse impact on Tesco's performance, and the unlikely benefits of diverting sales to the stores of Booker's symbol group customers do not outweigh this likely damage.[13]

(c) The filtering approach in the Decision suggests that there are only 64 local areas where consumer diversion to Booker-supplied symbol stores might

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11 See paragraph 109 of the Decision.

12 See, for instance, pages 2 and 4 of Tesco's Annual Report 2017.

13 For example, see: https://www.marketingweek.com/2016/02/01/morrisons-shifts-price-messaging-once-again-with-launch-of-price-crunch-campaign/.

feasibly reach the high levels required for it to be profitable to worsen Tesco's retail offering. Tesco's sales at its stores located in these areas are ✄. Changing Tesco's business model to implement a targeted deterioration of Tesco's retail offering in these areas of a sufficient magnitude to drive consumer switching would require significant investment and entail significant operational costs. ✄

4.2 Moreover, as explained in **Section 5** below, the filtering approach in the Decision is flawed, which means the number of local areas that could be "potentially problematic" is significantly lower than that stated in the Decision (and, in the Parties' view, non-existent). Therefore, any theoretical gains from adopting local pricing strategies are in the Parties' view illusory and, in any event, outweighed by the significant costs and risks of implementing such strategies.[14] It is inconceivable that the merged entity would depart from its effective strategy of determining its retail proposition nationally in the pursuit of negligible hypothetical benefits in a very small number of local areas.

4.3 This lack of incentive to vary Tesco's retail offering on the basis of local competition is illustrated by the fact that Tesco has not previously sought to adopt such a strategy in response to any perceived lack of competition at a local level. Tesco currently operates in areas with varying levels of local choice (given the geographic distribution of its competitors), including in areas where the CMA may consider it faces "low" competition (based on its narrow effective competitor set). Despite this potential "opportunity" to worsen its retail offering only in these areas, Tesco continues to determine its PQRS nationally, a strategy it has deployed for many years. Tesco has no incentive to adopt bespoke strategies to deteriorate its offering in specific local areas, which reflects the fact that there is strong competition at the retail level across all areas in the UK. There is no reason to consider that this would change post-merger.

5. The Decision's filters are highly theoretical and excessively conservative

5.1 As noted above, the Parties consider that a local overlaps analysis is not required to assess this theory of harm. The vertical GUPPI framework – which the CMA has accepted in principle and the Parties consider should be used by the CMA at Phase 2 – demonstrates that the merged entity would have no incentive to deteriorate Tesco's retail offering post-merger.

5.2 The Parties fear that the reasoning and evidence set out in this Annex was not sufficiently taken into account in the Decision, with the result that the filtering approach set out in the Decision is theoretical and excessively conservative. In particular, the Decision's filters do not adequately take into account that:

(a) the vertical GUPPI framework shows that critical diversion ratios materially exceed 100%;

(b) Booker's symbol group customers purchase on average ✄ of their wholesale groceries supplies from Booker; and

[14] The CMA recognised this point in its *Booker / Musgrave* merger inquiry (see paragraphs 6 and 59 of the Phase 1 decision).

(c) Tesco stores and Booker-supplied symbol stores are not close competitors at the retail level. <u>Each of Aldi, Lidl and Iceland is a (materially) more effective competitor to Tesco than Booker-supplied symbol stores</u>.

5.3 In any case, as explained in **Section 4** above, the merged entity would have limited ability and no incentive to depart from Tesco's strategy of determining its proposition nationally in order to implement a localised and targeted deterioration in a small number of areas. Any theoretical gains would be outweighed by the material commercial risks and significant operational costs of adopting a strategy based on deteriorating Tesco's offering in targeted local areas. Therefore, this theory of harm would not be profitable and could not result in a substantial lessening of competition.

PROPOSED MERGER BETWEEN TESCO PLC AND BOOKER GROUP PLC

INITIAL SUBMISSION TO THE CMA FOR PHASE 2 REVIEW

ANNEX 3: RESPONSE TO THEORY OF HARM 3 ON WORSENING OF BOOKER'S WHOLESALE SYMBOL GROUP OFFERING IN LOCAL AREAS WHERE BOOKER'S SYMBOL GROUP RETAILERS OVERLAP WITH TESCO STORES

1. Introduction and summary

1.1 The CMA concluded in its Phase 1 decision referring the Merger for a Phase 2 inquiry (the ***Decision***) that there is a reasonable prospect that the merged entity will have the ability and incentive to worsen the Booker wholesale symbol group offering in 369 local areas with the effect of substantially lessening competition.[1] As illustrated in **Figure 1** below, Booker's sales to its symbol group customers located in these 369 areas account for approximately ✂% of the merged entity's revenue and even less in terms of its profits.[2]

Figure 1: to scale diagram showing value of Booker's FY17 sales to stores in the 369 areas identified by the Decision's filters

✂

Source: Frontier analysis

1.2 <u>The Parties consider that this theory of harm is counter-intuitive and would not make commercial sense, as it directly undermines the strategic rationale for the Merger</u> which is based around growing each of the Booker and Tesco businesses (rather than diminishing one business to the benefit of the other which would undermine the strategic value of the Merger):

(a) Booker has a long history of growing with its customers, by improving the choice, price and service offered to them. A key element of the strategic rationale for the Merger is to improve Booker's offering further by providing better choice, price and service to business customers (including Booker's symbol group customers), enabling them, in turn, to offer better value and quality to their consumers.[3]

(b) Moreover, the merged entity is aiming to realise significant revenue synergies by utilising Tesco's skill and expertise to offer an improved product range and enhanced service proposition to Booker's customers (including its symbol group customers).[4] Pursuing a strategy based on the theory of harm set out in the Decision would directly undermine these expected revenue synergies.

The Parties have no interest in transferring revenues from one part of the business to another or attempting to construct artificially a less compelling offer in certain local

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1 See paragraph 173 of the Decision.

2 10 stores identified by the CMA on the basis of the Decision's filters have now left Booker's symbol group fascia.

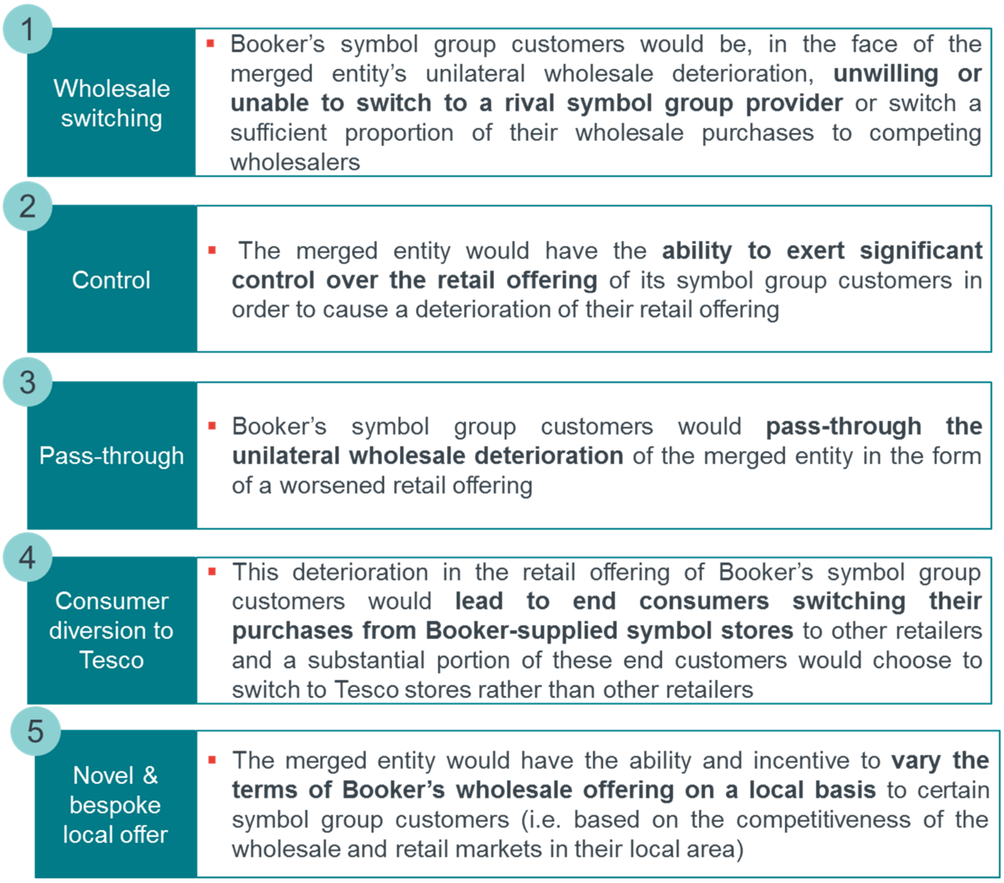
3 See the Parties' Rule 2.7 announcement.

4 See BCG's synergy report and Deloitte's Quantified Financial Benefits Plan Report.

areas in the hope of gaining some marginal hypothetical benefit that the Parties do not believe exists.

1.3 As well as the Parties clearly having no intention to deteriorate Booker's wholesale offering, the merged entity would neither be able nor incentivised to adopt any strategy based on worsening (rather than improving) Booker's offering. In order for the merged entity to have the ability and incentive to deteriorate Booker's wholesale offering to its symbol group customers in order to divert retail sales to Tesco stores, it would be necessary to show that all of the following five conditions are met:

Figure 2: necessary conditions for a worsening of Booker's wholesale offering to be viable



1.4 The substantial evidence submitted by the Parties during the Phase 1 process and set out in this Annex demonstrates that these cumulative conditions could not be met. Indeed, the Parties consider that none of these conditions – let alone all of them – would hold in practice, particularly given the highly competitive nature of the wholesale and retail groceries sectors (see Section 3 of the initial submission). As explained in detail below, there is substantial evidence demonstrating the following points:

(a) **Extensive wholesale supply options**: Booker's symbol group customers are willing and able to switch to a competing symbol group (as made clear in the Phase 1 market test) or to switch significant purchasing volumes to rival wholesalers (see **Section 2** below).

(b) **A lack of control over Booker's symbol group customers**: the merged entity has insufficient control over Booker's symbol group customers to give it the ability to influence the retail offering of Booker-supplied symbol stores to any meaningful degree (see **Section 3** below).

(c) **Limited pass-through**: Booker's symbol group customers are unlikely to pass-through fully any unilateral wholesale deterioration by Booker to their end consumers in the form of a worsened retail offering (see **Section 4** below).

(d) **A lack of closeness of competition at the retail level**: Booker-supplied symbol stores and Tesco stores are not close competitors at the retail level, which means it is implausible that the diversion of consumers from Booker-supplied symbol stores to Tesco stores would be sufficiently high to compensate for the substantial loss of Booker's wholesale revenue (see **Section 5** below).

(e) **No incentive to devise a novel and bespoke strategy to vary Booker's wholesale offering on a local basis**: it would make no commercial sense for the merged entity to vary Booker's wholesale offering on a local basis (see **Section 6** below).

1.5 This substantial evidence is captured by the Parties' vertical GUPPI framework, which was submitted to the CMA during the Phase 1 process[5] and was acknowledged in the Decision to be a useful framework when considering the Parties' incentives.[6] This vertical GUPPI framework reflects the fact that the economic incentives of the Parties post-merger are fundamentally different than they would be in a retail-to-retail merger, given that the transaction is a vertical merger between a wholesale business (Booker) and a retail business (Tesco). In particular, the vertical GUPPI framework demonstrates that a local overlaps analysis would be inappropriate for this Merger. This flows from the fact that critical diversion ratios are well above 100%, which means that no amount of factual investigation would be able to uncover problematic levels of diversion from Booker-supplied symbol stores to Tesco stores (see **Section 7** below).

1.6 This substantial evidence was not fully taken into account in the Decision. This means that the filtering approach set out in the Decision is theoretical and excessively conservative. Indeed, the Parties consider that no local overlaps analysis - and therefore no filtering exercise - is required at all.

[5] See **Annex 9.1** to the Merger Notice and **Appendix 9.A** to the Merger Notice for Frontier's technical paper on *Post-merger pricing incentives in retail-to-wholesale mergers* submitted to the CMA on 7 March 2017.

[6] See paragraph 167 of the Decision.

2. There are extensive alternative wholesale supply options available to Booker's symbol group customers

Summary

- **The wholesale groceries sector is dynamic, fragmented and highly competitive**. Any attempt to worsen Booker's wholesale offering would be defeated by symbol group customers:
  - o switching fascia to a competing symbol group provider; or
  - o switching wholesale volumes to rival wholesalers with a more competitive offering.
- Booker's symbol group customers can **easily switch to competing symbol group providers** in all regions of the UK (as shown in the Phase 1 market test): there are a wide range of effective symbol group providers and many offer national or substantial regional coverage. As such, Booker's symbol group customers have a wide choice of alternatives.
- Booker's symbol group customers also multi-source from a range of national, regional, local and specialist wholesalers across both the delivered <u>and</u> cash & carry channels:
  - o There is a large evidence base demonstrating that Booker's symbol customers source a significant proportion of their supplies from alternative wholesalers and **frequently switch significant purchasing volumes between competing wholesalers** in order to obtain the most attractive wholesale offer.
  - o Even if minimum purchasing requirements could be and were enforced (which is not the case), symbol group customers are able to source a sizeable proportion (approximately ✂) of their supplies from alternative suppliers. This is sufficient to discipline the merged entity and prevent any unilateral deterioration of Booker's wholesale offering.
- **<u>Conclusion</u>**: all of Booker's symbol group customers have a number of alternative wholesale supply options. As such, there can be no SLC: Booker's symbol group customers would be able to defeat any unilateral worsening of Booker's offering through wholesale switching.

2.1 As explained in the initial submission (see Section 3A):

(a) the wholesale groceries sector is highly competitive, with retailer customers typically multi-sourcing from a wide range of wholesale suppliers across different channels (i.e. from cash & carry <u>and</u> delivered operators); and

(b) there is strong competition for the supply of symbol group services, with many competitors operating in all regions across the UK.

2.2 This means that any attempt to worsen Booker's wholesale offering would be defeated by symbol group customers either switching to a competing symbol group provider or switching a significant proportion of their wholesale purchases from Booker to rival wholesalers providing a more competitive offering.

2.3 The fierce intensity of competition in the wholesale sector is demonstrated by the thin wholesale margins earned on sales to retailer customers. This reflects how retailers are willing and able to switch wholesale purchases between numerous alternative wholesalers.[7] Wholesalers must compete fiercely to attract retailer customers' wholesale purchases. Booker's average variable margins are between ✄ (Family Shopper) and ✄ (Budgens) for wholesale sales to Premier, Family Shopper, Londis and Budgens customers.

A. Booker's symbol group customers have a wide choice of alternative symbol group providers all across the UK and the option to become unaffiliated independent retailers

2.4 As recognised by the CMA in *Booker / Musgrave*,[8] there is strong competition for the supply of symbol group services among a wide range of players. There are several wholesalers offering symbol group services on a national basis (e.g. Nisa, Best-One, Costcutter, Spar and Lifestyle Express) and many other wholesalers offering symbol group services on a regional basis (e.g. Today's and Key Store). Independent retailers therefore have a number of choices, with rival symbol group providers operating in all regions of the UK (as shown by **Figure 3** below). Furthermore, many retailers often prefer to become, or go back to being, independent retailers.

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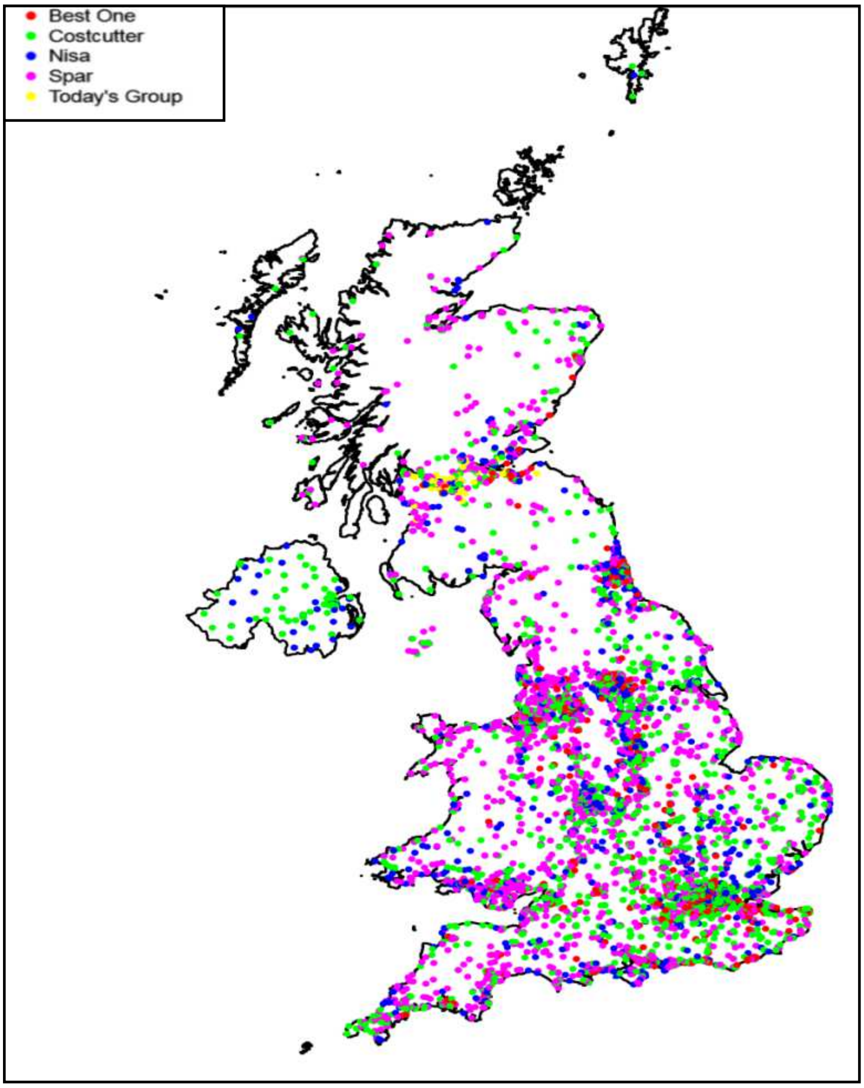
7 The CMA has also explicitly acknowledged that low variable profit margins are associated with greater price sensitivity (see paragraph 5.2.15(b) of the CMA's Merger Assessment Guidelines: "*Evidence that customers are very sensitive to price can also indicate low variable profit margins*"). The high price sensitivity of Booker's customers implies a high degree of switching (including volumes) by symbol group retailers in order to secure the most attractive wholesale supply. The relationship between low margins, high price sensitivity and therefore competitive wholesale alternatives forms the basis of price pressure indices (such as the GUPPI framework), which the CMA often applies in retail mergers (see Section 5 of the CMA's Retail Merger Commentary dated 10 April 2017).

8 See paragraphs 54 to 56 of the *Booker / Musgrave* decision.

Figure 3: location of symbol group members that are not affiliated to Booker or One Stop[9]



Source: Frontier analysis

(i) *The Decision's effective competitor set is unduly narrow and excludes almost one quarter of all non-Booker-supplied symbol stores in the UK*

2.5 The Decision recognised that Nisa, Spar, Costcutter and Best-One are effective competitors to Booker for the supply of symbol group services. However, it excluded Lifestyle Express, Today's and Key Store from the effective competitor set. The Parties consider that this is inappropriate, as it fails to reflect the market realities and competitive dynamics for the supply of symbol group services. In particular, <u>the Decision's approach to the effective competitor set excludes almost one quarter of all</u>

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9 This is based on data sources that are available to the Parties on the location of Spar, Nisa, Costcutter, Best-one and Today's Group stores. The map underestimates the number of Best-One and Today's stores, as the Parties do not have access to data on the location of all of these stores. The Parties do not have data on the location of Lifestyle Express and Key Store stores (so these stores are not shown on the map), but between them they amount to over 2,000 stores.

non-Booker-supplied symbol stores in the UK. This materially understates the alternative symbol group options available to Booker-supplied symbol stores.

2.6 These three symbol group providers provide a strong symbol group offering so should be included in any effective competitor set (see further the competitor profiles at **Annex 8**):

(a) **Lifestyle Express**: almost 2,000 stores in the UK operate under the Lifestyle Express brand,[10] which means Lifestyle Express has more symbol group members than Best-one and Nisa. In fact, Lifestyle Express is the fourth largest symbol group provider in the UK. As advertised on Lifestyle Express's website: "*Landmark Wholesale consists of 106 Member Cash & Carry Depots throughout the UK serving 140,000 Customers with Cash and Carry and Delivered services covering all of your Retail needs*". Lifestyle Express provides independent retailers with strong symbol group services, including nationally recognised fascia, promotions and guidance on store plans and range.[11] As shown by **Figure 4** below, the average store size of a Lifestyle Express store is very comparable to the average store size of a Premier store.

(b) **Today's:** 470 stores in the UK operate under the Today's symbol group. "*In the last twelve months, the Today's Group has been one of the fastest growing retailer networks in the UK*".[12] Today's is backed by "*the largest independent buying group*",[13] with 160 independent wholesale members offering cash and carry and delivered services.[14] Today's supports retailers with nationally recognised fascia, support and guidance and its own brand products.

(c) **Key Store:** 200 stores in Scotland operate under the Key Store fascia. In comparison, Booker operates just over ✂ Premier stores in Scotland and ✂ Londis stores. Therefore, for retailers operating in Scotland, Key Store represents a strong and credible alternative to Booker's symbol group fascia.

2.7 The Decision excludes Today's and Key Store from the effective competitor set on the basis that they do not have a share of supply of greater than 5% in any postcode area in the UK.[15] However, this analysis is flawed for the following reasons:

(a) it is based on incomplete data as the stores dataset used by the CMA does not have good coverage of symbol stores affiliated to Lifestyle Express, Today's or Key Store;[16] and

(b) it is inappropriate to assess whether a symbol group provider has a regional presence based on its share of supply in any given postcode area. This

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10 http://www.lifestyle-express.co.uk/

11 http://www.lifestyle-express.co.uk/retailer-advice/

12 http://www.todays.co.uk/retailer/why-join-todays/

13 http://www.todays.co.uk/retailer/why-join-todays/

14 http://www.todays.co.uk/wholesaler/

15 See paragraph 91 of the Decision.

16 Given the lack of publicly available information on the location of Lifestyle Express, Today's and Key Store stores (including the fact that there is no online store finder for these symbol groups), a solution to addressing this information gap would be to ask these wholesalers for their store locations. The CMA may be well placed to initiate this request and the Parties would be keen to support the CMA with this.

geographic frame of reference is far too narrow, as symbol group providers that operate on a regional basis will typically determine the core elements of their proposition centrally and apply this proposition uniformly across the regions in which they operate (with little variance between individual postcode areas).

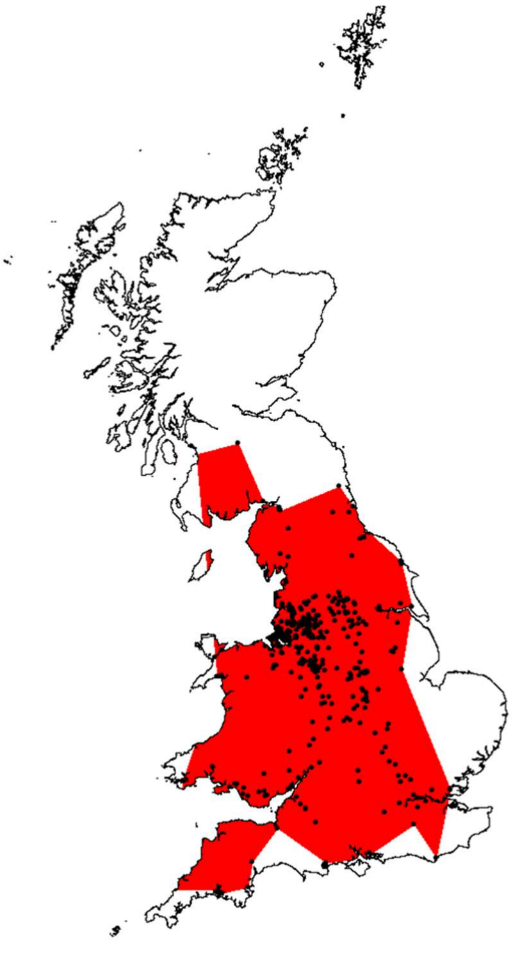
Figure 4: comparison of the Premier, Lifestyle Express and Today's symbol groups

✂

Source: Frontier analysis

2.8 Furthermore, Conviviality (Bargain Booze) has substantial coverage throughout England (see **Figure 5** below) and is therefore another alternative provider for many retailers who wish to join a symbol group or switch symbol group fascia.

Figure 5: catchment size for Conviviality based on current delivery network



(ii) The catchment size for symbol group providers should reflect, as a minimum, the reality of where symbol group providers deliver their services

2.9 Many of Booker's symbol group competitors offer national coverage, which means Booker's symbol group customers have a wide choice of symbol group alternatives.

2.10 The Decision uses a catchment size for symbol group providers based on where 80% of its symbol group members are located.[17] This approach is far too conservative and fails to reflect the market realities and competitive dynamics for the supply of symbol group services. In particular:

(a) the Parties consider that it is not appropriate to use 80% catchment areas in a business-to-business context, particularly where the symbol group provider (rather than the customer) is undertaking the travel;

(b) the location of symbol stores is known and the Parties have shared this information with the CMA during the Phase 1 process. As such, there does not appear to be any need to proxy the delivery networks of symbol group providers when their actual delivery catchments can be ascertained from the symbol stores that they are currently serving. For each of Spar, Nisa and Costcutter, the location of their current symbol group members demonstrates that their delivery networks are effectively national in scope (as shown in **Figure 7** below);[18]

(c) even basing the catchment size of symbol group providers on the symbol stores that they are currently serving would be conservative, as symbol group providers operate flexible business models with respect to delivery limits and are typically able to flex their delivery catchments to supply new customers. This was recognised by the CC in the *Booker / Makro* merger inquiry: "*Our investigations showed that delivery limits are, in practice, flexible* […] *We formed the view that delivered operators are likely to be effective alternatives in the wholesale market for most customers in most areas*";[19] and

(d) the Decision suggested that the quality of a symbol group wholesaler's delivery service could vary with distance from a delivery depot, although provided no evidence to substantiate this.[20] The Parties firmly dispute the assertion. As shown by **Figure 6** below, there was no correlation between the distance from Booker Retail Partners' depots[21] and the number of deliveries to customers in the last financial year (which can be seen as a proxy for customer loyalty).

Figure 6: correlation between distance from BRP depots and the number of delivery to customers

✂

Source: Frontier analysis of Booker data for FY 16/17

2.11 This means that almost all Booker-supplied symbol stores operating in the UK would have at least three alternative symbol group options (i.e. Spar, Nisa and Costcutter).

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17 See paragraph 91 of the Decision.

18 To determine the full extent of their delivery networks, the Parties drew the perimeter around the symbol stores currently served by each provider using Delaunay Triangle in MapInfo.

19 See paragraph 8.29 of the *Booker / Macro* decision.

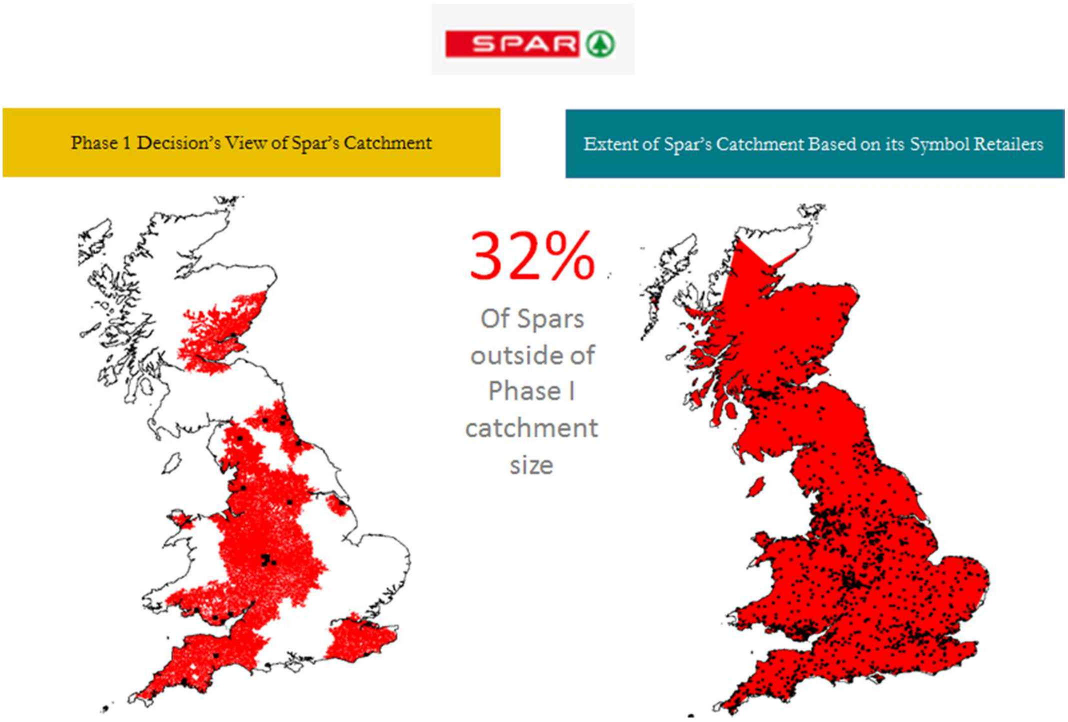
20 See paragraph 63(c) of the Decision.

21 Booker considers that its ✂ Booker Retail Partners' depots are most representative of a delivered wholesaler.

This is even before considering other national symbol group providers (such as Best-One and Lifestyle Express) and symbol group providers with a regional presence (such as Today's and Key Store).

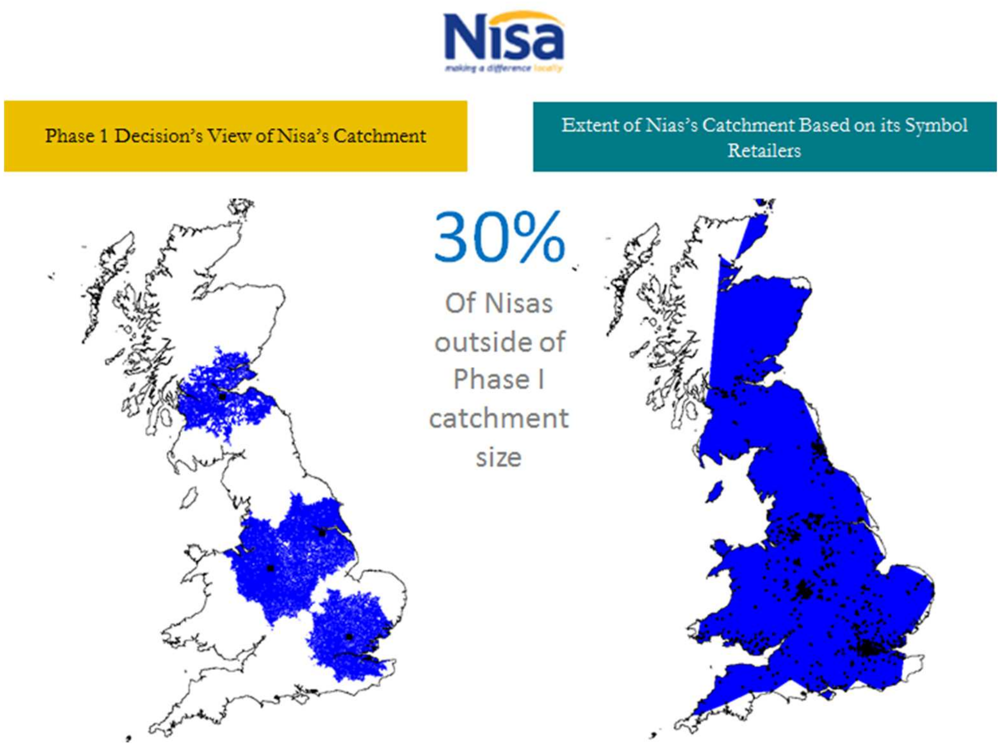
2.12 The Parties have estimated the catchment areas used in the Decision for each of Spar, Nisa and Costcutter.[22] These catchment areas are excessively narrow and fail to take account of the market reality of where these three wholesalers provide symbol group services. If taken literally, the catchment areas used in the Decision would imply that: (i) Spar is not an effective symbol group option for c.32% of Spar's symbol group members; (ii) Nisa is not an effective symbol group option for c.30% of Nisa's symbol group members; and (iii) Costcutter is not an effective symbol group option for c.21% of Costcutter's symbol group members.

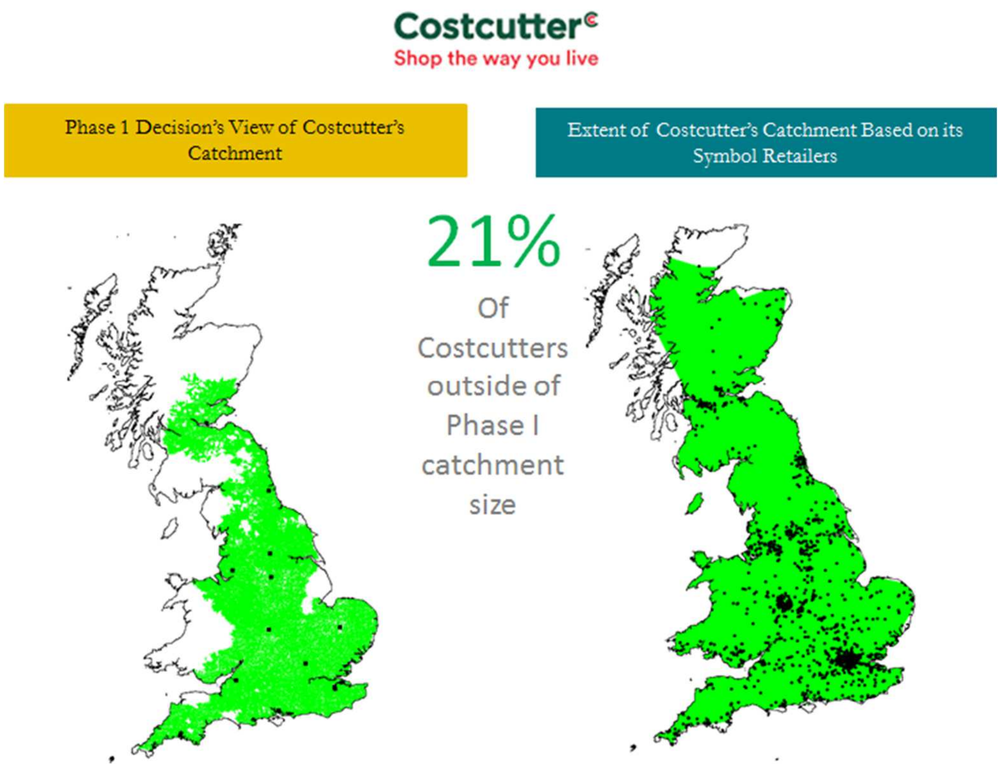
Figure 7: comparison of catchment areas used in the Decision and the current delivery networks of symbol group providers[23]



[22] While the Parties have not seen the exact drive times provided by each of these symbol group providers (which were not disclosed for confidentiality reasons), the CMA indicated to the Parties that the average drive time around depots was calculated as 82 minutes. The Parties have therefore used this drive time when estimating catchment areas.

[23] The catchment areas based on the Decision assume a delivered catchment of 82 minutes and a cash & carry catchment of 30 minutes.





2.13 Therefore, the Parties consider that the catchment size for symbol group providers should reflect the market reality that many symbol group providers offer national coverage and therefore – as a minimum - include all areas where symbol group providers currently deliver symbol group services.

2.14 As set out in **Table 1** below, around ✂ of Booker's symbol group customers are within 10 miles of at least three rival symbol group fascia (based on the Decision's unduly narrow effective competitor set) and ✂ would have the option of at least two symbol group alternatives to Booker. This indicates that ✂ of Booker's symbol group customers have alternative symbol group options, given that competing symbol group providers are already distributing to stores within close proximity to them.

Table 1: number of competing symbol group fascia within 10 miles of each Booker symbol group customer (based on Decision's effective competitor set)

Number of non-Booker symbol group fascia within 30 miles	Premier	Londis	Other[24]	Total
0	✂	✂	✂	✂
1 or more	✂	✂	✂	✂
2 or more	✂	✂	✂	✂
3 or more	✂	✂	✂	✂
4	✂	✂	✂	✂

Source: Frontier analysis based on Booker data

2.15 Of the 369 Booker-supplied symbol stores identified as failing the Decision's filters:

(a) ✂ have three or more competing symbol stores located within ten miles and ✂ have at least one (which itself is conservative, as it is based on the Decision's unduly narrow effective competitor set); and

(b) ✂ stores are identified as having no effective symbol group alternatives. However, the Decision's approach to the effective competitor set and catchment areas means this does not reflect reality. For example, **Figure 8** below provides visual evidence that one of these ✂ Booker-supplied symbol stores has recently switched from Spar to Premier.

[24] Namely, Family Shopper and Budgens.

Figure 8: illustrative example of fascia switching for a store that the Decision considers has no effective symbol group alternatives

Source: Google Maps of Manchester House, Sycamore Street, Carmarthenshire, SA389AJ

B. ***Booker's symbol group customers can easily switch to a wide range of competing symbol group providers***

(i) Barriers to switching symbol group are very low

2.16 There are very low barriers to switching symbol group provider. This means Booker's symbol group customers could easily switch to an alternative symbol group provider in the face of a unilateral deterioration of Booker's wholesale offer. This is shown by the Phase 1 market test for this Merger, in which "*the majority of symbol group retailers indicated that, if faced with a 5% price increase, they would switch fascia*".[25]

2.17 The ease with which retailers can switch between symbol group providers has been recognised previously by the UK competition authorities:

(a) The CMA noted in *Booker / Musgrave* that: "*most symbol group members […] considered that it was relatively easy to switch symbol group" and "customers consistently indicated that if their supplier of symbol group services (ie, Booker or Musgrave) were to increase the prices they charge by 5% on a permanent basis, they would consider switching to another symbol group*".[26]

(b) The OFT noted in *Costcutter / P&H* that: "*the vast majority of symbol group members considered that it was relatively easy to switch group*" and "*third party customers noted that if the parties increased their wholesale prices, that they would change symbol group*".[27]

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[25] See paragraph 154 of the Decision.

[26] See paragraphs 27(b) and 55(a) of the CMA's *Booker / Musgrave* decision.

[27] See paragraphs 31 and 42 of the OFT's *Costcutter / P&H* decision.

(ii) The ability to switch, rather than actual switching, to rival symbol groups is key to determining the merged entity's incentives

2.18 The Decision places undue weight on current switching rates between Booker and rival symbol group providers. Given that there is strong competition between a wide range of effective symbol group providers, <u>the threat of customers switching to competing symbol group providers is key.</u> The ability of Booker-supplied symbol stores to switch to a competing symbol group sufficiently disciplines Booker's wholesale offering to symbol stores and means that Booker does not have any incentive to deteriorate its symbol group offering unilaterally post-merger. This is recognised by the Decision itself: "*the majority of symbol group retailers indicated that, if faced with a 5% price increase, they would switch fascia*".[28]

2.19 The Decision asserts that the switching rate "*is generally low*".[29] This is however a subjective statement, as there is no benchmark for the expected rate of switching in a competitive market. For example, the current switching rates may simply reflect the fact that symbol group providers are competing intensely to retain their symbol group customers. In the context of symbol group providers operating in a highly competitive wholesale groceries sector, Booker has been competing intensely to deliver a very competitive offering to its symbol group customers, which means fewer of its symbol group customers have been incentivised to switch to rival symbol groups. For example, Booker has significantly improved its offering to Londis and Budgens customers following the acquisition of these businesses from Musgrave, including:

(a) ✄

(b) ✄

(c) ✄

2.20 In any event, the Decision understates the strong evidence of retailers switching between symbol group providers. The Decision considers that there are churn rates of less than 5%.[30] However, there is evidence that churn rates are likely to be higher than this. For example, between 2016 and 2017:[31]

(a) Costcutter experienced a 16% *net* reduction in its number of symbol group stores; and

(b) Best One experienced a 12% *net* increase in its number of symbol group stores.

These figures are based on the *net* change in store numbers. The gross level of churn will be even higher, as retailers will both join and leave a symbol group in any given year. As such, there is likely to be significant churn as new retailers enter the market, some retailers exit the market and existing retailers change symbol group fascia. For example, Nisa's 2016 annual report shows only a 1% net increase in its number of symbol group stores, but this figure hides the fact that 9% of Nisa's symbol group customers left in 2016 and 10% of Nisa's symbol group customers joined in 2016.

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28 See paragraph 154 of the Decision.

29 See paragraph 154 of the Decision.

30 See footnote 72 of the Decision.

31 The Grocer's Grocery Retail Structure Report 2017.

C. Booker's symbol group customers can and do source a significant proportion of their supplies from a wide range of alternative suppliers

(i) Booker's symbol group customers can and do multi-source

2.21 The Parties have provided a very large evidence base to demonstrate that Booker's symbol customers source a significant proportion of their supplies from alternative wholesalers and frequently switch significant purchasing volumes between competing wholesalers in order to obtain the most attractive wholesale offer (see Section 8B(vi) of the Merger Notice). Booker's symbol group customers multi-source from a range of national, regional, local and specialist wholesalers across both the delivered and cash & carry channels (i.e. there is no "cash & carry only" or "delivered only" wholesale market).

2.22 Under the contracts between Booker and its symbol group customers, symbol group customers are in theory required to purchase a certain value of goods from Booker (which generally ranges between ✂ per week).[32] For an average Premier or Londis symbol group customer, Booker estimates that this equates to approximately ✂ of their total wholesale purchases. Even if these requirements are consistently observed (which is not the case), symbol group customers are able to source a sizeable proportion (approximately ✂) of their supplies from alternative suppliers. This contestable spend is significant and means that a strong competitive tension is maintained between Booker and its wide range of competing wholesalers, even in respect of Booker's symbol group customers.

2.23 ✂ this would not impact the Parties' analysis of critical diversion ratios under its vertical GUPPI framework (as set out in **Section 7** below). The critical diversion ratios presented in the vertical GUPPI analysis are all based on Booker's symbol group customers meeting the minimum spend proportions implied by the relevant contracts. Even with this highly conservative assumption, the critical diversion ratios are significantly above 100%.[33] In other words, the ability of Booker's symbol group customers to switch a sizeable proportion (i.e. ✂) of their wholesale purchases to alternative wholesalers is sufficient to prevent a unilateral deterioration of Booker's wholesale offering.

2.24 As a result, these contractual provisions do not and could not realistically pose a barrier to Booker's symbol group customers switching wholesale purchasing volumes to alternative wholesalers. This would be the case even if Booker's symbol group customers observed their contractual provisions with Booker. ✂:[34] actual spend data shows that Booker's symbol group customers source a significant proportion of their wholesale purchases from alternative wholesalers (and, in practice, ✂). For example, across a sample of Premier and Londis stores,[35] these symbol group customers sourced on average approximately ✂% of their purchases from Booker and over ✂

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32 ✂

33 This is based on a 10% GUPPI threshold, which the Parties consider is appropriate for a Phase 2 merger inquiry. See, for example, the CMA's Phase 2 decision for *Ladbrokes plc / Gala Coral Group Limited* (footnote 118).

34 ✂

35 The sample consisted of 38 Premier stores and 11 Londis stores where Frontier was able to access EPOS data from the third party EPOS supplier on a one-off basis.

of the sample sourced less than half of their estimated purchase requirements from Booker. Booker estimates that around ✂% of Premier customers are purchasing below their minimum purchase requirements ✂.[36] This means symbol group customers, in practice, have even more flexibility in how they source their supplies.[37]

2.25 This tendency for symbol group customers to switch substantial purchasing volumes between Booker and rival wholesalers is evident at the product category level and across a broad range of categories. As evidenced in Booker's sales data to symbol group customers, Booker often witnesses customers materially varying its purchases from Booker across product categories, which is consistent with these customers purchasing from multiple wholesalers.

Figure 9: stylised example of a customer purchasing less than ✂ of own average

✂

Source: Frontier analysis

2.26 **Table 2** below shows the purchasing patterns for products within Booker's non-perishable categories[38] by two sets of customers:[39]

(a) all of Booker's symbol group customers; and

(b) the 369 symbol group customers identified by the CMA as failing the Decision's filters.

2.27 Analysis of purchases by these customer groups from Booker shows that, across all categories, a significant proportion of customers dramatically reduced their purchases relative to their typical level of purchases for at least one month. This strongly indicates that these customers switched to sourcing these products from alternative wholesale suppliers (given that the total quantity sold by a symbol store is not likely to vary to this magnitude on a month-by-month basis).

[36] Booker's Retail Development Managers do review performance and trading opportunities with customers.

[37] As such, the Parties consider that the assumption used in the Decision that Booker's symbol group customers purchase 100% of their supplies from Booker is clearly inappropriate (see paragraph 116(a) of the Decision).

[38] Fresh categories have a shorter shelf-life so stock has to be replenished more frequently.

[39] 'Category-level customers' are those who purchased a product in the category at least once throughout the financial year. Those customers who did not purchase anything from Booker in the first and last month of the year are excluded to omit customers who may have opened or closed part way through the financial year.

Table 2: proportion of customers who purchased less than 25% of their average in at least one month

Category	All symbol group customers			369 symbol group customers identified in the Decision		
	Category-level customers	… of whom purchase less than 25% of their average in at least one month	%	Category-level customers	… of whom purchase less than 25% of their average in at least one month	%
Bread and cakes	✂	✂	✂	✂	✂	✂
Chilled	✂	✂	✂	✂	✂	✂
Deli	✂	✂	✂	✂	✂	✂
Meat	✂	✂	✂	✂	✂	✂
Produce	✂	✂	✂	✂	✂	✂

Source: Frontier analysis of Booker data

(ii) Booker's symbol customers have extensive alternative wholesale supply options from which to multi-source

2.28 Booker's symbol group customers have extensive alternative wholesale supply options from which to multi-source across both the delivered and cash & carry channels. Indeed, Booker accounts for only c.11% of the total UK wholesale market (see Section 3A of the initial submission), which demonstrates that there are a large number of alternative wholesalers that retailer customers can (and do) use.

2.29 **Annex 8** provides a non-exhaustive set of profiles of some major wholesale competitors, which illustrates that there is a wide range of effective wholesale competitors across both the cash & carry and delivered channels. Therefore, the effective competitor set used in the Decision is unduly narrow. As an illustrative example, the individual wholesaler members of the Landmark and Today's buying groups should be included in any effective competitor set:

(a) **Landmark Group**: Landmark is a wholesale buying group with a turnover of nearly £3 billion and members throughout the UK. Landmark states that it is "*one of the UK's largest Wholesalers, wielding massive buying power, with which we negotiate excellent Terms for our Members*".[40] Similarly to Booker, they offer symbol group services to independent retailers under the Lifestyle Express fascia.[41] Landmark also advertises "*strong promotional packages*"

[40] http://www.landmarkwholesale.co.uk/the_landmark_wholesale_family.php

[41] http://www.landmarkwholesale.co.uk/lifestyle-express.php

and "*superb Own Brand ranges*", the latter of which includes over 1,000 SKUs.[42]

(b) **Today's Group**: Today's is the "*largest independent buying group of its kind in the UK with buying power exceeding £5.7bn*". The buying group sells four own brand ranges. It also provides symbol group services under the Day-Today and Today's Extra brands.[43] Today's has over 160 wholesale members.[44] For example, Wanis International Foods is one of the largest specialist food and drink wholesalers in the UK, stocking over 8,000 product lines and offering both cash & carry and delivered services. In its testimonial, the wholesaler states that: "*Today's £5.7 billion annual buying power is of huge value. Retailers love the promotions and prices we offer through Today's. They're always the best.*"[45]

2.30 Moreover, it is appropriate to consider both the cash & carry and delivered channels when assessing the alternative wholesale options available for Booker's symbol group customers. This is because there is strong evidence showing that <u>Booker's symbol group customers source products from a mix of cash & carry and delivered wholesalers</u>. In particular:

(a) As recognised in the Decision, Premier customers source c.37% of their requirements through the cash & carry channel.[46] This is a significant proportion of their wholesale supplies.

(b) An analysis of Premier customers' wholesale purchases from Booker shows that almost all of them use a mixture of cash & carry and delivered options for such purchases. As shown in **Figure 10** below, ✂ of Premier customers rely on deliveries for 90% of their Booker purchases, whilst a similar number rely on cash & carry visits for 90% of their Booker purchases. ✂, which illustrates that they typically obtain their wholesale supplies using <u>both</u> cash & carry and delivered channels.

Figure 10: distribution of cash & carry and delivered purchase splits amongst Premier customers (FY17)

✂

Source: Frontier analysis

(c) This is consistent with the *Booker / Makro* merger inquiry, in which the CC held that "*delivered operators are likely to be effective alternatives in the wholesale market for most customers in most areas*"[47] and that there was "*significant evidence of the mixed use of delivered and cash-and-carry sources suggesting that significant volumes would be lost from cash-and-carry to delivered competitors if a hypothetical monopolist of cash-and-carry services*

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42 http://www.landmarkwholesale.co.uk/join-landmark.php

43 http://www.todays.co.uk/retailer/promotions/

44 http://www.todays.co.uk/wholesaler/

45 http://www.todays.co.uk/wholesaler/wholesaler-testimonials/

46 See footnote 28 of the Decision.

47 See paragraph 8.29 of the final report

in a local area attempted to increase prices by a small (but sustained and non-transitory) amount".[48]

2.31 Therefore, all of Booker's symbol group customers have a number of alternative wholesale supply options. For example, all of Booker's symbol group customers have at least four non-Booker alternative wholesale options (based on a 30 minute drive time for cash & carry branches[49] and a 4 hour drive time for delivery depots).[50] Over three quarters of Booker's symbol group customers have seven or more alternatives.

2.32 Even this is only a conservative assessment of the alternative wholesale options available to Booker's symbol group customers, as:

(a) it is based on a narrow competitor set that materially understates the highly competitive nature of the wholesale market. It does not include the alternative supply options available from many effective wholesale competitors across both the cash & carry and delivered channels; and

(b) it adopts a 30 minute drive-time catchment size for cash & carry wholesalers, even though there is strong evidence that many wholesale customers frequently travel further than 30 minutes to obtain the best wholesale terms. For example, it is not uncommon for customers in regional areas to make regular trips to access London's large and diverse wholesale markets.

(iii) The Decision's filtering approach fails to take into account the strong evidence that wholesale customers extensively multi-source

2.33 The Decision's filtering approach does not take into account the substantial evidence that Booker's symbol group customers multi-source from a wide range of wholesalers.

2.34 It would be inappropriate for the CMA to follow the approach taken in the Decision of treating the switching of wholesale volumes away from Booker as an ineffective countermeasure to any attempt by the merged entity to deteriorate Booker's wholesale offering post-merger. The Decision appears to rely on the market test during Phase 1 in which only a small proportion of respondents indicated that they would switch volumes away from Booker in the face of a hypothetical deterioration.[51] However, this response is inconsistent with the weight of evidence demonstrating clearly that Booker's symbol group customers do – as a matter of fact - switch significant wholesale volumes between competing wholesalers in order to obtain the most attractive wholesale terms.

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[48] See paragraph 7.30(a) of the final report

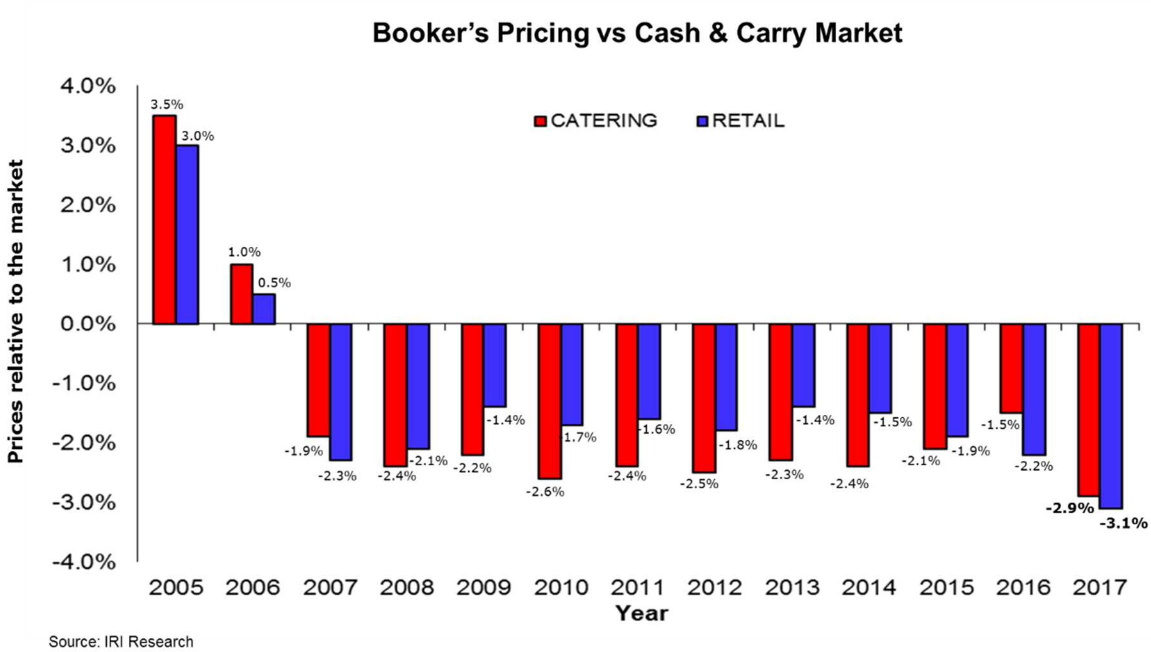
[49] The 30 minute drive-time catchment is consistent with the approach taken by the CC in *Booker / Makro*, although the Parties consider that this is conservative.

[50] Booker has carried out this exercise on a conservative basis and only included the following larger competitors: P&H, Fillshill, Nisa, Bestway, Batleys, Dhamecha, Blakemore, Parfetts, Hyperama, Costco and members of the Spar, Today's and Landmark buying groups (which for each group are treated together as a single fascia). Many of Booker's symbol group customers may also be located close to the wide range of other regional, local and specialist wholesalers.

[51] See paragraph 149(b) of the Decision.

2.35 The Decision is also inconsistent with customer submissions from *Booker / Musgrave*,[52] *Booker / Makro*[53] and *Costcutter / P&H*,[54] which indicated that retailers multi-source from a range of wholesalers and are willing to switch significant purchasing volumes between wholesalers. The competitive dynamism in the UK wholesale sector has increased since the CC previously looked at the sector in the *Booker / Makro* merger inquiry, further strengthening its previous finding that symbol group customers can and do switch wholesale volumes between a wide range of wholesalers. This is illustrated by **Figure 11** below, which shows that Booker's pricing has – if anything – become even more competitive over time:

Figure 11: Booker wholesale prices relative to Cash & Carry market



Source: Booker final results presentation for the 52 weeks ended 24 March 2017

2.36 All the above serves to emphasise that there are extensive alternative wholesale supply options available to Booker's symbol group customers, a conclusion which is entirely consistent with the CC's findings in *Booker / Makro*.

[52] See paragraphs 27(b), 55(d) and 59(a) of the Phase 1 decision.

[53] See paragraphs 8.5, 8.11, 8.13 and 8.17 and Table 3 of the final report.

[54] See paragraphs 40 and 41 of the Phase 1 decision.

3. Booker has insufficient control over its symbol group customers to give it the ability to influence their retail offering to any meaningful degree

<u>Summary</u>

- Booker operates a **highly flexible symbol group model** in which independent retailers have a high degree of autonomy and control in how they run their businesses. This was recognised by the CMA in *Booker / Musgrave*.
- Since the CMA's review of the *Booker / Musgrave* transaction, Booker's relationship with its symbol group customers has become even more flexible. As such, Booker exercises even less control over its symbol group customers compared to when the CMA last examined this issue.
- Booker has only **very limited ability to determine or influence its symbol group customers' retail offering**. Any meaningful influence that Booker exercises relates only to a narrow part of its symbol group customers' retail offering. The merged entity would therefore not have the ability to deteriorate the retail offering of its symbol group customers in a way that could cause material diversion of end consumers away from Booker-supplied symbol stores to competing retailers.
- Any control that stems from Booker's ability to enforce its contractual terms with its symbol group customers is **purely hypothetical**, as Booker undertakes very little monitoring and enforcement of its contracts.
- In any event, the merged entity would have **no incentive** to enforce its contractual terms with its symbol group customers post-merger:
  - this would fundamentally damage the trust and reputation that Booker has built with its symbol group customers; and
  - this would directly undermine the strategic rationale and expected revenue synergies of the Merger, which are based around growing each of the Booker and Tesco businesses and therefore improving Booker's wholesale offering to its customers.
- **<u>Conclusion</u>**: as the merged entity does not have the ability or incentive to influence the retail offering of Booker-supplied symbol stores in a way that would cause material diversion away from Booker-supplied symbol stores to competing retailers, this further demonstrates its inability to bring about the theory of harm set out in the Decision. As such, there can be no SLC.

A. Booker operates a highly flexible symbol group model

3.1 Booker's symbol group customers are typically small businesses and many are highly successful and entrepreneurial professional retailers. They take commercial responsibility for their own retail offering and they look for wholesale suppliers who can help them deliver a competitive retail offering to end consumers. As such, Booker's wholesale offering is designed to support retailers in understanding what consumers want. Booker is not a retailer and so its philosophy is not based around designing a particular retail model and then requiring customers to adhere to that model. Instead, <u>Booker operates a highly flexible symbol group model in which independent retailers have a high degree of autonomy and control in how they run</u>

their businesses. This is reflected in the minimal level of contractual requirements that Booker places on its symbol group customers.

3.2 Booker has a long history of working with its customers to improve choice, price and service:

(a) The aim is to retain customers through an attractive wholesale and symbol group services offering, rather than imposing contractual restrictions or requirements on its customer base.

(b) This highly flexible model is favoured by Booker, as it enables Booker to use the combined consumer reach of its symbol group members to negotiate competitive terms and promotions from suppliers, while allowing retailers to retain a high degree of flexibility in how they operate their own businesses. Capital investment requirements are low for both Booker and its symbol group customers,[55] and Booker's symbol group customers are able to source a significant proportion of their purchasing requirements from alternative suppliers (see **Section 2C** above).

(c) Consistent with the flexible nature of its symbol group model, Booker's contracts with its symbol group retailers are short and straightforward. ✂, these are all optional services for the retailer and form part of Booker's strategy of providing advice to symbol group retailers to help increase their performance (and thereby the ability of Booker to provide wholesale sales to its symbol group retailers).

3.3 ✂ This is demonstrated by the fact that:

(a) around ✂% of Premier customers are purchasing goods from Booker below the minimum purchase levels stipulated in their contracts;

(b) since 2007, ✂ symbol group customers have left the Premier symbol group while still "in contract" and Booker has pursued almost none of them to fulfil their contractual obligations; and

(c) since joining the Booker Group, ✂.

✂[56]

3.4 The Decision considers that the merged entity has the ability to exert a meaningful degree of control over its symbol group customers due to its ability to enforce its contractual terms with symbol group customers.[57] However, any control that stems from Booker's ability to enforce contractual terms is purely hypothetical and insufficient to cause a substantial lessening of competition:

(a) as described above, ✂; and

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[55] There is ✂ and Booker makes an upfront payment of approximately ✂ for Premier and Londis customers (and approximately ✂ for Budgens customers) to cover fascia and internal signage support, as well as other necessary setup costs. ✂

[56] ✂

[57] See paragraph 131 of the Decision.

(b) even if the contractual terms could be and were enforced by the merged entity, this would not impact the Parties' analysis of critical diversion ratios under its vertical GUPPI framework (as set out in **Section 7** below). For example, the critical diversion ratios presented in the vertical GUPPI analysis are all based on Booker's symbol group customers meeting the minimum spend proportions implied by the relevant contracts. Therefore, it is incorrect to suggest that Booker's ability to enforce its contractual terms provides the merged entity with the ability and incentive to deteriorate Booker's offering to its symbol group customers in order to divert sales to Tesco stores.

3.5 Moreover, the merged entity has no intention to change its highly flexible symbol group model post-merger by seeking to enforce its contracts with its symbol group customers. Indeed, the merged entity would have no incentive to do so post-merger:

(a) Booker has significant experience in providing symbol group services and has extensive feedback from customers highlighting that they value Booker's highly flexible symbol group model. Booker believes that ✂ would make no commercial sense, as it would fundamentally damage the trust and reputation that Booker has built with its symbol group customers. In turn, this would result in many customers switching to alternative wholesale supply options (as explained in **Section 2** above) and also hamper the ability of Booker to attract new symbol group members.

(b) Any strategy based on deteriorating Booker's wholesale offering to its symbol group customers would directly cut across the strategic rationale and expected revenue synergies of the Merger (and therefore be commercially unacceptable). In particular: (i) a key element of the strategic rationale for the Merger is to offer better choice, price and service to business customers (including Booker's symbol group customers), enabling them, in turn, to offer better value and quality to their consumers;[58] and (ii) the merged entity is aiming to realise significant revenue synergies by utilising Tesco's skill and expertise to offer an improved product range and enhanced service proposition to Booker's customers (including its symbol group customers).[59]

B. The CMA has previously concluded that Booker has no meaningful control over its independent symbol group customers

3.6 The CMA has previously examined the relationship between symbol group providers and symbol group retailers in *Booker / Musgrave and Costcutter / P&H*. In both cases, the CMA concluded that symbol group retailers were independent and symbol group providers did not exercise sufficient control over symbol group retailers to facilitate coordination between them at the retail level:

(a) In *Booker / Musgrave*, the CMA stated that:

(i) *"Evidence from customers who responded to the CMA's merger investigation on their independence and purchasing habits and the Parties' fascia analysis indicates that they consider they are sufficiently independent, have sufficient alternative sources of supply*

[58] See the Parties' Rule 2.7 announcement.

[59] See BCG's synergy report and Deloitte's Quantified Financial Benefits Plan Report.

and face enough local competition to prevent a substantial lessening of competition at the retail level."[60]

(ii) "*the Parties would not have the ability or incentive to increase prices, or reduce the quality of the retail offer or facilitate coordination at the retail level as a result of the following factors: (i) the small number of stores where such a strategy may be profitable; (ii) the independence of member stores in setting prices and differentiating their offerings by sourcing from alternative providers; and (iii) the risk that they would switch to another symbol group.*"[61]

(b) In *Costcutter / P&H*, the OFT noted that:

(i) "*Third party customers noted that if the parties increased their wholesale prices, they would change symbol group or, in some cases, self-supply such services. Their comments suggest that higher recommended retail prices or rebates would be ineffective at stopping them from switching.*"[62]

(ii) "*the parties would not have an incentive to increase prices, reduce the quality of retail offer or facilitate co-ordination given the independence of member stores, their ability to differentiate their offerings and the risk that they would switch to another symbol group.*"[63]

C. The CMA's previous conclusions still stand: Booker does not have the ability to influence the retail offering of its symbol group customers to any meaningful degree

3.7 The CMA's previous findings still stand. Indeed, since the CMA's review of the *Booker / Musgrave* transaction, Booker's relationship with its symbol group customers has become increasingly flexible in line with its "pull" strategy for the supply of symbol group services. ✂ As such, Booker exercises even less control over its symbol group customers compared to when the CMA last examined this issue in *Booker / Musgrave*.

3.8 <u>The Parties have provided substantial evidence supporting the CMA's previous findings that Booker's symbol group customers are independent retailers and not subject to any meaningful control by Booker</u>. In particular, Booker has limited ability to determine or influence most aspects of their symbol group customers' retail offering, including (but not limited to):

(a) their choice of store location;[64]

(b) their opening hours;

(c) their pricing;

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[60] See paragraph 59 of the Phase 1 decision.

[61] See paragraph 6 of the Phase 1 decision.

[62] See paragraph 42 of the Phase 1 decision.

[63] See paragraph 53 of the Phase 1 decision.

[64] ✂

(d) their service level and staffing;

(e) their product availability and replenishment standards;

(f) their store layout[65] and category mix; and

(g) their general product range.[66]

3.9 For instance, Londis symbol stores have their own webpages on the Londis website which symbol group retailers can customise to choose what they advertise on the "*What's in Store*" section. Symbol group retailers overwhelmingly use this to focus on services outside of Booker's control or influence, with the five most commonly advertised features all being services or products not supplied by Booker:

Figure 12: percentage of Londis store websites advertising certain features

✂

Source: Frontier analysis

3.10 As set out in detail in Sections 8(B)(i) to 8(B)(v) of the Merger Notice, there is considerable evidence demonstrating that Booker's symbol group members are free to set their own retail pricing and determine their own product range (✂).[67] Moreover, the Decision fails to explain how the merged entity would be able to exercise any meaningful degree of influence over the retail offering of its symbol group customers. In particular:

(a) The Decision relies on the finding in *Booker / Musgrave* that symbol group retailers place importance on the services provided by symbol group providers.[68] However, there is no explanation as to how this would enable the merged entity to deteriorate the retail offering of its symbol group customers. In fact, the overarching conclusion in *Booker / Musgrave* was that Booker's symbol group customers are sufficiently independent and Booker would not be able to exercise any meaningful degree of influence in order to deteriorate the retail offering of its symbol group members (see paragraph 3.6(a) above).

(b) The Decision considers that Booker's contractual arrangements with its symbol group customers contain requirements relevant to "*all aspects of the symbol group retailers' eventual retail offering*".[69] This is not the case, as Booker's contractual arrangements ✂.

(c) The Decision asserts that Booker has access to 'softer' means of potential influence without explaining how this would actually enable it to exert any

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65 ✂

66 ✂

67 For example, see paragraph 59 of the CMA's *Booker / Musgrave* decision: "*Customers corroborated the Parties' submission that member stores are independent and have viable alternative sources of supply. For example, most customers noted that they would not automatically accept an increase to the RRP and would price according to their local competitive conditions*".

68 See paragraph 130 of the Decision.

69 See paragraph 131 of the Decision.

meaningful degree of influence over the retail offering of its symbol group customers.[70] The Parties do not consider that any 'softer' means of potential influence give Booker the ability to deteriorate the retail offering of its symbol group customers. For example, the advice provided by Booker's retail development managers is optional and based around improving the performance of the Booker-supplied symbol store: a retailer would clearly not follow any advice based around worsening its retail offering.

3.11 Any hypothetical deterioration of Booker's wholesale offering could at most have only a limited impact on the symbol group customer's retail offering, which means it is highly unlikely to cause any material diversion of end consumers away from Booker-supplied symbol stores to competing retailers. In any event, all of the points referred to in paragraph 3.10 above were also present when the CMA last examined Booker's symbol group arrangements (i.e. in *Booker / Musgrave*) and they did not impact the CMA's conclusion that Booker has insufficient control over its symbol group customers to deteriorate their retail offering in any meaningful way.

[70] See paragraph 132 of the Decision.

4. Booker's symbol group customers are highly unlikely to pass-through fully any unilateral wholesale deterioration by Booker to their end consumers

Summary

- As noted in **Section 3** above, Booker has insufficient control over its symbol group customers to give it the ability to influence their retail offering to any meaningful degree. Therefore, the merged entity does not have the ability to cause a material diversion of consumers from Booker-supplied symbol stores to Tesco stores.
- **The Parties consider that a pass-through rate of 50% is a reasonable estimate**:
    - Booker's symbol group customers operate in highly competitive retail groceries markets, so they would likely do everything in their power to avoid worsening their retail offering unilaterally in order to prevent losing end consumers to competing retailers.
    - Booker has a very limited role in setting RRPs: they are typically set by suppliers and changed by Booker only on an exceptional basis. Booker's symbol group customers are not required to follow RRPs and there is no reason that these highly informed and price sensitive business owners would follow RRPs if set at an uncompetitive level.
    - In relation to branded products that are sold by Booker as a price-marked pack or as part of a mandatory promotion, it is <u>the supplier</u> that is the source of any meaningful influence over the retailer customer.
- **<u>Conclusion</u>**: a pass-through rate of 50% is a reasonable estimate, which means that any diversion from Booker-supplied symbol stores to Tesco stores is unlikely to be material. This is particularly the case where there are many competing players at the retail level (i.e. the Decision's retail filter based on a fascia reduction of 5 to 4 (or fewer) is inappropriate and excessively conservative).

4.1 The Decision's retail filter appears to be based solely on the difference between Tesco's retail margin and Booker's wholesale margin. As such, the Decision's retail filter fails to account for the fact that:

(a) the pass-through rate by symbol group customers of any unilateral deterioration of Booker's wholesale offer is unlikely to exceed 50% (as described in this **Section 4**); and

(b) Booker-supplied symbol stores and Tesco stores are not close competitors at the retail level (see **Section 5** below).

A. The Decision's assertion that pass-through is likely to be above 80% cannot be supported

4.2 The Decision asserts that "*the rate of pass-through of wholesale prices to retail prices is typically high, often above 80%*".[71] The Parties consider that this approach cannot be supported and runs counter to the CMA's previous decisional practice in Phase 2 merger cases.

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[71] See paragraph 142 of the Decision.

4.3 The Decision rightly notes that "[e]*conomic models predict that a wide range of pass-through effects is possible*".[72] These economic models vary in terms of the assumptions they make on the number of competing firms, the shape of the demand curve, the degree of differentiation between competing firms and how firms compete (i.e. by setting prices or by setting quantities). The RBB paper referred to in the Decision notes that under a commonly assumed market structure in sectors such as those in which the Parties are active (i.e. market participants with differentiated offerings who compete by setting prices), and with the starting point of linear demand, individual firm pass-through is likely to be between 50% and 55%.[73]

4.4 For an individual firm facing a unilateral cost increase (i.e. a Booker symbol group retailer facing a unilateral wholesale price rise) to pass on 80% or more of an input cost change to end consumers, the CMA would have to assume a specific "convex" shape for the demand function. There is no economic evidence or precedent to support any such approach:

(a) As the RBB paper notes: "*Ultimately, therefore, the curvature of demand is liable to have an important bearing on the extent of pass-through. Whether estimation methodologies are capable of identifying or approximating this factor in practice is therefore a critical empirical issue*".[74] The empirical section of the same paper subsequently notes that: "*very few empirical studies report on the role of the curvature of demand in explaining cost pass-through*".[75]

(b) In recent Phase 2 decisions, namely *Poundland / 99p Stores* and *Reckitt Benckiser / K-Y brand*, the CMA has assumed that the demand curve is linear. In *Poundland / 99p Stores*, the CMA calculated illustrative price rises assuming linear demand elasticity.[76] In its *Reckitt Benckiser / K-Y brand* decision, the CMA also noted that linear demand is a "*common and conservative assumption for IPR calculations*".[77] When the CMA has considered a convex "isolelastic" demand function, it has done so on a cautious basis in Phase 1.[78] Furthermore, this cautious approach has been a result of historic beliefs rather than firm economic evidence. For example, in *Somerfield / WM Morrisons*, the choice of an isoelastic demand function was said to be because: "*intuitively, it seems more plausible that demand would become less elastic at higher prices, when demand has already fallen*".[79] In

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72 See paragraph 142 of the Decision.

73 Figure 13 of the RBB report shows the range of firm-specific cost pass-through in a differentiated Bertrand setting with different numbers of competitors and different degrees of product differentiation.

74 See section 3.2 of the report.

75 See section 7.4 of the report.

76 See paragraph 6.151 of the CMA's final report.

77 See paragraph 7 of Appendix F to the CMA's final report.

78 See paragraph 59 of *Asda Stores Limited / Co-operative Group Limited* (ME/6466-14) and paragraph 34 of *Lincolnshire Co-operative Limited / Musgrave Retail Partners GB Limited* (ME/6476/14).

79 See paragraph 14 of Appendix D to the final report. This justification was also used as the rationale for assuming isoelastic demand in *Asda Stores Limites / Co-operative Group Limited* (ME/6466-14, see paragraph 59) and *Lincolnshire Co-operative Limited / Musgrave Retail Partners GB Limited* (ME/6476/14, see paragraph 35).

response, the parties in this merger inquiry noted that this intuitive assumption would imply price increases of over 1,000% in certain stores.[80] Unrealistic price rises are not uncommon when using an assumption of isoelastic demand, as this approach predicts pass-through rates of over 100% as standard.

4.5 The Parties consider that the pass-through rate by symbol group customers of any unilateral deterioration of Booker's wholesale offer is unlikely to exceed 50%. The evidence and economic theory suggest that any unilateral wholesale deterioration by Booker would be passed through only to a limited extent, if at all, by Booker's symbol group customers:

(a) any deterioration by Booker would represent a unilateral cost change for Booker's symbol group customers. Given that Booker's symbol group customers operate in a highly competitive retail groceries sector (see section 3B of the initial submission), Booker's symbol group customers would likely do everything in their power to avoid worsening their retail offering to prevent losing end consumers to competing retailers. As such, a high pass-through rate is unlikely where the Booker-supplied symbol store is located in an area with many competing retailers (which was not reflected in the Decision's retail filter); and

(b) direct evidence from previous merger inquiries suggests that retailers would not pass through wholesale cost increases. For example, in the *Booker / Musgrave* merger inquiry, the CMA stated that: "*Customers corroborated the Parties' submission that member stores are independent and have viable alternative sources of supply. For example, most customers noted that they would not automatically accept an increase to the RRP and would price according to their local competitive conditions. Customers' would also not automatically pass through a 5% wholesale price increase but may, as discussed above, switch to alternative wholesale supply options*".[81]

B. The merged entity lacks the ability to ensure any wholesale deterioration is passed-through to end consumers

4.6 As noted in **Section 3** above, Booker has insufficient control over its symbol group customers to give it the ability to influence their retail offering to any meaningful degree. This means the merged entity would lack the ability to ensure pass-through of any unilateral wholesale deterioration. The points raised in the Decision do not impact this conclusion. In particular:

(a) the Decision states that "*Booker effectively sets the RRPs it communicates to symbol group retailers, even if those RRPs may be influenced by pricing recommendations made by Booker's suppliers*".[82] However, this materially overstates Booker's role in setting RRPs, as ✂;

(b) the Decision relies on the fact that its Phase 1 market test indicated that symbol group retailers' adherence to RRPs was generally high.[83] However, the

[80] See paragraph 7.19(e) of the final report.

[81] See paragraph 59 of the CMA's *Booker / Musgrave* decision.

[82] See paragraph 143 of the Decision.

[83] See paragraph 143 of the Decision.

evidence does not support this. Based on a sample of ✂ Londis retailers which transferred their retail prices to Booker between 30 March 2017 and 17 May 2017,[84] Londis retailers exhibited a ✂ of freedom in deviating from RRPs:

(i) across all products, retailers deviated from the supplier-set RRP on approximately ✂ of the product lines sold during this period;

(ii) considering only non-price-marked products, retailers deviated from the RRP on approximately ✂ of the product lines sold during this period; and

(iii) in instances where retailers charged a price above the RRP, the average increase was ✂%. In instances where retailers charged a price below the RPP, the average decrease was ✂%.

Figure 13: distribution of Londis retailers' RSP Compared with Londis RRP

✂

Source: Frontier analysis

(c) in any case, where retailers adhere to RRPs, this may simply reflect the fact that RRPs are currently set (typically by suppliers) at very competitive levels (particularly given the highly competitive nature of the wholesale and retail groceries sectors). Even if Booker's symbol group customers do typically follow RRPs (which the Parties do not consider to be the case), there is no evidence to suggest that they would continue to do so if the RRPs were set at an uncompetitive level. Booker's symbol group customers are highly informed and price sensitive business owners whose personal business success is tied to their ability to source products on competitive terms. Faced with a unilateral increase in RRPs, they would simply continue to set their retail prices at a competitive level (irrespective of the RRP). This is consistent with the CMA's finding in *Booker / Musgrave* that customers "*would not automatically accept an increase to the RRP and would price according to their local competitive conditions*" (see paragraph 4.5(b) above);

(d) the Decision states that "*Booker has a role in negotiating promotional prices and in determining the availability of price-marked products*". However, Booker's role in these areas would not enable it to ensure that any unilateral wholesale deterioration would be passed through by Booker's symbol group customers to a significant degree. In particular: (i) a significant proportion of Booker's promotions comprise promotions where Booker does not apply any obligation on its symbol group customers to support the promotion (e.g. only ✂% of Booker's wholesale sales to Premier customers involve a promotion with an obligation on its symbol group customers to support an associated

[84] As explained to the CMA during pre-notification, these retailers transfer their retail prices to Booker for the purposes of showing the POR percentage on the despatch notes (i.e. enabling the retailer to better measure whether Booker is offering a competitive proposition and allowing the retailer to make a good return). Booker is not automatically provided with a retailer's retail selling price when that retailer downloads a Booker price file or alters a retail price on their EPOS system.

retail promotion in-store); and (ii) where branded products are sold as a price-marked pack or as part of a mandatory promotion, it is the supplier that is the source of any meaningful influence over the retailer customer, which means Booker would need to negotiate with suppliers to change the key terms influencing retailer customers.[85] It is implausible to suggest that Booker would be able to negotiate with suppliers to print a higher price mark on a product or to allow Booker to implement less attractive promotions on the suppliers' products, as:[86]

(i) it would not be profitable for suppliers to agree to fund a higher margin for Booker at the expense of their retail sales volumes to end consumers; and

(ii) it would not be feasible for suppliers to sign up to highly customised versions of promotions and price-marked packs that could be targeted at a selected minority of Booker's symbol group customers. For example, suppliers typically produce price-marked packs on a consistent basis for the entire wholesale channel (i.e. they are not specific to Booker).[87] Booker would simply not be able to persuade a supplier to alter the price mark on a minority of its volume just to pursue a targeted local pricing strategy.

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85 Frontier conducted an analysis at Phase 1 of the different influences on the retail offering of symbol group customers to end consumers (see **Appendix 8.AO** to the Merger Notice). This analysis indicated that symbol group customers would be able to achieve – at most – pass-through of a wholesale cost increase of between ✂% and ✂% only. This reflects that there is scope for: (i) complete pass-through on less than ✂% of products sourced from Booker; and (ii) pass-through at the symbol group customer's discretion on around ✂% to ✂% of products sourced from Booker. Overall, this suggests that even a pass-through rate of 50% is conservative.

86 See paragraphs 8.31 to 8.32 of the Merger Notice.

87 The only exceptions to this are ✂

5. Booker-supplied symbol stores and Tesco stores are not close competitors at the retail level

Summary

- High diversion ratios from Booker-supplied symbol stores to Tesco stores are implausible, as they **do not closely compete with Tesco stores**: consumers at Booker-supplied symbol stores are likely to perceive other symbol stores, petrol forecourt retailers and unaffiliated independents as closer alternatives than Tesco stores.
- **Aldi, Lidl and Iceland are effective competitors in the retail groceries sector** and provide a strong and credible offering across all customer missions.
  - They continue to grow rapidly and are adapting their offering to compete more directly with players in the convenience sector.
  - It is irrefutable that the discounters are close competitors to Tesco (and the other multiples). The presence of discounters in an area will therefore significantly influence the extent to which consumers divert from Booker-supplied symbol stores to Tesco stores, as – to the extent that these consumers do not divert to other symbol stores, petrol forecourt retailers or independents - the discounters will compete strongly against Tesco for their custom.
- **Conclusion**: if the retail offering of Booker-supplied stores is deteriorated, consumers are likely to divert to a wide range of stores (including McColls, Aldi, Lidl, Iceland, symbol stores, petrol forecourt retailers and unaffiliated independents). Therefore, the Decision's effective competitor set is unduly narrow and the Decision's retail filter is excessively conservative.

5.1 This is explained in detail in **Annex 7**.

6. It would make no commercial sense for the merged entity to vary Booker's wholesale offering on a local basis

<u>**Summary**</u>

- **Booker's wholesale offering is set on a national basis** and there is ✂.
- The merged entity would therefore need to devise a novel and bespoke strategy in order to deteriorate Booker's offering in targeted local areas in a hypothetical attempt to foreclose its own customers (i.e. individual symbol group retailers to which it provides services). This would involve a **fundamental change to Booker's business model, be impractical and entail significant costs and investment** in a strategy that would inevitably result in reputational damage to the merged entity.
- In any event, the merged entity has **no incentive** to vary Booker's offering in targeted local areas:
  - Such a strategy would **fundamentally damage the trust and reputation that Booker has built with its symbol group customers**.
  - Any theoretical gains would be minimal and substantially outweighed by the commercial risks and significant costs involved. Even based on the excessively conservative filters set out in the Decision, only 369 areas were identified where the CMA considered that such a strategy could be profitable:
    - Booker's symbol group customers located in these 369 areas comprise less than c.✂% of its symbol group customers and only c.✂% of its total number of retailer customers (considering only those retailer customers who purchased at least £1,000 from Booker in the last financial year).
    - Moreover, Booker's sales to these symbol group customers comprise **only c.✂% of its total sales and only c.✂% of its total operating profit**.
- <u>**Conclusion**</u>: the merged entity would not change Booker's business model and nationally defined wholesale proposition to bring about some kind of hypothetical local diversion involving Booker-supplied stores that generate only c.✂% of Booker's operating profit. As such, the Parties consider that the theory of harm set out in the Decision cannot be substantiated and no substantial lessening of competition arises.

A. Booker does not target or vary its wholesale offer according to local competitive conditions

6.1 Booker operates in a highly competitive and low margin sector. The diversity of wholesale competitors means that the boundaries of the wholesale market cannot easily be defined. Booker runs its business on the basis that all its customers have access to a large number of alternative supply options. This is why Booker has a long established and successful strategy ✂.

6.2 This means that Booker's entire corporate strategy, as well as its management infrastructure, is set up to improve continuously its choice, price and service to all its customers. The very significant turnaround in the fortunes of the Booker business under this strategy – having been close to bankruptcy in 2005 – is a testament to the importance of serving all customers well in this market (see **Figure 14** below).

Figure 14: Booker sales and customer satisfaction since 2006-07

✂

6.3 ✂

6.4 ✂

6.5 ✂[88]

6.6 Importantly, the CC extensively investigated whether Booker could adjust its offer to target local wholesale competitive conditions in the *Booker / Makro* merger inquiry. It found:[89] "*A limited likelihood that there is a significant number of captive cash-and-carry customers that could be exploited through price discrimination strategies. This assessment was supported by evidence that…the price-concentration analysis, which suggests that there was only a limited profit gain to Booker in areas where Booker currently faces little or no local cash-and-carry competition*".

B. It would be difficult for the merged entity to implement any hypothetical targeting strategy

6.7 ✂

6.8 ✂

6.9 ✂

(a) ✂[90][91]

(b) The Decision suffers from a number of further misconceptions of how Booker's business operates and therefore draws erroneous conclusions as to what the merged entity would be able and incentivised to do:

(i) The Decision states that "*Booker negotiates prices with local suppliers on behalf of symbol group retailers*".[92] ✂.[93] Retailers remain entirely free to source directly from and negotiate with local suppliers. ✂.

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88 ✂

89 See paragraph 7.30 of the final report.

90 See paragraph 136(b) of the Decision.

91 See Booker's website for information on the Spend & Save discount structure and how it is determined: http://www.booker.co.uk/pages/SpendAndSave.aspx. The discount level is determined by the retailer's 4-weekly spend across both tobacco and non-tobacco purchases, and the discount is then calculated on the non-tobacco element of the retailer's spend.

92 See paragraph 136(c) of the Decision.

93 ✂

(ii) Moreover, the Decision insinuates that Booker would deteriorate delivery services to particular retailers with a view to worsening their offering (which under that hypothesis would in turn result in consumers diverting to Tesco).[94] However, ✂

(iii) Finally, the Decision notes that Booker's retail development managers (***RDMs***) provide advice on elements of the retail offering and the service provided by Booker.[95] It is not clear what the Decision is implying. Any suggestion that Booker might instruct its RDMs to advise certain stores that they should over-price or under-serve their customer base (presumably while appearing to advise the opposite) would clearly not be tenable and is inconceivable in practice. It would require the RDMs – in defiance of their function – to betray the retailer's trust, thwart rather than aid their development, and ultimately destroy the retailer's relationship with Booker.

(iv) The Decision refers to the provision of advice as a "*softer*" means of potential influence.[96] Where the advice would damage the retailer's business, it is difficult to see how this would confer any influence at all, as the retailer would either not implement Booker's advice in the first place or not do so in the future. Either way, this would clearly damage Booker's relationship with its retailer customers.

6.10 In summary, many of the Decision's underlying assumptions leading it to conclude that the merged entity would extend its very limited local variation to its wider wholesale symbol group offering (in a strategic effort to achieve hypothetical local diversion to Tesco stores) suffer from several misconceptions of the commercial dynamics within which Booker operates and how it runs its business.

C. The merged entity would have no incentive to vary Booker's offering in targeted local areas

6.11 The Decision failed to address whether the merged entity would have any incentive to vary Booker's offering in targeted local areas. The merged entity would have no such incentive as the commercial risks of doing so would be substantial and therefore make no commercial sense. In particular, deteriorating Booker's offering in a small number of local areas would create serious reputational risks that extend across Booker's entire customer base and undermine the customer trust and relationships that have driven its commercial success. Booker's symbol group customers are savvy, highly informed and price sensitive business owners – it would quickly become apparent to them that certain customers were being offered different terms based solely on their location. Therefore, any attempt to target specific symbol group customers with a worse offering would fundamentally damage the trust and reputation that Booker has built with its symbol group customers. This would, in turn, have a detrimental impact on Booker's ability to retain its current symbol group members and attract new symbol group retailers.

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94 See paragraph 136(d) of the Decision.

95 See paragraph 136(e) of the Decision.

96 See paragraph 132 of the Decision.

6.12 Moreover, any theoretical gains from implementing local pricing strategies would be minimal, particularly when compared against the significant risks and costs of implementing such strategies. The filtering approach in the Decision suggests that there are 369 areas where consumer diversion to Tesco stores might feasibly reach the high levels required for it to be profitable to worsen Booker's wholesale offering. Booker's sales to symbol group customers in these areas are £✂ million, which comprise only ✂% of Booker's total sales and ✂% of Booker's total operating profit.[97] In addition, the filtering approach in the Decision is flawed and excessively conservative, which means the number of local areas that could be "potentially problematic" is significantly lower than that stated in the Decision (and, in the Parties' view, non-existent). Therefore, any theoretical gains from adopting local pricing strategies would be in the Parties' view illusory and, in any event, outweighed by the costs and risks of implementing such strategies. It would simply not make commercial sense (and would be ultimately unprofitable) for the merged entity to deteriorate Booker's offering in relation to a very small number of symbol group customers which generate such minimal profit for Booker. This lack of incentive to engage in a bespoke strategy targeted at specific local areas, particularly where there are only a small number of areas where such a strategy could conceivably be profitable, was recognised by the CMA in *Booker / Musgrave*.[98]

[97] 10 stores identified by the CMA on the basis of the Decision's filters have now left Booker's symbol group fascia.

[98] See paragraphs 6 and 59 of the decision.

7. The vertical GUPPI framework demonstrates that this theory of harm is implausible

7.1 As explained in Section 2 of the initial submission, the transaction is a vertical merger between a wholesale business (Booker) and a retail business (Tesco). This means that the economic incentives of the Parties post-merger are fundamentally different than they would be in a retail-to-retail merger.

7.2 In past retail-to-retail mergers, the CMA has used the GUPPI framework to assess the merging parties' incentives to deteriorate their offer post-merger. The same economic logic can be applied to this Merger by modifying the standard GUPPI framework to reflect the fact that this is a retail-to-wholesale merger and capture the substantial evidence set out in **Sections 2 to 6** above (i.e. using a vertical GUPPI framework).[99]

7.3 The vertical GUPPI framework demonstrates that there is no level of consumer diversion from Booker-supplied symbol stores to Tesco stores that could create an incentive for the merged entity to deteriorate Booker's wholesale offering to its symbol group customers post-merger. This flows from the fact that the critical diversion ratios **are materially above 100%** based on a 10% GUPPI threshold, which the Parties consider is the appropriate threshold for a Phase 2 inquiry (see **Figure 15** below).[100] In other words, it would be unprofitable for the merged entity to deteriorate Booker's wholesale offering to symbol group customers post-merger as:

(a) Booker would suffer a substantial decline in its wholesale sales, as many of its symbol group customers would likely switch to a competing symbol group provider or increase the proportion of their purchases from alternative wholesalers. In such circumstances, it would not be possible for the merged entity to re-capture this significant loss of sales at the wholesale level, as Tesco is not active in the wholesale groceries sector.

(b) In relation to Booker's wholesale sales to its symbol group customers that are not lost to competing wholesalers, symbol group customers would likely (at least in part) absorb Booker's worsened wholesale offering (i.e. not worsen their retail offering) due to strong competition at the downstream retail level. In such circumstances, this would significantly reduce the ability of the merged entity to re-capture any sales at the retail level through Tesco-owned stores, as there would be no deterioration (or only a limited deterioration) in the retail offering of Booker's symbol group customers causing consumers to divert their spend to competing retailers.

(c) Given this switching at the wholesale level and the limited pass-through of any unilateral deterioration by Booker's symbol group customers, even if 100% of any retail sales that were nonetheless lost by Booker-supplied symbol stores diverted to Tesco stores (which is highly unlikely, if not impossible), a deterioration of Booker's wholesale offering would still not be profitable for the merged entity post-merger.

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99 See **Annex 9.1** to the Merger Notice and **Appendix 9.A** to the Merger Notice for Frontier's technical paper on *Post-merger pricing incentives in retail-to-wholesale mergers* submitted to the CMA on 7 March 2017.

100 See, for example, the CMA's Phase 2 decision for *Ladbrokes plc / Gala Coral Group Limited* (footnote 118).

Figure 15: critical diversion ratios from Booker-supplied symbol stores to Tesco stores (10% GUPPI threshold and 50% pass-through assumption)

	10% GUPPI	
To **From**	**Tesco average**	**One Stop**
Premier	✂%	✂%
Family Shopper	✂%	✂%
Londis	✂%	✂%
Budgens	✂%	✂%

7.4 Given that critical diversion ratios are materially in excess of 100%, <u>a detailed local overlaps analysis is not required</u>: no amount of factual investigation would be able to uncover problematic levels of diversion from Booker-supplied symbol stores to Tesco stores.

7.5 The Decision notes that the CMA did "*not believe it would be appropriately cautious to rely on the modified GUPPI framework … for its phase 1 assessment*".[101] The Parties consider that it is appropriate for the CMA to use the vertical GUPPI framework for its Phase 2 assessment, particularly since the Parties have already undertaken reasonable sensitivity checks to show that any further local variation in critical diversion ratios would be relatively limited.[102]

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101 See paragraph 167 of the Decision.

102 See **Annex 9.1** to the Merger Notice.

8. Conclusion

8.1 The Parties consider that a local overlaps analysis is not required to assess this theory of harm. The vertical GUPPI framework – which the CMA has accepted in principle and the Parties consider should be used by the CMA at Phase 2 – demonstrates that the merged entity would have no incentive to deteriorate Booker's offering to its symbol group customers post-merger. Moreover, as explained in **Section 6** above, the merged entity would have at most a limited ability and no incentive to depart from Booker's existing strategy of determining its proposition nationally in order to implement a localised and targeted deterioration in the small number of areas identified in the Decision. Any theoretical gains from adopting bespoke strategies in targeted local areas would be minimal and, in any event, outweighed by the substantial commercial risks and significant costs involved. Therefore, this theory of harm does not make commercial sense, would not be profitable and cannot result in a substantial lessening of competition.

PROPOSED MERGER BETWEEN TESCO PLC AND BOOKER GROUP PLC

INITIAL SUBMISSION TO THE CMA FOR PHASE 2 REVIEW

ANNEX 4: RESPONSE TO THEORY OF HARM 4 ON WORSENING OF BOOKER'S CASH-AND-CARRY WHOLESALE OFFERING IN LOCAL AREAS WHERE BOOKER'S INDEPENDENT RETAIL CUSTOMERS' STORES OVERLAP WITH TESCO'S STORES

1. Introduction

1.1 Booker supplies a number of independent retailers that are not part of its symbol group offering. The CMA did not reach a conclusion in its Phase 1 decision referring the Merger for a Phase 2 inquiry (the ***Decision***) on "*whether the Merger gives rise to a realistic prospect of* [a substantial lessening of competition] *as a result of the foreclosure of independent retailers in any local areas in the UK*".[1]

1.2 The Parties consider that this theory of harm would not make commercial sense and would not be profitable. Moreover, it is implausible, as the merged entity could not influence the retail proposition of independent retailers. This is underpinned by the fact that Booker has ✂, and – for the vast majority of retailers – supplies only a minimal proportion of their wholesale requirements.

1.3 In relation to whether the merged entity could deteriorate the retail offering of independent retailers that source supplies from Booker:

(a) the wholesale market is highly competitive (see Section 3A of the initial submission), and a plethora of potential supply options exists for all of Booker's independent retail customers. This means that any deterioration of Booker's wholesale offering to independent retailers would result in them switching their purchases to alternative wholesalers. The wholesale competitor set used in the Decision for assessing this theory of harm is inappropriately narrow (e.g. it excludes delivered wholesalers, as well as regional and local cash & carry (***C&C***) wholesalers), and therefore fundamentally overstates the extent of Booker's ability to worsen the retail offering of independent retailers (as they could easily switch to alternative sources of supply). It also risks materially contradicting the Competition Commission's (***CC***) findings in *Booker / Makro*;

(b) even applying the excessively conservative wholesale and retail filters used in the Decision, the vast majority of independent retailers failing the combined filter purchase only a small proportion of their requirements from Booker, and are therefore not dependent on Booker for their wholesale supplies; and

(c) in any event, it is implausible to suggest that the merged entity would have sufficient control over independent retailers to deteriorate their retail offering. Booker does not have a meaningful degree of control over its symbol group customers (see Section 3 of **Annex 3**), and it has even less control over independent retailers. Moreover, the merged entity could not even hypothetically exert more control over independent retailers through ✂.

[1] See paragraph 192 of the Decision.

1.4 The merged entity would also not have the incentive to deteriorate Booker's wholesale proposition to independent retailers in areas where its independent retail customers' stores overlap with Tesco stores. This is because:

(a) even applying the excessively conservative wholesale and retail filters set out in the Decision, the number of Booker's independent retailers identified represents a negligible proportion of Booker's customer base and revenue. For example, of the ✂ independent retailers identified by the CMA as failing the Decision's filters following the Phase 1 State of Play call, Booker estimates that these independent retailers represent c.✂% of its annual turnover and c.✂% of its operating profit, and there is no single business centre with more than ✂ retailers failing the combined filter. Booker serves approximately 1.2 million customers and 120,000 retailer customers in total.[2] Whilst there is a wide variation in the number of customers served at individual C&C business centres, business centres have approximately ✂ customers and ✂ retailer customers on average. Given this, it would not make commercial sense and not be profitable for the merged entity to change Booker's business model and start varying Booker's offer locally in order to target theoretical gains in a small number of local areas; and

(b) the Decision's retail filter significantly overstates the extent of any incentive for the merged entity to deteriorate Booker's wholesale proposition to independent retailers. As noted in **Annex 7**, consumers at independent retailers are highly likely to perceive other unaffiliated independents, symbol stores and petrol forecourt retailers as closer alternatives than Tesco stores. Any effective competitor set for this theory of harm should include independents. Given that there are in the region of c.28,000 unaffiliated independents and petrol forecourts located across all areas of the UK,[3] any consumer diversion from independents to Tesco stores is likely to be immaterial.

1.5 These points are discussed in more detail below.

2 See Booker's 2017 annual report.

3 See page 8 of ACS's Local Shop Report 2016.

2. The merged entity could not influence the retail offering of independent retailers

2.1 As noted in the Decision, Booker "*does not have the level of direct contractual influence over independent retailers that it has over symbol group retailers*".[4] This means that Booker's ability to worsen the retail proposition of independent retailers is *even lower* than for symbol group retailers, in relation to which Booker already has no meaningful degree of control (see Section 3 of **Annex 3**).

2.2 Therefore, the *only* means through which Booker may be able to worsen the retail offering of an independent retailer would be if that independent retailer was dependent on Booker for its wholesale supplies. This is noted in the Decision as being the key consideration for assessing whether the merged entity has the ability to deteriorate the retail offering of independent retailers.[5]

2.3 As discussed below, it is highly implausible that a material number of independent retailers, if any, are dependent upon Booker for their wholesale purchases. The highly competitive nature of the wholesale sector means that independent retailers have a number of credible alternatives to Booker, a number of which were inappropriately excluded from the effective competitor set in the Decision. This is demonstrated by the fact that even those independent retailers that the Decision's filters suggest have zero effective alternatives to Booker are in fact purchasing substantial volumes from third party suppliers.

A. There is a strong competitive constraint imposed on Booker from wholesalers other than those included in the Decision's effective competitor set

2.4 The wholesale competitor set used in the Decision for assessing this theory of harm is inappropriately narrow.[6] The result of this is that the Decision erroneously concludes that Booker would have the ability to worsen the retail proposition of some of its independent retailers.

2.5 The implication of the competitor set adopted in the Decision for assessing wholesale alternatives is that a hypothetical monopolist of "major C&C providers"[7] would be able to increase prices by 5-10% profitably. A range of evidence – including the findings of the CC in *Booker / Makro* – shows that this is wholly unrealistic. This is because a 5-10% price increase by such a hypothetical monopolist would lead to significant demand-side substitution to other forms of wholesale, including national and delivered wholesalers as well as local and regional C&C wholesalers.

2.6 The competitor set used in the Decision to identify independent retailers with sufficient alternative wholesale options is the same as that used by the CC in *Booker /*

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[4] See paragraph 180 of the Decision. ✂. The Retail Club is a flexible and free promotional package to help independent retailers drive football and increase their performance. Customers receive a trading pack that explains all offers and promotions that are available to them and a point of sale kit (i.e. customer facing marketing). The customers can choose which promotional offers are best suited to improve their performance and can use point of sale materials as they see appropriate for their businesses. ✂

[5] See paragraph 180 of the Decision.

[6] The wholesale competitor set used in the Decision comprises Bestway, Costo, Booker, Blakemore, Dhamecha, Hyperama, Parfetts and United.

[7] The competitors set out in Annex 3 of the Decision.

Makro for the purposes of an "*initial filtering process*"[8] [emphasis added]. The CC noted that this approach was "*conservative*", and that when considering the competitive environment in each local area it took into account national delivered operators and local C&C operators. This was because the CC considered that: "*national delivered operators and local cash-and-carry operators (particularly those that are members of buying groups) may also provide a relevant competitive constraint*".[9] The strength of the constraint from such operators is borne out by the fact that the CC considered the constraint imposed by these types of wholesaler to be sufficient to constrain the merging parties in local areas with no alternative major C&C competitors (i.e. none of those competitors included in the Decision's wholesale filter). By way of example:

(a) in Ipswich, the CC considered that there was sufficient competition from delivered wholesale operators and three local competitors to constrain the merged entity post-merger;

(b) in Norwich, the CC concluded that competition from delivered operators and three local competitors (Forward Wholesale, Anglia Culinary Supplies and Select C&C) would be sufficient to constrain the merged entity post-merger; and

(c) in Poole, the constraint from national delivered operators, symbol group operators (such as Nisa) and local competitors was again considered to be sufficient to constrain the merged entity post-merger.

2.7 That the CC deemed local areas to be unproblematic in *Booker / Makro*, where Booker would have had a "monopoly" position post-merger based on the competitor set used in the Decision's wholesale filter, demonstrates that the Decision adopts an inappropriately conservative view of the wholesale competitive landscape.

2.8 The position adopted in the Decision as to the relevant wholesale competitor set is also at odds with current commercial reality. If it were the case that a subset of Booker's independent retailers have access to less wholesale choice in areas with limited "major C&C" wholesale competition – which is a pre-requisite for this theory of harm – the theory dictates that one should observe Booker charging higher wholesale prices to such customers today.

2.9 Booker does not vary its offer in areas with fewer "major C&C" wholesalers. In *Booker / Makro*, the CC explicitly explored whether the quality of Booker's proposition (i.e. price, quality, range and service) varied with respect to the level of local C&C competition. It concluded that Booker's "*profitability does not does not markedly increase in areas with limited cash-and carry competition, underlining that other types of wholesaler do provide an alternative for customers*".[10]

2.10 If this theory of harm were well-founded, the fact that Booker does not vary its offer to independent retailers depending on the level of "major C&C" wholesale competition indicates that the wholesale competitor set used in the Decision is

8 See paragraph 4 of Appendix 11 of the Competition Commission's *Booker / Makro* Final Report (2013).

9 See paragraph 5 of Appendix 11 of the Competition Commission's *Booker / Makro* Final Report (2013).

10 See Competition Commission news release: "*CC set to clear Booker / Makro merger*".

inappropriately narrow, and does not fully account for the range and depth of wholesale options available to all of Booker's independent retail customers.[11] In any event, it supports the Parties' views that local variation of Booker's wholesale in response to a perceived level of local C&C competition offering would not be profitable.

2.11 The position adopted in the Decision as to the relevant wholesale competitor set is also at-odds with other evidence considered by the CC in *Booker / Makro* and referred to in the Parties' submissions during Phase I.[12] For example:

(a) the CC stated that: "*The product market is for cash-and-carry wholesaling but is significantly constrained by other forms of wholesaling in local markets where these are present*"[13]. Among other things, this was because the CC considered that it would be challenging for a hypothetical monopolist of only C&Cs to sustain profitably a 5-10% price increase: "*significant volumes would be lost from cash-and-carry to delivered competitors if a hypothetical monopolist of cash-and-carry services in a local area attempted to increase prices by a small (but sustained and non-transitory) amount*"[14] [emphasis added];

(b) in its press release announcing its Provisional Findings, the CC stated that it had concluded that "*the merged company would continue to face sufficient competition from other wholesalers — both cash-and-carry and delivered — in all areas affected by the merger*"[15] [emphasis added];

(c) in relation to the constraint from delivered wholesale – which the Decision dismissed on the basis that independent retailers rely "*more heavily on cash-and-carry*" – the CC noted that: "*We formed the view that delivered operators are likely to be effective alternatives in the wholesale market for most customers in most areas and we therefore took the likely constraint from delivered operators into account as part of our local analysis, alongside consideration of the constraint from local and regional cash-and-carry operators*"[16] [emphasis added];

(d) the CC stated in its Final Report that: "*We collected evidence from a range of third parties through hearings and formal submissions. Most held similar views to the parties. In particular, all parties held the view that customers multi-sourced*"[17] [emphasis added]; and

[11] While there may be some variation in Booker's proposition depending on the cash & carry business centre in question (e.g. certain alcohol promotions are not available in Scotland due to licensing regulations), this variation is generally not due to Booker tailoring its proposition in response to any variation in the level of local competition.

[12] In particular, see paragraphs 8.39 to 8.71 of the Merger Notice.

[13] See paragraph 7.30 of the Competition Commission's *Booker / Makro* Final Report (2013).

[14] See paragraph 7.30 of the Competition Commission's *Booker / Makro* Final Report (2013).

[15] See Competition Commission news release: *"CC set to clear Booker / Makro merger"*.

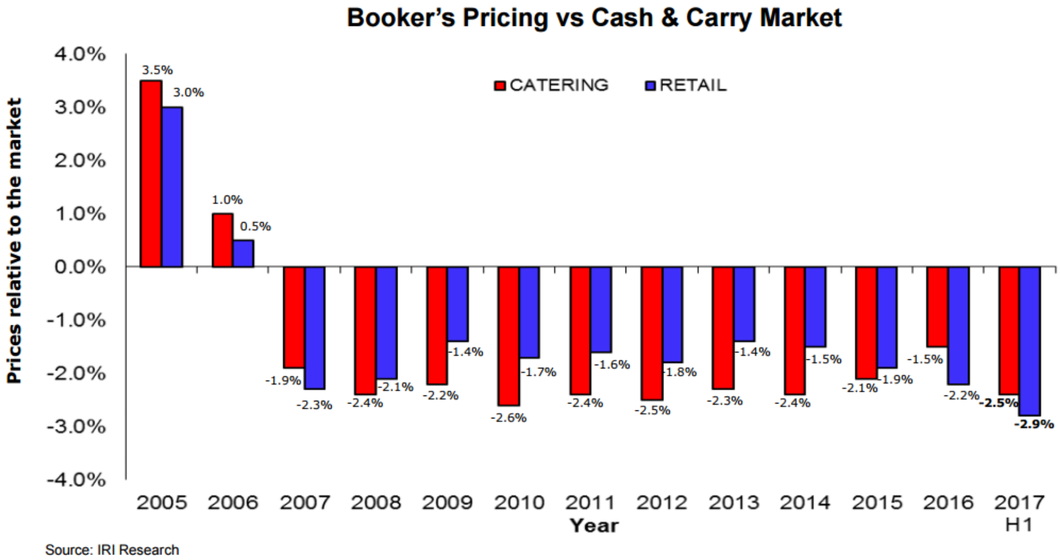
[16] See paragraph 8.29 of the Competition Commission's *Booker / Makro* Final Report (2013).

[17] See paragraph 8.5 of the Competition Commission's *Booker / Makro* Final Report (2013).

(e) the CC stated in in its Final Report that: "*we looked at a number of surveys conducted by research companies […] the surveys suggested that the overall customer base multi-sources across wholesale channels. This includes the national and local cash-and-carry operators, delivered operators and specialists*"[18] [emphasis added].

2.12 Booker considers that the wholesale market is at least as competitive as, if not more competitive than, when the CC assessed the *Booker / Makro* transaction. This is borne out by **Figure 1** below, which shows that the competitive intensity in the wholesale market has not reduced since the CC reached the above conclusions. As such, the CC's former conclusions regarding the competitive landscape in the wholesale market are equally applicable to this Merger.

Figure 1: Booker wholesale prices relative to cash-and-carry market



Source: Booker Interim Results presentation of October 2016

B. Analysis of independent retailers' purchases from Booker shows that the Decision's wholesale filter cannot be correct

2.13 In a scenario where the wholesale competitor set and wholesale filter used in the Decision is correct, one should observe independent retailers in areas with no "major C&Cs" other than Booker purchasing all (or, at least, the vast majority) of their wholesale requirements from Booker. This is because, based on this hypothesis, such retailers should have no effective alternative wholesale suppliers, and therefore should be entirely (or at least almost entirely) dependent on Booker for their supplies. However, it is clear from an analysis of independent retailers' purchases from Booker that this is not the case, and that they must therefore be purchasing substantial volumes from wholesalers outside of the competitor set used in the Decision. This illustrates that the competitor set adopted in the Decision is far too narrow, and should be widened for the purposes of assessing alternative wholesale options.

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18 See paragraphs 8.9 to 8.13 of the Competition Commission's *Booker / Makro* Final Report (2013).

2.14 The Decision has used a combined wholesale filter and retail filter. The wholesale filter is failed where there are three or fewer cash & carry wholesalers in the local area post-merger (based on the Decision's unduly narrow effective competitor set for wholesalers). Of the ✂ independent retailers that were identified in the files provided by the CMA on 26 June 2017 following the State of Play call (which fail the wholesale *and* retail filters in the Decision),[19] Booker has been able to identify ✂ independent retailers in its customer database in the time available. As an exercise to determine the appropriateness of the wholesale filter, Booker considered only those independent retailers which were listed as having <u>no effective wholesale alternatives</u>, of which there are ✂ independent retailers. If it were true that these independent retailers had no effective wholesale alternatives other than Booker, one would expect these customers to source all (or virtually all) of their requirements from Booker. However, an analysis of those independent retailer customers within this set reveals that:

(a) half of these independent retailers purchased less than £✂ from Booker last year.[20] This is significantly less than an independent retailer would need to purchase across all wholesale suppliers in order to operate a viable retail business – independents are expected to purchase c.£ ✂ of wholesale supplies in total across a year;[21]

(b) the above implies that half of the sample are purchasing less than ✂% of their wholesale purchases from Booker in those areas where the Decision's wholesale filter considers Booker to be the only effective wholesale supplier. The fact that these independent retailers are purchasing approximately ✂% of their wholesale requirements from third party suppliers not captured by the Decision's wholesale filter demonstrates that the approach taken in the Decision is wholly unrealistic;

(c) in fact, if these independent retailer customers were purchasing 100% of their requirements from Booker (as would be expected if Booker were the only effective provider of wholesale services in the area), one would need to consider that half of independent retailers purchased less than £✂ worth of wholesale products in a year. Based on a margin of ✂%,[22] this would imply that independent retailers made no more than £✂ of profit a year before even considering other costs such as rent, utilities, business rates, etc. This demonstrates that Booker cannot be the sole provider for the ✂ independent retailers identified and therefore the Decision's wholesale filter is flawed; and

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[19] An equivalent list of independent retailers was not provided following the Decision, so the Parties have relied on these files for the purposes of this analysis.

[20] This corresponds to a time period of MAT FY18 Week 12. The median in this sample is £✂.

[21] Page 8 of the ACS Local Shop Report 2016 (https://www.acs.org.uk/wp-content/uploads/2016/09/Local-Shop-Report-2016.pdf) suggests that revenue figures for an independent store are c.£330k. Assuming an average VAT rate of 15% and a retail margin of ✂, this equates to c.£ ✂ of wholesale purchases per year.

[22] See Figure 8 in Annex C of **Appendix 9.A** to the Merger Notice: *Frontier Economics – Post-merger pricing incentives in retail-to-wholesale mergers.*. ✂% is an estimate of the typical retail commercial gross margin for Premier stores, based on retail commercial gross margins provided by a sample of EPOS data for Premier customers.

(d) **Figure 2** below shows the distribution of retailer purchases with Booker in those areas that fail the Decision's filters and have no effective wholesale alternatives (based on the Decision's competitor set).[23] It shows that ✂% of customers in the sample purchased less than £✂ from Booker (i.e. purchased less than c.✂% of their total wholesale requirements from Booker).

Figure 2: distribution of spend with Booker for independent retailers identified by the CMA as failing the Decision's filters (with zero wholesale alternatives based on the Decision's competitor set)

✂

Source: Frontier analysis

C. Even based on the conservative approach in the Decision, wholesale purchases of independent retailers failing the Decision's filters show the merged entity lacks the ability to worsen the retail proposition of independent retailers

2.15 It is clear that the merged entity would not be able to influence the retail proposition of the ✂ customers identified by Booker in paragraph 2.14. This is because Booker does not supply a large enough proportion of these customers' wholesale purchases in order to have any material ability to exert even indirect control over their retail proposition.

2.16 The Decision notes that *"competition concerns are unlikely to arise in local areas that fail the assessment criteria where independent retailers do not source a substantial proportion of their wholesale supply from Booker"*.[24] An assessment of the wholesale purchases of independent retailers failing the Decision's wholesale *and* retail filters shows that Booker is highly likely to be supplying only a relatively small proportion of these customers' wholesale supplies in the vast majority of cases.[25] It therefore follows that there can be no SLC in relation to this theory of harm.

2.17 **Figure 3** below shows the distribution of purchases from Booker by those independent retailers that failed both the wholesale and retail filters in the Decision (but, unlike **Section 2B** above, this also includes retailers that have one or two effective wholesale alternatives under the Decision's effective competitor set).[26] On average, these customers purchased £✂ from Booker over the last 12 months (✂). This suggests that the "average" customer failing the Decision's filters is purchasing ✂% of its total wholesale requirements from Booker. These independent retailers do not "*rely on Booker to a significant degree for their wholesale purchases*", which means it is implausible that Booker would be able to deteriorate their retail proposition.[27]

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23 Where Booker has been able to locate these customers in its customer database.

24 See paragraph 191 of the Decision.

25 As set out above, in the time available, Booker has been able to identify ✂ of the ✂ customers identified in the files provided by the CMA based on the Decision's filtering approach.

26 Where Booker has been able to identify them in its customer database.

27 See paragraph 180 of the Phase 1 decision.

2.18 It is therefore implausible that Booker would be able to deteriorate the retail proposition of these independent retailers, and as such, **Figure 3** below also shows that:

(a) over ✄% of these retailers purchased less than £✄ from Booker (around ✄% of a typical retailer's annual wholesale purchases); and

(b) over ✄% of these retailers purchased less than £✄ from Booker (i.e. less than c.✄% of a typical retailer's annual wholesale purchases).

Figure 3: distribution of spend with Booker for customers identified as failing the Decision's wholesale and retail filters

✄

Source: Frontier analysis

D. Booker cannot identify "captive" C&C independent retailer customers or use contractual arrangements to exert control

2.19 Finally, the Parties note that:

(a) For the merged entity to be able to realise any theoretical gains from deteriorating Booker's proposition to independent retailers, it must be able to identify those customers that have limited wholesale alternatives. It is clear from **Sections 2A to 2C** above that the wholesale filter used in the Decision would not suffice in this respect, and the CC's findings in *Booker / Makro* further suggest that it would be highly challenging to identify those customers that would not switch to delivered wholesalers in response to a deterioration by the merged entity (i.e. are "C&C-only"). In particular, the CC noted that there was a *"limited likelihood that there is a significant number of captive cash-and-carry customers that could be exploited through price discrimination strategies"* and the CC *"therefore considered it unlikely that there was a substantial captive cash-and-carry customer group that could be exploited through price discrimination strategies"*.[28]

(b) As the Decision explicitly acknowledges, ✄. For example, independent retailers served by Booker ✄. Given this, and the analysis set out above in relation to the lack of independent retailers' dependence on Booker, it is unclear how Booker could influence its retailers' end proposition in any respect.

3. No incentive to foreclose independent retailers

3.1 The previous section explained why the merged entity could not worsen the retail proposition of its independent retail customers. While this is sufficient to demonstrate that there cannot be a lessening of competition in respect of Booker's independent retail customers, for completeness this section explains why the merged entity would also not have any incentive to deteriorate its wholesale proposition to these customers.

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[28] See paragraphs 7.30(b) and 8.50 of the Competition Commission's *Booker / Makro* Final Report (2013).

A. The merged entity would not have any incentive to vary Booker's offering locally in order to benefit Tesco's retail business in the small number of local areas that fail the Decision's filters

3.2 As noted in Section 6 of **Annex 3**, to change Booker's corporate strategy and management infrastructure away from its strong focus on customer satisfaction and towards a new alternative focus on local competitive conditions would not only involve a fundamental change of Booker's business strategy, but also involve breaking the formula which has underpinned Booker's survival and success in the highly competitive wholesale market.

3.3 Nor would any individual C&C business centre have the incentive to start "flexing locally" in order to deteriorate its wholesale offer as a result of any perceived lack of combined wholesale and retail competition in a local area. The independent retailers failing the Decision's wholesale and retail filters comprise an insignificant proportion of Booker's revenue and customer base both at the individual business centre level and the aggregate level.

3.4 By way of example, if one assumes that Booker serves all of the ✂ retailers that failed the Decision's filters (as identified by the CMA) and that the relevant Booker business centre for each retailer is that which is closest to the independent retailer:[29]

(a) ✂;[30]

(b) **Figure 4** below shows Booker's estimate of the proportion of business centre revenue that these independent retailers comprise.[31] Even assuming – on a conservative basis – that Booker supplies all of the ✂ customers failing the Decision's filters, business centre sales to such customers do not exceed ✂% of overall business centre revenue at more than ✂% of Booker's business centres; and

(c) Booker estimates that sales to these customers represent ✂% of its total annual revenue and approximately ✂% of total retailer revenue, even if one assumes that it serves all ✂ retailers failing the Decision's filters. The potential theoretical gains from successfully "targeting" a deterioration at such an insignificant proportion of Booker's revenue would be significantly less than the operational time, costs and reputational damage that such a strategy would involve (see Section 6 of **Annex 3**).

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29 As determined by straight line distance.

30 A regular customer defined for this purpose as someone purchasing in excess of £✂.

31 Where a business centre has at least one independent retailer that fails the Decision's filters (there are ✂ where this is not the case).

Figure 4: estimated proportion of Booker business centre revenue comprising those independent retailers that fail the Decision's wholesale and retail filters[32]

✂

Source: Frontier analysis

3.5 Given the above, Booker would not have the incentive to deteriorate its proposition at individual C&C business centres. A business centre-wide deterioration would make no economic sense and be unprofitable, given that Booker's sales in the relevant business centres are predominantly to those customers that do not fail the Decision's filters (and as such where Booker would stand to lose significant sales, with no possibility to re-capture material sales at Tesco).

3.6 In relation to whether the merged entity may have the incentive to deteriorate its proposition at the individual customer level (e.g. by offering worse terms to independent retailers that fail the Decision's combined filter), the Parties have set out at Section 6 of **Annex 3** why the merged entity would have no incentive to pursue such a strategy. Any hypothetical gains are even smaller than the negligible hypothetical gains identified in **Annex 3**, given that independent retailers purchase a smaller proportion of their requirements from Booker than symbol group customers (on average).

B. The Decision's retail filter is excessively conservative, as it significantly overstates the extent to which the merged entity could have an incentive to foreclose independent retailers

3.7 As explained in detail in **Annex 7**:

(a) Independent retailers compete most strongly with other independent retailers, as well as symbol stores and petrol forecourt retailers. In particular, consumers at independent retailers are likely to perceive other independent retailers, symbol stores and petrol forecourt retailers as closer alternatives than Tesco stores for the types of shopping mission they undertake at independent retailers. Given that this theory of harm is based around independent retailers, it would be inappropriate and wholly unrealistic to exclude independent retailers from the effective competitor set.[33] There are c.28,000 independent retailers and petrol forecourts located across all areas of the UK, which means it is implausible that there would be any areas where there would be significant consumer diversion from independents to Tesco stores.

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[32] Based on the list of ✂ independent retailers identified by the CMA as failing the Decision's filters, and assuming average wholesale purchases by Booker to these retailers of £✂. Total Booker revenue was £5.33bn in 2017 and total Booker retailer revenue was £3.36bn over the same period (see Booker Group Annual Report 2017).

[33] See footnote 38 of the Decision, which recognises that "*customers who shopped at an independent retailer may be more likely to divert to an independent retailer when faced with a worse retail offering*".

Figure 5: location of independent retailers in the UK

Source: Frontier analysis of Nielsen data

(b) Moreover, Aldi, Lidl and Iceland are strong and effective competitors in the retail groceries sector. These three retailers would compete strongly against Tesco to attract any consumers that choose to divert away from independent retailers.

This means any consumer diversion from independent retailers to Tesco stores is likely to be immaterial.

3.8 Therefore, the Parties consider that there can be no substantial lessening of competition in relation to this theory of harm.

PROPOSED MERGER BETWEEN TESCO PLC AND BOOKER GROUP PLC

INITIAL SUBMISSION TO THE CMA FOR PHASE 2 REVIEW

ANNEX 6: RESPONSE TO THEORY OF HARM 7 ON BUYER POWER

1. Introduction

1.1 The CMA's Phase 1 decision referring the Merger for a Phase 2 inquiry (the ***Decision***) has raised the possibility of the Merger giving rise to a realistic prospect of a substantial lessening of competition as a result of possible detrimental effects on competition arising from the exercise of excessive buyer power by the Parties.[1] The Decision states that the merged entity might enjoy greater buyer power than the Parties had pre-merger which could: (i) allow the Parties to impose excessive risks and unexpected costs on suppliers, thus reducing their ability and incentive to invest and innovate (though the CMA has acknowledged that no third parties raised concerns in this respect and therefore has not assessed it in the Decision);[2] and/or (ii) lead to a so-called 'waterbed effect' whereby, as a result of the Parties' ability to obtain more favourable terms from suppliers post-merger, suppliers would try to maintain a constant revenue margin by increasing their prices to other buyers, who would lose out and become less competitive.

1.2 There is no realistic prospect that the Merger could lead to a detrimental impact on competition as a result of the merged entity's position as a buyer for the following reasons:

(a) the Parties will need to continue to work collaboratively with suppliers and to nurture their supply chains, given the importance of having strong relationships with suppliers and fostering innovation to compete effectively. There will be no incentive for the Parties to do otherwise. Synergies will depend on the Parties' ability to generate genuine efficiencies throughout the supply chain. The Merger will also provide opportunities to many suppliers to access a wider pool of retailers, caterers and end consumers;

(b) the Merger will result in only small increments to overall purchases and only small overlaps on an individual category basis, which means the Parties have no meaningful ability to increase their buyer power materially; and

(c) the Parties are not aware of any evidence that suggests the 'waterbed effect' theory (which is an academic theory that has been found wanting in previous investigations into the UK retail groceries sector and more generally) will either exist as a result of the Merger or that it could have any detrimental effect on suppliers or consumers.

1.3 This Annex expands on these three points in turn, after a brief overview of the Parties' approach to merger synergies in relation to procurement.

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1 See paragraphs 213 to 218 of the Decision.

2 See paragraph 216 of the Decision.

2. Continued incentives to continue working collaboratively with suppliers

2.1 Tesco's success in attracting consumers is dependent on having the right range of products on offer and making them available to consumers in the right quantities and at the right time. Tesco's relationships with its suppliers are therefore driven by a need to build the product ranges that consumers want to buy (with the right mix of quality and price points), to provide a consistent offer across products and categories, and to put in place the supply chain operational skills that ensure those products can be brought to market. These capabilities enable Tesco to develop consistent own brand and fresh ranges across multiple products, suppliers and categories, as well as ensuring the efficient distribution of fresh products to consumers (which typically have a short shelf life and can be easily damaged). Tesco's success will continue to depend on its suppliers, and the Parties will have every incentive to carry on working collaboratively with its suppliers.

2.2 Tesco enjoys good relationships with its suppliers, with performance improving year-on-year. Improving its relationship with suppliers has been an essential component of Tesco's strategy to regain overall competitiveness. Tesco ranked first among six large retailers on six out of the eight criteria in a recent Advantage survey.

Figure 1: Advantage survey - Tesco ranking compared to competitors, 2014-2016

Source: Advantage Supplier Survey 2016

2.3 The Parties will be able to work closely with fresh and own brand suppliers to create a more efficient end-to-end supply chain.

2.4 The Merger will create significant opportunities and benefits for the supplier base: growth, improved end-to-end supply chain management and efficiencies, continued focus on close relationships with suppliers and providing increased support to create stronger and more credible ranges and better insights and category management.

2.5 The Parties also expect to be able to achieve some procurement savings as a result of the Merger:

(a) ✂

(b) ✂

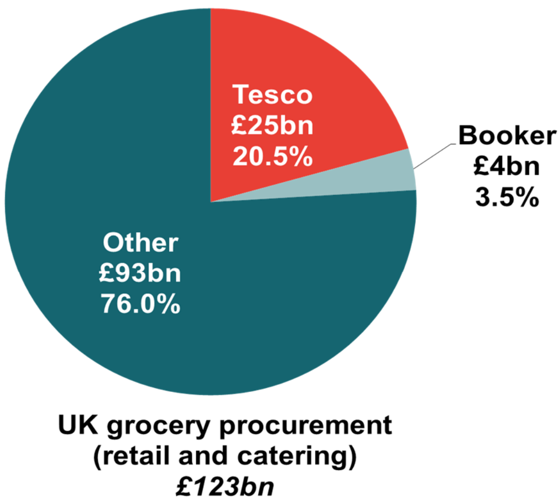
2.6 As such, realisation of such synergies will not mean that the Merger will have a detrimental impact on the supply base, indirectly on consumers or ultimately on competition.

3. No substantial increase in increments to purchases

3.1 Exploring procurement market shares and increments may be a useful starting point to assessing the potential for buyer power, although high market shares and increments are not indicative of buyer power by themselves. The increment in purchases overall will be limited and, in the categories where the increments are larger, suppliers have strong bargaining power themselves. The Parties do not consider that the combination of Tesco's and Booker's purchases will lead to a significant increase in negotiating power vis-à-vis suppliers.

3.2 Tesco purchases approximately £25 billion worth of food and grocery in the UK, while Booker's purchases amount to £4 billion in the retail segment. Total UK grocery procurement (in both retail and catering sectors) amounts to approximately £123 billion meaning that the Merger will result in a combined share of 24%, with an increment of 3.5% (as shown in **Figure 2**). As set out below, the Parties consider that the whole sector (i.e. both retail and catering segments) should be considered when looking at market shares and increments.

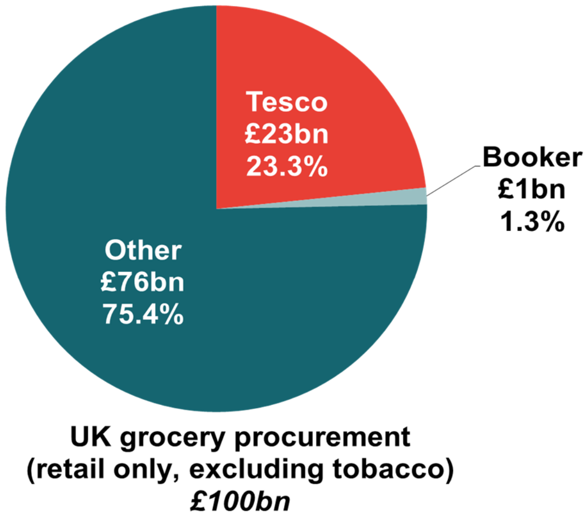
Figure 2: Tesco's and Booker's total purchases as an approximate proportion of all UK grocery procurement (in the retail and catering segments including tobacco)



Source: Frontier analysis. These figures are an approximation of the UK grocery sector procurement.

3.3 An alternative to how the CMA might undertake this methodology is to consider the retail segment alone. The percentage increment is lower on this basis (2.6%) and much lower if tobacco is also excluded (1.3%), as shown in **Figure 3**.

Figure 3: Tesco's and Booker's total purchases as an approximate proportion of all UK grocery procurement (in the retail segment excluding tobacco)



Source: Frontier analysis. These figures are an approximation of the UK retail grocery procurement segment.

3.4 The Parties consider that the most appropriate methodology to assess whether the Merger will lead to any meaningful increase in buyer power is as follows:

(a) Procurement shares are calculated on a category basis, rather than on a sub-category basis. This is in line with precedent, mirrors the way Tesco and Booker and its competitors organise their procurement operations and accounts for the fact that a substantial number of suppliers manufacture multiple products within a category.

(b) Given that the market for these categories is almost always broader than that of the retail segment (insofar as suppliers can supply the market through different channels), it is appropriate to calculate the Parties' procurement shares taking into account purchases for retail and non-retail (i.e. not just taking into account purchases for retailers, but include also the foodservice industry and other non-retail customers).[3]

(c) Procurement shares are based on the Parties' purchases (expressed as COGS) against total sales of suppliers (with a discount for wholesale margins for the part of the market which is addressable from wholesale).

(d) In line with the CMA's approach at Phase 1, the Parties understand that the CMA may wish to look further at areas where combined procurement shares exceed 30% and there is also an increment of over 5%. Specifically, the CMA may wish to look practically at whether suppliers are likely to have sufficient

[3] ✂

negotiating power to offset any hypothetical increase in buyer power. However, it does not follow that a competition concern would arise simply if suppliers do not have sufficient negotiating power (see **Section 4** below).

3.5 On this basis, there is no product category where the Merger would lead to a significant increase in incremental purchases, with the exception of tobacco:

Figures 4 and 5: Tesco's and Booker's procurement market shares in the retail and non-retail segments (using Booker's retail and non-retail COGS)

✂

Source: Frontier analysis

3.6 The same conclusion would be reached when looking at the retail segment in isolation, except that the combined procurement shares would additionally exceed 30% in spirits:

Figures 6 and 7: Tesco's and Booker's procurement market shares in the retail segment (using Booker's retail COGS)

✂

Source: Frontier analysis

3.7 **Figures 4 to 7** above show that the increments to the Parties' share of purchases as a result of the Merger would be low and therefore the Merger does not result in sufficient increments or combined procurement shares to raise any competition concerns:

(a) in fresh and grocery categories, Booker's retail COGS represent a very small increment to Tesco's purchases, as no category will see an increment exceeding 3.5%; and

(b) Booker has a larger procurement share of the tobacco, drinks and impulse categories, but, even in those categories, the combined procurement shares post-merger only exceed 30% in relation to tobacco and in spirits (the latter only when looking at the retail segment alone).

3.8 When looking at the two sub-categories identified by the CMA in its First Day Letter (and as previously submitted at Appendix 16.L to the Merger Notice), as potentially exceeding the threshold for concern, the Merger would not raise buyer power concerns:

(a) Tobacco: the supplier base is very concentrated and suppliers have very strong negotiating power, as ✂ of Tesco's sales come from four large, global producers that sell a number of powerful cigarette brands (Japan Tobacco, Imperial Tobacco, British American Tobacco and Philip Morris). Their brands are expected to be stocked in all tobacco-selling retailers and the merged entity cannot credibly threaten to switch to alternative suppliers as these four suppliers make up more than 90% of UK tobacco sales. As such, these suppliers will have substantial bargaining power over Tesco. ✂

(b) Hot beverages: most of the sales in this category come from brands that are owned by large suppliers with market power. For example, Nescafé is owned by Nestlé, Douwe Egberts and Jacobs are partly owned by Mondelez and Carte Noire is owned by Lavazza. In tea, Unilever owns Lipton and PG Tips and Associated British Foods owns Twinings. ✂ of Tesco and ✂ of Booker COGS in hot beverages come from branded products that customers are loyal to and that retailers are expected to stock.

4. The waterbed effect is highly unlikely to materialise

4.1 The Decision has suggested that, following the Merger, the Parties may be able to obtain more favourable terms as a result of their combined size. It also suggests that there may be a 'waterbed effect' as a result of this ability to obtain more favourable terms since, for suppliers to maintain a constant revenue margin, they may increase prices to other buyers, who would become less competitive and potentially exit the market.[4]

4.2 This waterbed effect theory has never been accepted and in fact was explicitly dismissed in relation to the groceries market by the Competition Commission.[5] For the waterbed effect to occur, all of the following necessary conditions must arise:

(a) the merged entity would need to succeed in negotiating better prices as a result of increased buyer power (rather than by sharing the cost savings arising from added efficiencies throughout the supply chain);

(b) the suppliers would need to succeed in increasing their prices to the merged entity's competitors; and

(c) retailers, having accepted these higher prices, would need to pass on higher costs to their customers, thus becoming less competitive (and potentially exiting the market).

4.3 These necessary conditions are each discussed in turn. The Decision notes that four pieces of evidence[6] "*could be supportive of concerns arising as a result of waterbed effects*".[7] As will be demonstrated below, the Parties do not believe any of these pieces of evidence – either together or separately – is enough to cause or be an effect of the waterbed effect.

A. The merged entity can negotiate better prices as a result of increased buyer power

4.4 As depicted in **Figures 4 to 7** above, the increments to Tesco's market share are low in the majority of categories. Tobacco is the only category that would see a combined procurement share of 30% with a 5% increment (or higher) when considering both the retail and non-retail segment. No other categories (✂) have a procurement share above 30% with a 5% increment (with the exception of spirits if the retail segment is considered on its own).

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4 See paragraphs 217(a) to (d) of the Decision.

5 See paragraphs 5.19 to 5.43 of the Competition Commission's Final Report on the Supply of Groceries in the UK market investigation dated 30 April 2008.

6 See paragraphs 217(a) to (d) of the Decision.

7 See paragraph 217 of the Decision.

4.5 Furthermore, as shown in Appendix 16.L to the Merger Notice, there are no sub-categories where combined procurement shares or increments arising from the Merger would exceed the threshold of concern outlined above. ✂. In any case, as explained above, the most appropriate methodology to calculate procurement shares is on a category basis. The sub-category analysis was carried out as an additional sensitivity test. As such, the Parties do not expect to see a material increase in increments to procurement shares in a number of categories or sub-categories, contrary to the statement at paragraph 217(a) of the Decision.

4.6 The Decision considers the fact that the Parties could benefit from significant procurement synergies may be supportive of waterbed effects. ✂. Therefore, the Parties do not accept, as noted at paragraph 217(b) of the Decision, that the expected procurement synergies can be considered as evidence of increased buyer power.

4.7 It is important to note that there is likely to be significant countervailing supplier power in several categories:

(a) The categories in which the increments are highest are those which are ✂, and as such, the suppliers in these categories (✂) are also large, global powerful suppliers. ✂

(b) To have significant buyer power, the merged entity would need to be able credibly to threaten to switch purchases to alternative suppliers. However, ✂, many products are likely to be ‘must stock’ products, ✂. Switching away from several of these products is not a credible threat. ✂

(c) If the merged entity is not able credibly to threaten to switch purchases to an alternative supplier, in order to command more favourable terms, it would have to act as a significant route to market for these suppliers. Only in that scenario would there be any prospect of harm to competition. The merged entity does not control a sufficient proportion of the downstream market for this to be an issue. In particular:

(i) Tobacco is sold through other large supermarkets, convenience stores and some non-retail channels. It is highly unlikely that the big four tobacco companies would not be able to find a route to market for their products.

(ii) Hot beverages are sold through the very large non-retail channel as well. While retail sales are around £1.9bn, the out of home segments for tea and coffee are around £3.4bn and £3.7bn respectively.[8]

B. Suppliers would increase their prices to the merged entity’s competitors

4.8 The Decision has noted that some suppliers stated that they would seek to maintain their profitability in the event that the Parties sought to negotiate lower purchasing process, and therefore “*may increase their prices to other customers to compensate*”.[9] The Parties do not understand how this mechanism could work given the following:

8 See Tetley Tea Report 2017; ProjectCafe2017 UK – Allegra World Coffee Portal report.

9 See Paragraph 217(d) of the Decision.

(a) If it were the case that such suppliers "*may increase their prices to other customers to compensate*", this would suggest that these suppliers are currently not negotiating the best possible price with each retailer. Negotiations happen bilaterally, and there is no reason to believe that negotiations with one customer should impact the negotiations with another.

(b) Furthermore, the Parties note that the OFT also believed that there were theoretical questions that, at the time of its investigation into the groceries market, needed to be resolved before concluding on the evidence of a waterbed effect. It stated that "*it is not clear how suppliers would be able to charge significantly above cost to smaller retailers without rivals undercutting them in the market; similarly, it is not clear why suppliers would price persistently below cost to the large supermarkets*".[10]

4.9 The merged entity's competitors are also large multi-billion players in the grocery market. It is likely that Tesco's more direct competitors (other multiples and discounters) would be able to resist suppliers' attempts to increase prices.

4.10 As a result, the statements made by suppliers as to their hypothetical decision to increase prices to other customers referenced by the CMA at paragraph 217(d) of the Decision are unsubstantiated and unsustainable, and cannot therefore support a finding that a 'waterbed effect' would occur post-merger.

C. Retailers, having accepted higher prices, would pass these onto their customers

4.11 The Parties are confident that the CMA does not need further persuading that the groceries market is fiercely competitive. Indeed, this was a conclusion of the CC's 2008 groceries market investigation and, since then, the rapid expansion of discounters and online players means that the market is even more competitive.

4.12 Even if retailers accepted higher prices and passed these onto their customers, it is difficult to predict precisely how these increased costs would feed through to consumers. Retailers need not pass on higher costs via price increases, but can tailor their overall offer in a number of different ways to enable them to compete effectively across different competitive dimensions. For example, a retailer could stock a different product mix to deliver a similar margin, vary its service levels or loosen other operational targets.

4.13 Even if it were true that Tesco's competitors would have to absorb higher cost prices imposed by suppliers, it is not credible to believe that this would make them compete less effectively overall or – even less so – exit the market.

4.14 Retailers exiting the market seem even less likely to be the case if this effect occurred in relation to a reduced number of product categories (e.g. tobacco). The Decision has noted that "*some of the segments where the Parties may appreciably increase their buyer power, appear to be important to the overall purpose of the customer's shopping trip (e.g. tobacco), and so may play an important role in the customer's choice of store*", which could theoretically make a 'waterbed effect' more pronounced. However:

[10] See paragraph 6.13 of "The grocery market: The OFT's reasons for making a reference to the Competition Commission", May 2006, OFT.

(a) For all of the reasons outlined above, ✂.

(b) Moreover, the Parties note that it is highly unlikely that some segments may be sufficiently important to the customer's choice of store that waterbed effects in one category may encourage customers to switch entire baskets from one retailer to another. Tobacco has historically been a footfall driver, but its importance is in decline as the number of smokers in the UK has reduced to less than one in six people today.[11] So, at best, tobacco could be a footfall driver for less than 16% of customers. Therefore, even assuming that the Parties would appreciably increase their buyer power in tobacco post-merger (which is contradicted by the evidence), contrary to the assumption underpinning paragraph 217(c) of the Decision, any price differential in that category would not influence the choice of store of a sufficient number of customers to have a meaningful impact on competition.

5. Conclusion: there is no realistic prospect of the Merger resulting in a negative impact on consumers

5.1 The Parties consider that they can unlock growth in the dynamic and growing UK food sector by combining their respective expertise and skills in the sourcing and distribution of food. This belief is predicated on their ability to continue fostering and developing their relationships with suppliers and to carry on improving their supply chain operational skills. Tesco's success will continue to depend on its suppliers, and the Parties will have every incentive to carry on working collaboratively with its suppliers. Harming its suppliers would hinder its position at the retail level, where competition is fierce.

5.2 The Parties understand that the CMA may have concerns about buyer power. The Parties have demonstrated that increments to their share of purchases are generally low. Where combined market shares are high, these are in categories in which suppliers have strong negotiating power.

5.3 The CMA has raised some concerns about two categories in particular: hot beverages and tobacco. As set out above, there is only a low increment to the Parties' procurement shares in the hot beverage category, it is a heavily branded category where suppliers are likely to have strong negotiating power, and it is a small part of consumers' overall grocery purchases. While tobacco is a category where the Parties have a high increment to their procurement market shares, ✂.

5.4 Finally, the CMA has raised the possibility of a 'waterbed' effect materialising. Aside from this effect being theoretically unsound and lacking precedent, the Parties have not yet seen any evidence from suppliers that supports this theory. The Parties also note that if the waterbed effect were to exist, one would expect to observe only one surviving supermarket today. Yet, a number of supermarkets exist, each with differentiated offers not only on price, but also on quality, range and service, which allows each of them to compete in a fiercely competitive grocery market.

5.5 Therefore, the Parties consider that can there be no substantial lessening of competition in relation to this theory of harm.

[11] See "Adult smoking habits in the UK: 2016", ONS.

PROPOSED MERGER BETWEEN TESCO PLC AND BOOKER GROUP PLC

INITIAL SUBMISSION TO THE CMA FOR PHASE 2 REVIEW

ANNEX 7: ASSESSMENT OF COMPETITION IN THE RETAIL GROCERIES SECTOR AND THE EFFECTIVE COMPETITOR SET

1. Introduction

1.1 The Parties consider that a local overlaps analysis is not necessary for Theories of Harm 2, 3 and 4, as it would not be profitable for the merged entity to deteriorate Tesco's retail offering or Booker's wholesale offering (as explained in **Annexes 2, 3 and 4**). Nonetheless, given this subject matter was covered in the Decision, this Annex outlines the Parties' views on competition and the effective competitor set in the UK retail groceries sector.

1.2 The Parties consider that Premier retailers, Londis retailers and other Booker-supplied independent retailers are not close competitors to Tesco stores at the retail level. This means that consumer diversion between Booker-supplied symbol stores and Tesco stores is likely to be low:

(a) Tesco's main competitors are the multiples and discounters. Any deterioration of Tesco's offer would primarily be to the benefit of these competitors, rather than Booker-supplied symbol stores.

(b) Booker-supplied symbol stores compete most strongly with other symbol stores, petrol forecourt retailers and independents, as these retailers have a more comparable offer to Booker-supplied symbol stores than do Tesco stores.

1.3 The Parties welcome the Decision's finding that McColls should be included in the effective competitor set.[1] However, given the strength of evidence and industry recognition, the Parties consider that there are no longer any credible grounds for regarding Aldi, Lidl and Iceland as not being effective competitors in the retail groceries sector. Each of Aldi, Lidl and Iceland is a materially more effective competitor to Tesco than are Booker-supplied symbol stores.

1.4 Each of these overarching points is discussed below.

2. Booker-supplied symbol stores and Tesco stores are not close competitors

2.1 Premier retailers, Londis retailers and other Booker-supplied independent retailers are not close competitors to Tesco stores at the retail level meaning that any diversion of consumers – either way – between Booker-supplied symbol stores and Tesco stores is likely to be low.

2.2 Tesco's stores offer a different retail proposition to Booker-supplied symbol stores and target a different (and wider) range of shopping missions. In particular:

(a) **Booker's symbol group customers typically have smaller stores than Tesco-owned stores and ✂**. The average revenue for a Premier or Londis store is approximately ✂ per year, compared to approximately ✂ for a Tesco

[1] See paragraph 86 of the Decision.

Express store and approximately ✂ for a One Stop owned store. **Figure 1** below demonstrates the differences in average store size between Tesco's stores and the stores owned by Booker's symbol group customers. For example, a typical Tesco Express store is ✂ a typical Premier store.

Figure 1: comparison of average store sizes

✂

Source: Frontier analysis based on ✂.

(b) **Booker's symbol group retailers typically have a much narrower product range than Tesco's stores**, as well as a much more limited fresh offering (see **Figure 2** below). Therefore, shopping missions undertaken at Tesco-owned stores will often not be replicable at Booker-supplied symbol stores (e.g. due to less availability of fresh products).

Figure 2: comparison of category mix

✂

Source: Frontier analysis based on ✂.

(c) **Symbol group retailers typically have higher retail prices than Tesco's stores**. ✂. Therefore, in order to have any prospect of diverting consumers from Tesco stores to Booker-supplied symbol stores, the merged entity would need to increase Tesco's retail prices materially.

(i) Tesco competes most strongly with the multiples and the discounters

2.3 Tesco's main competitors at the retail level would profit from a deterioration of Tesco's retail offering, rather than Booker's symbol group customers. Tesco's main competitors are ✂. They exert a greater competitive constraint on Tesco than do Booker-supplied symbol stores:

(a) these are the retailers which Tesco monitors on a regular basis, as evidenced by Tesco's internal documents.[2] ✂;

(b) Tesco's pricing (and PQRS more generally) is defined with reference to ✂; and

(c) ✂

(ii) Booker-supplied symbol stores compete most strongly with other symbol stores, petrol forecourt retailers and unaffiliated independents

2.4 Booker-supplied symbol stores compete most strongly with other symbol stores, petrol forecourt retailers and unaffiliated independents, which means the most significant proportion of any consumer diversion would be to these retailers. In particular:

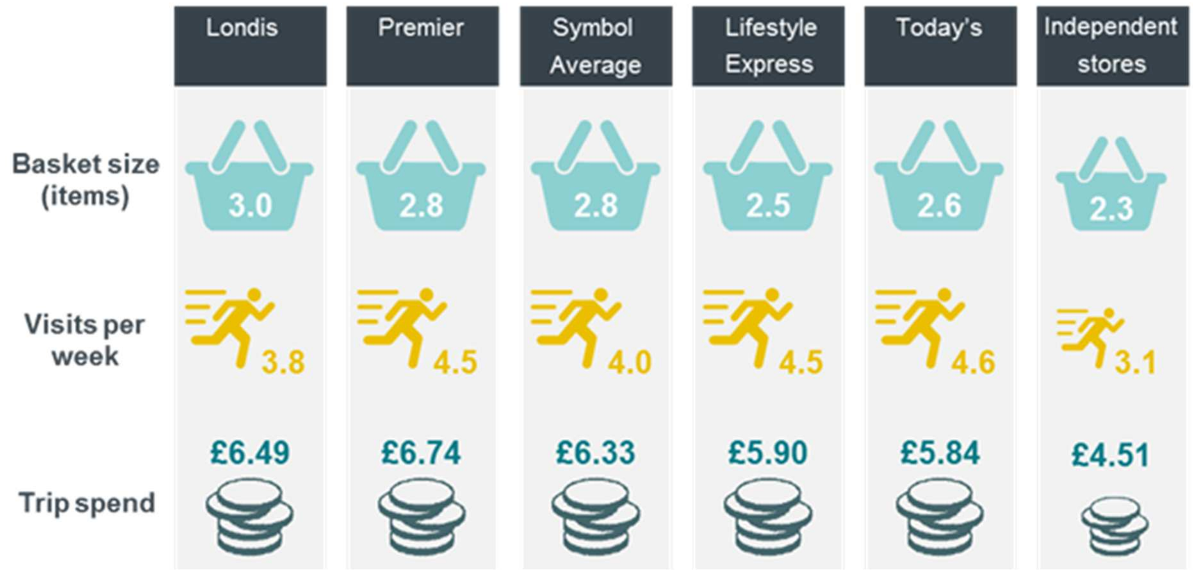
[2] See **Appendices 9.K to 9.M** of the Merger Notice for examples of competitor monitoring documents prepared or sourced by Tesco.

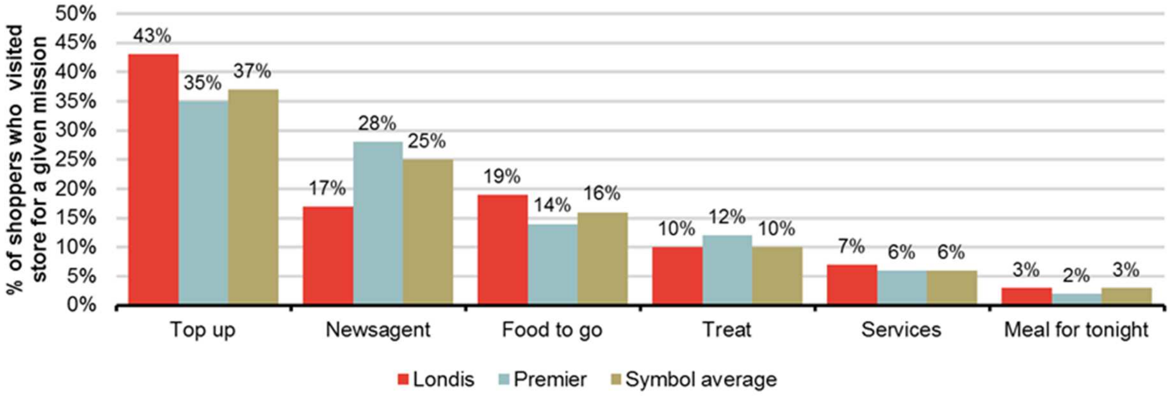
(a) Booker-supplied symbol stores are generally small businesses of single retail stores or small chains, which are more akin to other symbol stores, petrol forecourt retailers and unaffiliated independents; and

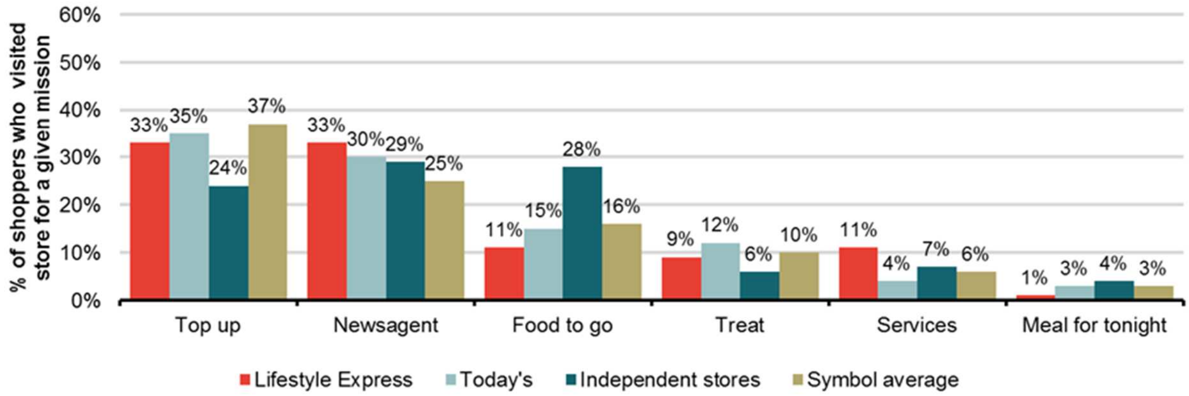
(b) consumers at Booker-supplied symbol stores are more likely to be purchasing smaller baskets focused on impulse and basic grocery products and undertaking shopping missions based around top-up shopping. For this narrower type of shopping mission, consumers are likely to perceive other symbol stores, petrol forecourt retailers and unaffiliated independents as closer alternatives that Tesco stores.

2.5 Unaffiliated independents have many similar characteristics to symbol stores and are likely to exert a strong competitive constraint on them. From a customer perspective, unaffiliated independents are likely to provide a very comparable convenience-mission offering to symbol stores. **Figure 3** below shows that consumers at unaffiliated independents share similar characteristics to those at symbol stores in terms of basket size, visit frequency and mission mix.

Figure 3: customer characteristics for symbol stores and unaffiliated independents







Source: Him!, Retailer Snapshots – Symbols and Independents 2015

2.6 Petrol forecourts also provide a strong alternative to consumers on a convenience mission. Petrol forecourts are increasingly developing their offer so that they are not reliant on petrol sales and a high proportion of consumers now use them as convenience stores. In particular, more consumers visit forecourts only for purchasing food compared to visits only for purchasing fuel, and the share of shoppers using forecourts for top-up shopping doubled between 2014 and 2016 (making it the main footfall driver for petrol forecourts).[3] Customer characteristics are also comparable to those at symbol stores and unaffiliated independents: for example, the average basket size is 2.1 items; the average spend is £5.82 and the average visit frequency is 2.7 times per week.[4]

2.7 Past survey evidence also supports the suggestion that unaffiliated independents exert a competitive constraint on other convenience stores. **Figure 4** below demonstrates how previous survey evidence has shown substantial reported consumer diversion ✂.

Figure 4: consumer reported diversion from ✂

✂

Source: Frontier analysis of ✂

2.8 If the CMA considers that consumers would divert from Tesco stores to Booker-supplied symbol stores, the CMA should also recognise that consumers would divert to other symbol stores (whether or not currently included in the CMA's effective

[3] Him!, *Forecourt Focus*, 2016.

[4] Him!, *Forecourt Focus*, 2016.

competitor set), as well as petrol forecourt retailers and unaffiliated independents (which are not included in the CMA's effective competitor set). This means that the presence of any such stores in the same local area as the Booker-supplied symbol store will mean diversion ratios between Booker-supplied symbol stores and Tesco stores would likely be very low.

2.9 Therefore, in the event that the merged entity deteriorates Booker's wholesale offering unilaterally and this is "accepted" (i.e. no wholesale switching) and passed-through by Booker's retailer customers through a worsening of their retail offering, there is likely to be more diversion to other symbol stores, petrol forecourt retailers and unaffiliated independents (relative to Tesco stores).

3. *Aldi, Lidl and Iceland are effective competitors in the retail groceries sector*

A. Market-wide impact of Aldi, Lidl and Iceland

3.1 Aldi, Lidl and Iceland are effective competitors in the retail groceries sector, and provide a strong and credible offering across all customer missions, <u>including convenience missions</u>. The Parties have provided substantial evidence to demonstrate this during the Phase 1 process[5] and it is widely recognised by the industry that the discounters provide a strong offering in the retail groceries sector. Indeed, their advertising often targets the multiples (including Tesco). By excluding these retailers from its effective competitor set, the Decision fails to take account of market realities. In particular:

(a) **Aldi, Lidl and Iceland have grown to become some of the largest players in the UK retail groceries sector**.[6] Aldi and Lidl, for example, have trebled their market share since 2008, and now have sales of over £8 billion and £6 billion respectively.[7] Of note:

(i) Aldi is the 5th largest grocery retailer, with a market share larger than the Co-operative Group, Waitrose and M&S Simply Food;

(ii) Lidl is 8th largest grocery retailer, ahead of M&S Simply Food and on track to overtake Waitrose shortly; and

(iii) Iceland is the 10th largest grocery retailer.

Overall, the combined sales of Aldi, Lidl and Iceland are higher than the combined sales of all symbol group stores in the UK.[8]

(b) **Aldi, Lidl and Iceland are expected to continue to grow rapidly**. For example, Kantar data shows that Aldi and Lidl continue to gain market share[9] and Aldi's CEO for the UK and Ireland recently stated "*with absolute*

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5 See Annex 4 to **Annex 9.1** of the Merger Notice.

6 Kantar.

7 IGD.

8 IGD.

9 https://www.kantarworldpanel.com/en/PR/Highest-supermarkets-sales-growth-in-five-years-.

assurance" that Aldi "*will be at 1,000 stores well in time for 2022*".[10] This is also recognised by IGD: "*Discounters will contribute most to the cash growth in the [food and grocery] market over the next five years, as they continue to open new stores and keep improving the shopper experience with new additions such as food-to-go, self-checkouts […].*"[11]

(c) **Aldi, Lidl and Iceland have each significantly increased the quality and range of their customer proposition** to become a credible alternative to other grocery retailers across all customer missions. In particular, they have each expanded their fresh offering and significantly increased their basket sizes and sales density. Iceland in particular can no longer be considered just a "frozen food retailer" and now boasts a much broader category mix, with around 40% of its sales relating to frozen food, around 30% of its sales relating to non-frozen fresh food and around 30% of its sales relating to packaged goods.[12] This is recognised by industry experts: "*The difference today is that Aldi and Lidl aren't solely associated with low-priced brands, having been very astute at promoting the quality and price of their private-label range to appeal to a wider array of shoppers. Aldi and Lidl's momentum continues due to new stores opening and the average shopper spending more – testament to the wider and higher quality of products available*".[13] This improvement in the offering of Aldi, Lidl and Iceland is also evidenced by customer perception surveys focused on the convenience sector (see **Figure 5** below).

Figure 5: customer perceptions of grocery convenience retailers

✂

Source: Tesco ✂

(d) **Aldi, Lidl and Iceland are all visited by a large proportion of shoppers** (see **Figure 6** below). For example, more shoppers visited each of Aldi, Lidl and Iceland last year than they visited the Co-op and Waitrose, while Aldi and Lidl were also visited by more shoppers than M&S Simply Food.

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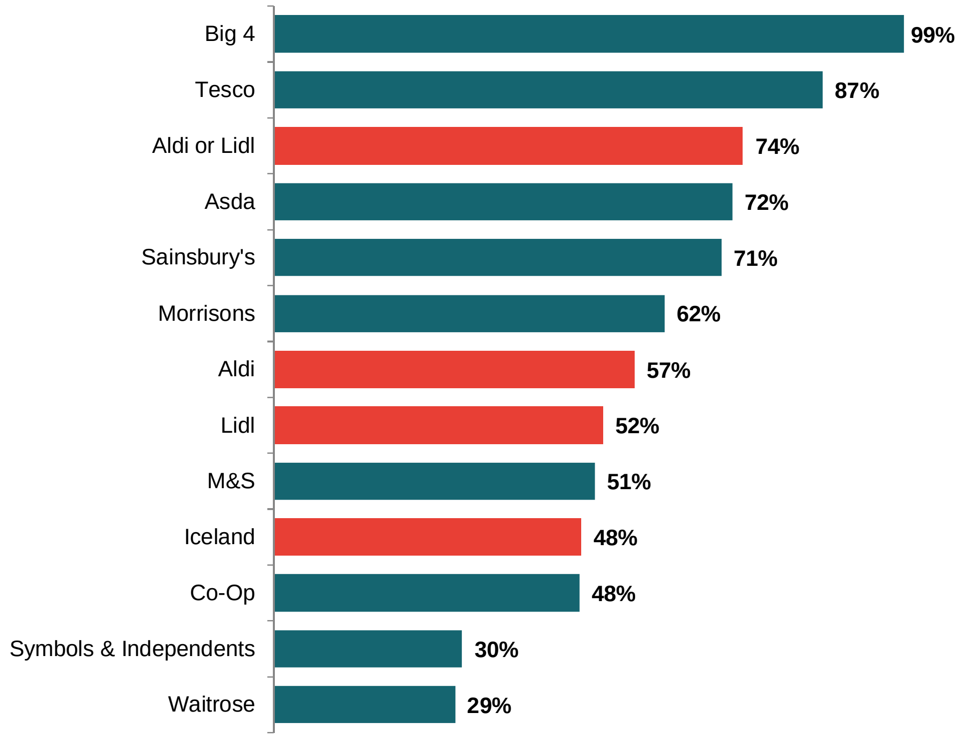
[10] See The Grocer's article dated 14 May 2017 called "*Aldi: 'massive opportunity' to quadruple store number*", in which Aldi's CEO for the UK and Ireland also stated that he sees no reason why Aldi could not expand its store estate to around 2,600 stores.

[11] Joanne Denney-Finch, IGD chief executive, see: https://www.igd.com/about-us/media/press-releases/press-release/t/igd-uk-food-and-grocery-forecast-to-grow-by-15-by-2022/i/16927

[12] Kantar.

[13] This quote is by Mike Watkins, who is the Nielsen UK head of retailer and business insight. See: https://www.retail-week.com/sectors/grocery/discounters-market-share-spikes-as-sales-soar/7019116.article.

Figure 6: percentage of shoppers who have visited each retailer within the last year

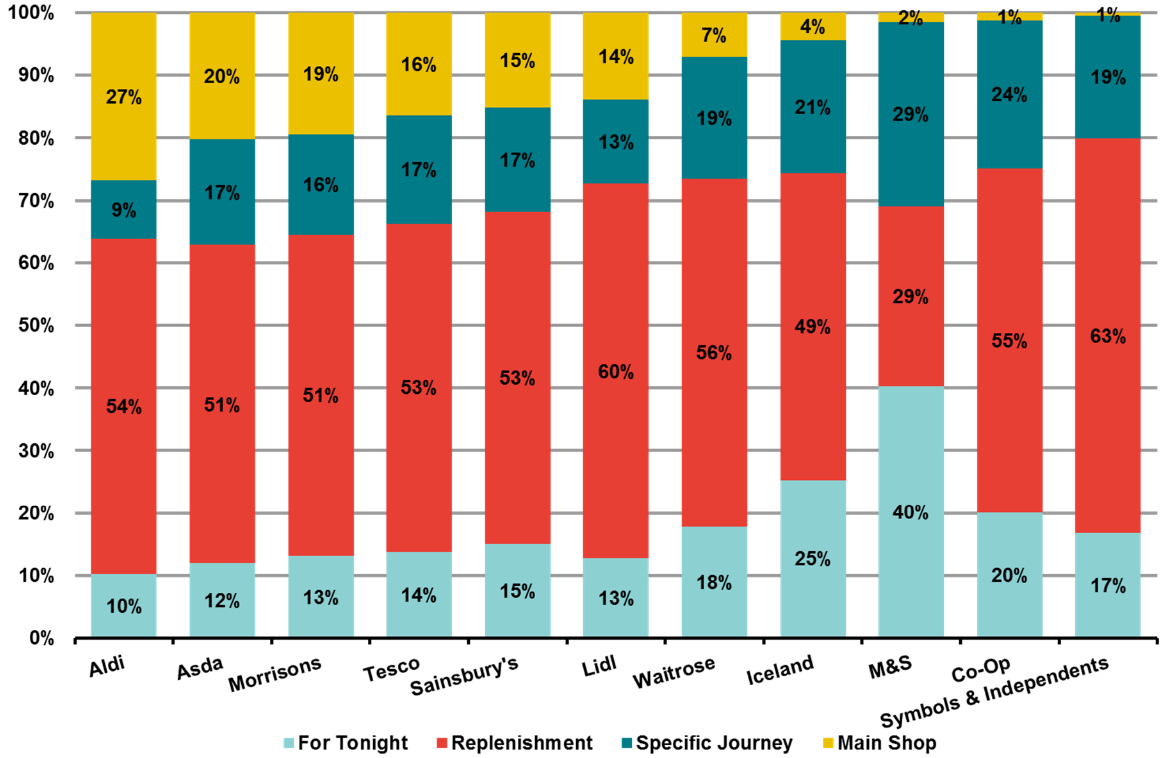


Source: Frontier analysis of Kantar data

3.2 Aldi, Lidl and Iceland compete for all customer shopping missions in the UK, including convenience missions. This is illustrated by **Figure 7** below which shows that Aldi, Lidl and Iceland have a similar proportion of convenience-type missions (i.e. missions other than main shop) to other retailers:[14]

[14] Kantar define the following shopping missions: "For Tonight" (buying something for dinner that evening), "Replenishment" (anything top up), "Main Shop" (re-stocking the cupboards, fridge and freezer) and "Specific Journey" (to buy something specific).

Figure 7: mission mix by customer trips across retailers



Source: Frontier analysis of Kantar data

3.3 Moreover, each has been adapting its offering to compete even more directly with retailers in the convenience sector and capture a greater share of convenience missions. As noted by IGD: "*High street discounters are also targeting opportunities in grocery, often taking them into competition with convenience stores*".[15] In particular:

(a) **They are improving their convenience proposition**, including significantly expanding and improving their 'food to go' offering (e.g. lunchtime meal deals and "fresh to go" areas) and improving their offering of alcoholic products. For example:

(i) "*[…] Aldi launches a range of fresh Ready Set Cook meal kits for as little as £2.99. Up to 50% cheaper than competitors, each meal kit serves two people and can be prepared in less than 15 minutes. Perfect for the time-poor and health-conscious.*"[16]

(ii) "*Lidl has become the latest retailer to give its BWS aisles a revamp, with a major focus on its wine offer and a shift towards craft beer. Lidl's beer range was about to get an update […] and would be*

[15] IGD, *UK Channel Opportunities*, June 2016.

[16] https://www.aldipresscentre.co.uk/press-releases/view/299

‘extending over some new categories in the lager section’, with a ‘big focus’ on craft beer.” [17]

(iii) *“This week saw the opening of Iceland’s brand new Clapham Common store, refitted and modernised to give the frozen food specialist a new look. […]New ranges of self-service Lavazza coffee, craft beer, food-to-go and chilled champagne have also been rolled out across the store.”*[18]

(b) **They are increasingly revamping existing stores and opening smaller stores in high street locations.** This trend has been well documented in the media for several years, for example:

(i) *“By investing in higher spec stores and higher quality product ranges Aldi and Lidl are becoming more like supermarkets to shoppers but retain price advantages […] Aldi has doubled its range to 1,500 SKUs over the last five years.”*[19]

(ii) *“Aldi and Lidl are to carpet Britain with dozens of smaller convenience outlets, threatening the dominance of big established stores. The move marks another blow for Tesco and Sainsbury’s, which are already under pressure from the discounters as their supermarkets lure customers with cheap food and special offers.”*[20]

(iii) *“Traditionally Aldi has stuck to the outer limits of the city, where it can find the 1,200 sq metre sites that let it keep operations simple and efficient. Tooting is Aldi’s smallest store yet […] and part of its latest weapon. At only 580 sq metres, it’s less than half the size of a standard store but employs nearly twice the staff – to keep shelves full throughout the day and checkout queues short.”*[21]

(iv) *“Lidl, which grew sales by 13% year on year, making it the fastest-growing supermarket in Britain, is in the middle of a £1.5bn three-year investment programme. Aldi rolled out 80 new stores last year. Both are planning to double their outlet numbers and, in a sign that the high street is changing, they are among those snapping up former BHS stores”*.[22]

(c) **They are changing their existing stores to make it easier for consumers to engage in convenience or top-up shopping**. This includes adding

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[17] https://www.thegrocer.co.uk/stores/ranging-and-merchandising/lidl-revamps-bws-with-a-major-focus-on-wine-and-craft-beer/553427.article

[18] https://www.retailgazette.co.uk/blog/2016/10/retail-gazette-loves-icelands-new-look/

[19] IGD, *UK Country Presentation*, August 2016.

[20] http://www.dailymail.co.uk/news/article-2835378/Aldi-Lidl-join-rush-small-stores-Discounters-battle-Tesco-Sainsbury-s.html

[21] https://www.theguardian.com/global/2016/apr/02/aldi-cranks-up-pressure-big-four-supermarkets

[22] http://www.propertyweek.com/opinion/will-aldi-and-lidl%E2%80%99s-move-into-more-affluent-areas-mean-the-end-of-the-%E2%80%98waitrose-effect%E2%80%99?/5089707.article

convenience store features to their stores, such as bakeries and self-checkout lanes for small baskets.[23] For example:

(i) *"Lidl […] is continuing its recent transformational journey with significant changes in-store. It is currently trialling self-checkouts as well as a more traditionally British checkout that allows shoppers to pack groceries right away rather than remove them to the bench at the back of the stores".*[24]

(ii) *"Iceland is currently experimenting with new branding in Clapham, where the store has been overhauled to appeal to a middle class audience -* ***bringing fresh and chilled food to the front of the store, updating the freezers, and offering more beer and wine****. The experiment will be followed by a handful more, and if that's successful, could be rolled out."*[25]

3.4 The strong competitive threat from Aldi, Lidl and Iceland is irrefutable. In response, the multiples, co-operatives and other grocery players are having to change their customer offering significantly to compete more effectively. Tesco has made several significant commercial decisions to respond to the competitive threat of the discounters and Iceland. ✂. The discounters' strategies also influenced Tesco's strategic aims to reduce its range and offer low, but stable, prices.[26]

B. Tesco-specific impact of Aldi, Lidl and Iceland

3.5 In addition to the evidence presented above which shows the impact that Aldi, Lidl and Iceland have had on the UK retail groceries sector (including the convenience segment), there is substantial evidence which shows how ✂. For example:

(a) **Switching data** illustrates how Aldi, Lidl and Iceland have all ✂:

Figure 8: net Tesco consumer switching by brand, June 2016 – June 2017

✂

Source: Kantar

(b) **Tesco's entry analysis** demonstrates that discounter store openings typically have ✂ (see **Figure 9** below):

Figure 9: impact of competitor store openings on Tesco Express store sales by fascia

✂

Source: Frontier analysis of ✂

[23] IGD, *The Convenient Market Place, Retail Analysis Report*, November 2015.

[24] https://www.thegrocer.co.uk/stores/store-design/grocer-of-the-year-lidl-weighs-up-in-store-changes/520031.article

[25] https://www.aol.co.uk/money/2017/07/07/is-iceland-the-new-aldi/

[26] https://www.tescoplc.com/media/1870/prelim_2015-2016_presentation.pdf

(c) **One Stop's entry analysis** also demonstrates how the discounters have had ✂.

C. *The Decision's exclusion of Aldi, Lidl and Iceland from the effective competitor set is not credible*

3.6 In excluding Aldi, Lidl and Iceland from the effective competitor set, the Decision places significant weight on two factors:

(a) these retailers do not sell tobacco products; and

(b) its view that the Parties' evidence mainly addresses the competitive constraint that these retailers exert on Tesco so cannot be used as evidence that they are effective competitors to Booker-supplied symbol stores.[27]

(i) Tobacco

3.7 The mere fact that these retailers do not sell tobacco products is not a plausible reason for excluding them from the effective competitor set. In particular:

(a) Only a minority of consumers consider tobacco products when deciding where to shop: only 15.8% of adults in the UK were smokers in 2016 (a decline of more than 4% since 2010).[28] The number of smokers is forecast to continue declining significantly due to legislative, regulatory and cultural changes, including the introduction of plain packaging and an increasing public focus on health. Moreover, an increasing share of smokers are switching to vaping (27% of UK smokers in 2015 and growing rapidly), and these products are predominantly bought on the internet and in specialist shops (67% of products sold in 2015).[29] The significant decline in tobacco sales means that many convenience retailers, for example McColls, have been changing their proposition to avoid any focus on tobacco products and provide a broader convenience offering.[30]

(b) Aldi, Lidl and Iceland provide a strong offering to consumers across the vast majority of shopping missions and product categories. Their rapid growth is testament to the fact that selling tobacco products is not needed to provide a strong offering to consumers. Tobacco is merely one product category[31] and there is a wide range of stores from which consumers can purchase tobacco

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27 See paragraph 86(a) of the Decision.

28 See: ONS statistical bulletin on adult smoking habits in the UK (https://www.ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/healthandlifeexpectancies/bulletins/adultsmokinghabitsingreatbritain/2016).

29 Euromonitors, *Vapour Products in the UK*, 2016.

30 See McColls' Interim Results statement and presentation for the 26 week period ended 28 May 2017 (published on 24 July 2017), in which the CEO notes: "*We are continuing our work to improve our convenience offer, with a particular focus on fresh and chilled foods. These categories have performed well in the first half of the year and we are exploring new ways to improve our fresh food credentials which are very important to the top-up shopping mission*".

31 The sale of tobacco products is not a requirement under IGD's definition of a convenience store.

products outside of the main grocery retailers. In particular, a substantial portion of UK tobacco sales is from independent retailers;[32] and

(c) although M&S and Whole Foods also do not sell tobacco products, they have nonetheless rightly been included in the CMA's effective convenience competitor set in previous decisions, given that they provide a strong offering to consumers across the majority of shopping missions and product categories.

(ii) Parties' evidence base

3.8 The Decision's exclusion of Aldi, Lidl and Iceland from the effective competitor set on the basis of its view that the Parties' evidence mainly addresses the competitive constraint that these retailers exert on Tesco is misguided for the following reasons:

(a) As noted at paragraphs 3.1 to 3.3 above, Aldi, Lidl and Iceland exert a strong competitive constraint on convenience retailers, including Booker-supplied symbol stores. For example, ✂.

(b) Two of the theories of harm set out in the Decision are based on whether consumers would divert from Booker's retailer customers to Tesco stores. It is clear that Aldi, Lidl and Iceland are close competitors to Tesco (and the other multiples). Therefore, the presence of Aldi, Lidl or Iceland in an area will significantly influence the extent to which consumers divert from Booker's retailer customers to Tesco stores, as they will compete strongly against Tesco to attract these diverting consumers.

(c) The approach taken by the Decision is inconsistent with the CMA's previous decisions on retail groceries mergers, which have consistently found that there is an asymmetric competitive constraint (i.e. convenience stores are constrained by other convenience stores, mid-sized stores and one-stop stores). As noted above, Aldi, Lidl and Iceland compete strongly with and are constrained by other larger grocery stores (e.g. the multiples and the Co-op). As such, if the CMA considers that Booker's retailer customers are competitively constrained by larger grocery stores (e.g. Tesco Superstore and Extra stores), it follows that Booker's retailer customers are also competitively constrained by Aldi, Lidl and Iceland.

3.9 Therefore, the Parties consider that there are no longer any credible grounds for regarding Aldi, Lidl and Iceland as not being effective competitors in the retail groceries market.

[32] For example, Action on Smoking Health reported recently that nearly half of smokers buy cigarettes from corner shops (http://ash.org.uk/media-and-news/press-releases-media-and-news/ash-research-shows-corner-shops-dont-need-tobacco-to-be-profitable/).