Anticipated Merger between J Sainsbury plc ("Sainsbury's") and Asda Group Ltd ("Asda") (together, the "Parties")

Response on behalf of […]

1 Introduction

1.1 […] welcomes the opportunity to respond to the Issues Statement published by the CMA on 16 October 2018 (the "**Issues Statement**"), in respect of the anticipated merger between the Parties (the "**Anticipated Merger**").

1.2 The CMA will be aware from the previous responses to its two supplier questionnaires that […] has serious concerns about the impact of the Anticipated Merger, not just for its own business, but for competition in the market more generally. Therefore, whilst the Issues Statement quite rightly covers a broad range of competition concerns, this response has been limited to those areas of concern which will directly affect suppliers such as […] and, as a result, competition in the market to the detriment of retail customers.

1.3 In other words, […]'s concerns ultimately reflect not only the publicly-stated intention of the Parties to secure a 10% cost reduction from their suppliers, but also the inevitable consequence that these actions will cause significant harm on the market for the supply of groceries in the UK (and therefore adversely affect UK consumers in the medium to long term).

1.4 Against this background, our response focuses on three key areas.

1.5 The first two of these relate to theories of harm ("**ToHs**") already identified by the CMA in the Issues Statement and which we agree should be a primary focus of its investigation into the Anticipated Merger.

1.5.1 The exercise of increased buyer power by the Parties might result in reduced incentives for suppliers to invest and innovate (the "**Innovation ToH**").

1.5.2 The exercise of increased buyer power by the Parties may raise the purchasing costs of rival retailers, which may result in price increases to certain customers (the **"Waterbed Effect ToH"**).

1.6 Our third area of concern is that the synergies and efficiencies predicted by the Parties as a result of the Anticipated Merger are both i) unsustainable and ii) unlikely to be passed on to customers ("**Synergies and Efficiencies**").

2 The Innovation ToH

2.1 The CMA will already have noted our responses to […] and to […], which are broadly summarised below.

2.1.1 Innovation is a primary driver of growth in the […] category and is therefore fundamental to […]'s business: over the past 5 years, approximately […]% of our total expenditure has been focused on the development of innovation and in-market support. Such investment has been particularly targeted towards i) […] and ii) […].

2.1.2 As identified in the spreadsheet accompanying our response to […], innovation and new product development ("**NPD**") launches are very expensive (and the financial assumptions underpinning the business case for such investments are complex and finely-balanced).

2.1.3 Successfully launching innovation in the market for the supply of groceries in the UK (and achieving a sustainable return on investment ("**ROI**")) is therefore critical to […], particularly in […] and so innovation is a key enabler of long-term growth and expansion.

2.1.4 As such, support for innovation is a very important element of […]'s ongoing relationship with retailers. In particular, due to their significant scale the Parties are integral to […]'s overall innovation strategy across grocery and convenience channels, such that continued support from the merged entity (which is likely to become […]'s largest grocery customer) would be essential for […] to achieve a sustainable ROI and thus justify the business case for developing new products and/or categories. In other words, without the merged entity's continued support, an inability to achieve a sustainable ROI might deter […] (and indeed other suppliers) from continuing to invest as frequently and/or as significantly in NPD and innovation.

2.1.5 Against this background, it is clear that the merged entity would wield significantly greater market power, most notably in its increased ability to dictate the level of consumer choice (by virtue of its decision(s) to either offer or withhold support for supplier innovation).

2.1.6 On this basis, given the level of investment made by suppliers ahead of sharing plans with customers, suppliers will be forced to choose between taking the risk of investing in innovation or not, pending agreement of support by the two largest retailers. Over time, this would substantially reduce the overall level of innovation in the market and would clearly have a long-term detrimental impact on consumers, who would be faced with material reductions in product choice and/or quality.

2.2 At paragraph 118 of the Issues Statement, the CMA makes the following points:

2.2.1 the Innovation ToH is more likely to materialise where i) investment by suppliers involves significant upfront costs, ii) suppliers and retailers find it difficult to contract for future terms of supply in advance of making the investment and iii) suppliers cannot spread this risk across multiple large retail customers;

2.2.2 if retailers have significant market power in future negotiations vis à vis the supplier(s) in question, they may be able to force the price down towards the marginal cost of supplying the products. Anticipating this outcome, suppliers may refrain from making the investments in the first place; and

2.2.3 the analysis the CMA has gathered to date indicates that these circumstances are more prevalent for the development of new products (rather than in other types of investment such as investment in additional capacity or processes) and to the supply of branded products (rather than the supply of private or own-label products).

2.3 […] strongly endorses each of these propositions for a number of reasons.

2.3.1 As highlighted by the spreadsheet accompanying our response to […], investment by […] involves significant upfront costs (and we would anticipate that the same is true of many other suppliers to the Parties).

2.3.2 Within the retail channel, the Parties' significant market share means that they are already critical enablers of supplier innovation (and this would be amplified in respect of the merged entity). Without their support, investing in innovation is very challenging for […] (as both the efficiency and efficacy of any such investment would be hugely compromised).

2.3.3 As noted in our response to […], discussions around support for innovation form an integral part of […] negotiations between […] and its major customers (including the Parties). However, […] does not contract with retailers for future terms of supply in advance of making the investment.

2.3.4 If the “Big Four” group of retailers becomes a “Big Three” as a result of the Anticipated Merger, the ability of […] and other suppliers to spread the risk of innovation investment across multiple retailers will be materially reduced. In fact, given the relatively small market share of Morrisons in comparison to each of the merged entity and Tesco, the reality is that, post-merger, the “Big Four” will effectively become a “Big Two” duopoly (further reducing suppliers’ ability to spread the risk of innovation investment).

2.3.5 As noted in our response to […], if the merged entity sought to harmonise its suppliers’ pricing and/or terms, we would anticipate that suppliers would (amongst other things) materially reduce their innovation spend. This, in turn, would likely result in a substantial reduction in consumer choice.

2.3.6 A significant proportion of our innovation investment spend is attributable to NPD and, as the CMA is aware, […] […].

2.3.7 On this basis, the risks posed to […] by the Innovation ToH are particularly acute and the potential for resultant consumer harm is therefore particularly high. It is likely that a number of other suppliers will be in a similar position and, as such, the risk of negative consumer outcomes in the long-term cannot be overstated (particularly in terms of a material reduction in choice). We would therefore urge the CMA to examine closely the Innovation ToH in the context of the Anticipated Merger.

3 The Waterbed Effect ToH

3.1 At paragraphs 122 – 123 of the Issues Statement, the CMA makes the following points:

3.1.1 in the first instance, the lower wholesale prices obtained by the merged company allows it to reduce retail prices, and thereby attract customers from other, smaller retailers. As smaller retailers lose market share, their bargaining positions and their purchasing costs deteriorate. These smaller retailers then face two competing incentives: on the one hand, they would like to pass on some of the increase in their purchasing costs; on the other hand, they need to maintain lower prices to resist increased competition from the large retailer. If the former effect dominates the latter, then smaller retailers respond by increasing their prices, which harms their customers; and

3.1.2 the Waterbed Effect ToH is therefore more likely to hold if variations in market shares between retailers translate into significant variations in the variable costs of procuring goods, and if smaller retailers have an incentive to pass on a significant share of the resulting increase in their procurement costs.

3.2 Against this background, […] makes a number of submissions.

3.2.1 The Parties have already publicly stated that their intention is for the merged entity to extract a 10% cost reduction from its suppliers, enabling it to reduce its retail prices by the same percentage. As noted further below, given the resultant lessening of competition post-merger there is no guarantee that the anticipated reduction in retail prices for the merged entity’s customers would hold beyond “year one”.

3.2.2 Nonetheless, if the merged entity achieves the 10% reduction in retail prices, as the CMA suggests, it is indeed likely that it will attract customers from other, smaller retailers who will inevitably lose market share, suffer decreased bargaining power and therefore increased purchasing costs.

3.2.3 This eventuality is all the more likely to occur given that, as no doubt with other larger suppliers, […] has an overriding duty to its shareholders to provide appropriate mitigation in circumstances where such a major price reduction will be forced on the business. As noted in response to […], one of our most likely responses to the attempted harmonisation of pricing and/or terms by the merged entity would be to seek to pass on some or all of any resultant cost or price increases to our own suppliers and other customers. It is likely that many other suppliers will seek to do the same.

3.2.4 Faced with the two conflicting incentives outlined in the Issues Statement, […] considers it likely that the former will win out over the latter. In other words, smaller retailers would have little choice but to increase their retail prices to reflect the higher costs of supply. Such retail price increases would clearly have a long-term detrimental impact on consumers, particularly those who either i) do not have access to a Sainsbury's or an Asda store and/or ii) predominantly shop in the convenience channel.

3.2.5 In light of the above, in particular the need for suppliers to pass on cost increases (prompted by the demands of the merged entity) and likely loss of business to the merged entity, the logical conclusion of the Waterbed Effect ToH is that some smaller retailers will go out of business.

4 **Synergies and Efficiencies**

4.1 As noted above, we are concerned that the synergies and efficiencies anticipated by the Parties as a result of the Anticipated Merger are both i) unsustainable and ii) unlikely ultimately to be passed on to customers.

4.1.1 If the merged entity secures a 10% cost reduction from its suppliers, as noted above, […] (and indeed all other suppliers) will need to – and will therefore seek to - recover these costs from other customers.

4.1.2 In particular, […] is confident that it could land cost price increases in the majority of other retailers, and therefore, could foresee any customer price saving offered by the merged entity being offset by increased in-market pricing elsewhere (see also our above comments in relation the Waterbed Effect ToH). In other words, <u>the cost savings anticipated by the merged entity would not result in any net benefit for customers across the market more generally</u>.

4.1.3 We consider that this will be particularly true for customers who either i) do not have access to a Sainsbury's or an Asda store and/or ii) predominantly shop in the convenience channel.

4.1.4 Moreover, after "year one" of the Anticipated Merger, our strong expectation is that any 10% price reduction secured by the merged entity will very quickly become unsustainable. This is because the merged entity:

4.1.4.1 will hold a very significant market share, particularly in certain locations; and

4.1.4.2 will therefore have both the ability and the incentive to increase retail prices to customers (without any real fear of such customers potentially switching to other retailers).

4.2 Against this background, the CMA will no doubt scrutinise the Parties' claims in relation to any efficiencies and/or synergies that they expect to arise as a result of the Anticipated Merger.