Anticipated acquisition by Tesco plc (Tesco) of Booker Group plc (Booker)

Response of Bestway Wholesale Limited (Bestway)

1 Bestway welcomes the opportunity to comment on the Issues Statement published by the CMA on 9 August, which sets out the main issues or "theories of harm" (**ToHs**) which the CMA is proposing to consider in assessing the impact of the proposed merger on competition in the market.

2 At this early stage in the inquiry, our comments can be summarised as follows:

- We note that the CMA has identified three principal ways in which the Merger might harm competition and on which it intends to focus its assessment: namely ToH 1 (potential SLC between stores owned by Tesco and Booker), ToH2 (potential SLC between Booker supplied stores and Tesco stores as a result of Booker worsening its wholesale services) and ToH3 (potential SLC between Tesco stores and Booker supplied stores as a result of Tesco worsening its offer). We agree with the CMA that these ToHs warrant careful scrutiny, given the potential harm to competition identified by the CMA in its Phase I reference decision (the **Reference Decision**). Whilst Bestway is not particular well-placed to comment on the ability or incentive of the merged firm to engage in a foreclosure strategy, we would suggest that Tesco is likely to have an incentive to worsen its retail offering in local areas where its owned stores overlap with Booker's symbol stores and fail the assessment framework used by the CMA in the Reference Decision. This is particularly the case if the Tesco owned store in that area is only marginally profitable at present. We would therefore encourage the CMA to consider this ToH particularly closely, and the potential for a SLC to arise in the 64 local areas identified by the CMA as a result of either a worsening of the Tesco retail offering or a decision to close the relevant Tesco store.

- We are particularly concerned that the CMA has signalled in paragraph 27 of the Issues Statement that ToH 4 (potential SLC in the supply of delivered wholesale services) and ToH 5 (potential SLC as a result of increased buyer power) are not likely to be a main focus of its investigation. In our opinion, the proposed merger will have a profound impact on competition under both of these ToHs, and we strongly urge the CMA to devote appropriate resource during the next stage of its inquiry to consider these issues in a robust and objective manner. We note, in particular, that the CMA identified a number of factors and supporting evidence in the Reference Decision which could be supportive of competition concerns arising under each of these ToHs and which we believe merit detailed investigation.

3 Our arguments on these points, which are preliminary in nature, are set out more fully below.

ToH 4: likelihood of SLC arising from customer foreclosure in the supply of delivered wholesale services

4 The CMA indicated in its Reference Decision that it intended to assess whether, post-merger, the merged entity could have the ability and incentive to shift Tesco's wholesale purchases away from Palmer & Harvey (**P&H**) and self-supply in future, resulting in rivals becoming weaker

competitors (partial customer foreclosure) or exiting the market (total customer foreclosure), leading to an SLC in the supply of delivered wholesale services. It noted at paragraph 211 of the Reference Decision that that the following evidence could support concerns arising as a result of customer foreclosure. In particular:

(a) Ability: the CMA's Phase I assessment confirmed that Tesco's business represents a large proportion of P&H's total revenues (although the proportion was redacted from the Reference Decision). The CMA pointed out that, if Tesco were to shift this business away from P&H, then P&H's economies of scale would be substantially diminished, impacting its ability to compete;

(b) Incentive: the CMA noted in the Reference decision that the fact that Booker currently offers a similar range of delivered wholesale services to P&H means that, as a result of cost savings, the Parties may have an incentive to reduce or cease purchasing from P&H post-Merger;

(c) Effect: the CMA indicated that P&H "*could be characterised as an important delivered wholesaler, based on shares of supply, third party responses to the CMA's market test and Tesco internal documents*". As such, it indicated that any reduction in P&H's ability to compete could substantially lessen competition in the supply of delivered wholesale services.

(d) Third party evidence: the CMA confirmed that a number of third parties responding to the CMA's market testing raised concerns regarding the potential loss of competition in the supply of delivered wholesale services as a result of P&H's foreclosure. Third parties in particular noted the significance of Tesco's purchases to P&H's business model and the importance of P&H as a competitor in the supply of delivered wholesale services.

5 In view of the third party responses which the CMA received, and the outcome of its own evidence gathering (including a review of Tesco's internal documents), it is surprising that the Issues Statement indicates that, based on the information it currently has, the CMA is not minded to make this a main focus of its inquiry. In our view, there is a very real risk of harm to competition arising as a result of the merger in the supply of delivered wholesale services. We would urge the CMA to reconsider its current stance and to ensure that sufficient time and resource is dedicated to considering the potential for harm to competition to arise in the supply of delivered wholesale services. Our observations on the issues flagged at paragraph 211 of the Reference Decision are as follows:

(a) Ability: it is clearly the case that, if Tesco were to shift business away from P&H, then P&H would no longer be able to compete. Given the reliance of P&H on Tesco and its current (and well-documented) poor financial state, even a small reduction in volume would fundamentally impact P&H's viability as a going concern.

(b) Incentive: the merged firm would have a clear incentive to reduce or cease purchasing from P&H post-Merger, given Booker's competing offering (even if the timeframe within which that will occur is uncertain). An exit of P&H from the market would have significant ramifications for the delivered wholesale market: as Booker secures P&H's current customers and achieves substantial economies of scale, this would substantially increase barriers to entry and deter exit, and would strengthen Tesco/Booker's position in wholesale markets.

(c) Effect: P&H is the only national supplier of delivered wholesale services and is a critical supplier to a number of retailers (both large retailers, such as Tesco and Sainsbury's who rely on P&H for their tobacco deliveries) and smaller retailers (including convenience stores and smaller store formats). We therefore believe that any reduction in P&H’s ability to compete would substantially lessen competition in the supply of delivered wholesale services, in light of the factors set out above.

(d) Third party evidence: the fact that a large number of third parties confirmed the importance of P&H as a competitor in the supply of delivered wholesale services clearly suggests that, based on the current evidence before the CMA, this ToH warrants careful consideration and we would urge the CMA to do so.

ToH 5: likelihood of SLC arising from buyer power (including "waterbed effects")

6 The CMA points out at paragraph 52 of the Issues Statement that, in some specific circumstances, an increase in buyer power resulting from a merger may have a negative effect on competition and that it will examine whether this is the case here. It goes on to state (at paragraph 53) that it will assess the extent to which, as a result of the merger, the combined firm will benefit from greater buyer power than the parties could previously exert individually in purchasing groceries (or particular categories of groceries) which would be "…*of such a significant change that it could result in a [SLC] in the supply chain, whether at the supplier or the retail level*".

7 At the same time, the CMA has signalled (at paragraph 27) that, based on the evidence that it has received to date, this ToH is unlikely to be a main focus of its Phase II investigation.

8 We would strongly encourage the CMA to reconsider its proposed approach and to ensure that appropriate resources are devoted to investigating this ToH. It is critical that the CMA has due regard not only to the potential for adverse effects on competition not only at the supplier and retail level, but critically at the wholesale level. We believe the proposed merger will have a major impact on competition in the wholesale supply of symbol group services and the supply of cash and carry wholesale services where Bestway competes with Booker and other wholesalers. In particular, we believe the proposed merger would significantly distort competition in those markets by:

(a) significantly increasing the buying power of the merged firm (and therefore further reducing the cost prices which are currently available to Tesco); and

(b) more significantly, by substantially reducing Booker's current cost prices both in absolute terms and relative to those of its wholesale rivals, as the merged firm leverages its enhanced buying power across its supplier base in both wholesale and retail channels. This will give the merged firm a substantial advantage at the wholesale level over its rivals which is not ultimately justified by the operational or purchasing efficiency of the legacy Booker business compared to that of its rivals. This will prevent Booker's rivals from being able to compete on the merits against the leading supplier in the grocery wholesale sector. This will distort competition at the wholesale level and will have significant adverse price and non-price effects over time as indicated more fully below.

9 The CMA's statement at paragraph 27 of the issues statement is also not entirely consistent with the CMA's findings in the Reference Decision, where the CMA rightly identified that competition concerns could arise if an increase in buyer power allows the Parties to:

(a) impose excessive risks and unexpected costs on suppliers, which could in turn reduce the ability or incentive of suppliers to invest and innovate leading to the possibility of an SLC in the upstream supply of certain grocery products; or

(b) negotiate lower prices (or other purchasing terms) from suppliers, which may enable those suppliers to increase their prices to the Parties’ retail or wholesale competitors in order to recoup the loss from the lower prices achieved by the merged entity (the **waterbed effect**).

10 We are not well-placed to comment on the potential for the merger to lead to the potential for a SLC in the upstream supply of certain grocery products through the imposition of excessive risks and/or unexpected costs on suppliers and therefore our comments are focused on the second concern identified by the CMA in the Reference Decision, namely the potential for lower prices to give rise to competition concerns based on the waterbed effect.

11 As regards the possibility of waterbed effects, we note that the CMA's Reference Decision indicates that a number of third parties raised concerns on this basis, which is at odds with the CMA's statement in the Issues Letter that, based on the evidence currently available, this is unlikely to be a major focus of its inquiry. It is difficult to see how, in the context of a fast-track Phase II decision, the CMA has at this stage devoted sufficient resource to consider what is a relatively complex issue which requires careful investigation in the context of a merger control investigation. We do not agree with Tesco's assertion at paragraph 4.41 of their response to the Issues Statement that:

> *"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 market."*

12 It cannot be the case that a model which was applied in the context of a market investigation (as opposed to a merger) to analyse potential competition harm over a decade ago in the context of the grocery retail market is a proper basis on which to discount a theory of harm in the context of a merger which is taking place in a rapidly changing retail market, where (on any view) the merger would combine the leading retail and wholesale grocery suppliers and would substantially improve the cost prices and leverage that Booker will have over its suppliers relative to those of its rivals. It is all the more important to investigate this issue thoroughly given the Competition Commission has identified possible waterbed effects in two previous mergers in the healthcare and retail sectors in 2000 and 2003, respectively.

13 The CMA rightly identified that, for the waterbed effect to occur, several necessary conditions need to arise, including that suppliers have the ability to raise prices to other customers in

response (for example, because customers have few other alternative suppliers they can switch to) and that there is a detrimental effect on other customers. The CMA noted at paragraph 217 of the Reference Decision that the following evidence could be considered supportive of concerns arising as a result of waterbed effects:

(a) Firstly, the CMA noted that the Parties' combined procurement spending indicated that they could have significant procurement shares post-Merger of at least 30% with a 5% increment or higher, across a number of grocery segments. As a result, the CMA recognised that the Parties could have an appreciably enhanced ability to extract better prices from suppliers across a number of grocery segments. However, the CMA also noted that this analysis has limitations because data was not available for some plausible sub-categories, which could have higher or lower shares and increments than the broader segments.

We agree with the CMA that, in absolute terms, the combined entity would have significant procurement shares post-Merger of at least 30% with a 5% increment or higher in a number of categories and sub-categories. However, these thresholds are high, and certainly higher (for example) than the thresholds which the European Commission has considered in the context of some previous merger cases in the grocery sector. For example, in *Carrefour/Promodès*, a supplier was deemed to be "*economically dependent*" on one buyer if the latter accounted for more than 22% of that supplier's total revenues. Applying a threshold of filter of 30% (with a 5% increment of greater) is therefore likely to understate the true purchasing power of the merged entity.

(b) Secondly, the CMA noted that Parties estimated that, post-Merger, they could benefit from significant procurement synergies as a result of harmonising purchasing terms. The scale of these procurement synergies indicated that the merged entity's increased buyer power could be significant.

We agree and would urge the CMA to consider this issue carefully, particularly in the context of the *relative* cost price advantages that the legacy Booker business would enjoy over its wholesale rivals. We would remind the CMA that these issues have been considered by the European Commission in the context of previous cases in the grocery market. For example, in *Kesko/Tuko*, the Commission considered that the unmatched discounts of the merged firm would make new entry into the market more difficult. Moreover, in *Rewe/Meinl*, as well as in *Carrefour/Promodès*, the Commission went further and considered that the exercise of buyer power would, via the associated discounts and the potential of predatory conduct, lead to further consolidation of market power at the retail level (through a so-called "spiral effect"). ToH 5 is therefore not novel and merits careful scrutiny on the basis of the substantial relative cost price advantages which Booker would enjoy at the wholesale level immediately following the merger and the very real prospect that Booker's rivals (including Bestway) would be charged higher cost prices as a result of the waterbed effect.

(c) Thirdly, the CMA pointed out that the product mix that end-customers typically purchase in convenience stores and Tesco stores indicates 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 (eg tobacco), and so may play an important role in the customer's choice of store.

Again, we agree with the CMA's analysis: Booker will benefit from significantly improved cost prices across the full product range compared to those of its rivals, which cannot be justified by reference to the underlying scale and operational efficiency of the legacy wholesale business. This will distort price competition at the wholesale level (and, over time, at the retail level) across the full product range and will also distort non-price competition. For example, we anticipate that the merger will lead to a rationalisation in pack sizes/formats over time as suppliers become reluctant to incur costs in tailoring their pack sizes (including price mark packs) to meet the needs of wholesale customers other than Booker.

(d) Finally, the CMA noted that a number of suppliers stated that they would seek to maintain their profitability in the event that the Parties sought to negotiate lower purchasing prices post-Merger and therefore may increase their prices to other customers to compensate.

In our view, this provides important support for the prospect that the merger would harm competition through waterbed effects and provides another important reason why the CMA should devote sufficient resource in order to consider this ToH carefully. There is a very real prospect that, as a result of the substantial relative disparity in costs, coupled with the expected increase in costs as suppliers seek to recoup their lost margins, a number of wholesale suppliers may either exit the market or be forced to scale back their existing operations and/or halt their current expansion plans.

14 Finally, we note in this context that there is substantial support in academic literature for the proposition that the waterbed effect can, in certain circumstances, lead to substantial harm to competition (by effectively raising rivals costs). For example:

(a) As Adrian Madjumdar states in his paper on *Waterbed Effects and Buyer Mergers* (CCP Working Paper 05-7 produced by the University of East Anglia's Centre for Competition Policy and RBB Economics), the waterbed effect is similar in many ways to a theory of harm based on raising rivals' costs. This paper recognises that, under the waterbed effect, raising rivals' costs as a result of a merger is profitable because it is accompanied by a reduction in the merged firm's own costs. Therefore, even in the absence of the cost raising effect, the merger would be profitable. Dr Majumdar's paper provides a theoretical grounding for the assertion that a buyer merger could lower the buyer's input price and lead to other buyers paying more. The waterbed effect is therefore a theoretical possibility that should not be dismissed and, where it does exist, mergers are particularly profitable and the resulting welfare effects may well be negative.

(b) Similarly, Paul Dobson and Roman Inderst's paper entitled "*Differential Buyer Power and the Waterbed Effect: Do Strong Buyers Benefit or Harm Consumers?*" highlights that a firm's ability to negotiate discounts depends on its relative bargaining power – relative to its suppliers (i.e. in a vertical sense) and relative to its rival buyers (i.e. in a horizontal sense). It is this consideration of vertical and horizontal competition that is fundamental to determining the ultimate effects on consumers. As they point out in their paper, if discounts to one buyer puts other buyers in a worse bargaining position to the

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extent of them paying even higher prices (i.e. premiums rather than discounts) then the knock-on consequence can be higher retail prices and dampened competition amongst these buyers (due to their skewed competitive positions). This is an instance of a "waterbed effect" – where differential buyer power means that some buyers gain at both the *relative* and *absolute* expense of other buyers.

15 We look forward to discussing these issues with the CMA members and staff as its inquiry continues.