10 June 2015

Proposed Acquisition of K-Y Brand by Reckitt Benckiser

Response to Remedies Notice

Reckitt Benckiser (**RB**) has set out below its initial comments in response to the CMA's Remedies Notice, published on 22 May 2015. Comments are made below on the hypothesis that the CMA maintains its current line of reasoning set out in its Provisional Findings as to whether there is an SLC in this case. Nothing in this response should be taken as an acknowledgement of the veracity of the CMA's current position. RB will make a separate submission to respond to the CMA's Provisional Findings.

1 Proportionality

1.1 As a preliminary matter, RB notes that the CMA is obliged to seek to ensure that no remedy is disproportionate in relation to the substantial lessening of competition (**SLC**) and its adverse effects identified by the CMA.[1]

1.2 When taking into account the proportionality of any remedy option being considered in this case, the CMA should be cognisant of the following factors:

(a) Even on the basis of the conclusions reached by the CMA in the Provisional Findings (which RB disputes on a number of grounds) it is clear that the SLC finding depends on a number of fine judgments on issues such as competition between the brands, new entry and buyer power. In particular, the CMA's finding of an SLC includes an acknowledgment that the products are differentiated and only viewed as substitutes by some customers, that entry is possible into the national pharmacy chains (a significant part of the relevant market the CMA has identified) and that buyer power is hard to assess (although RB would note that retailers think they have it[2]). Moreover, the CMA admits that shopping habits are changing and that online sales are increasing.[3] This is not, therefore, a typical SLC; it is a case where the evidence is complex, often contradictory, and where the CMA's view has been reached "*on balance*".[4]

(b) The market affected by the SLC is very small – total wholesale sales of lubricants to grocery and national pharmacy customers in the UK were less than £10 million in 2013.[5] K-Y's wholesale revenues[6] in 2013 were only marginally above [✂] (and some of these revenues were achieved in retail channels where the CMA does not have concerns). As a result, this merger is not likely to create significant adverse effects for consumers.

(c) Approximately [✂] of the revenue for the K-Y UK business is derived from the supply of "sterile" K-Y to the NHS, which raises no competition concerns whatsoever.

1.3 When taking these factors into account, it is clear that the CMA must consider the cost of imposing any remedy in the UK very carefully given the scale and the balanced nature of the SLC finding in this case.

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[1] *Merger Remedies: Competition Commission Guidelines, CC8,* November 2008, para. 1.9.
[2] The majority of grocery and national pharmacy chain retailers thought they had countervailing buyer power in this market, as is clear from the third party hearing summaries published by the CMA.
[3] Provisional Findings, paragraph 8.123 and 8.125.
[4] CMA press release of 22 May: "*However, on balance, there seems to be enough of an overlap in the market for personal lubricants for there to be a realistic prospect of consumers facing less competition and possibly higher prices if the 2 biggest brands come under single ownership*."
[5] Phase 1 decision para 270.
[6] Excluding sales to the NHS – see paragraph 1.2(c).

2 Relevant customer benefits

2.1 In addition to general questions of proportionality, RB believes the CMA should also take into account a relevant customer benefit generated by this transaction. This relates to the supply of K-Y to the NHS, in respect of which the CMA has identified no competition concerns.

2.2 Even accepting the CMA's counterfactual (which RB does not agree is correct, for reasons to be set out in more detail in RB's response to the Provisional Findings), there is no guarantee that another purchaser of the K-Y brand would have the expertise and/or inclination to maintain this NHS supply. Indeed, it is relatively unlikely that they would wish to do so unless they already supply a significant range of products to the NHS, since such supply involves an entirely separate and specific set of supply relationships which are different from those in the retail sector. Moreover, such supply tends to be cumbersome and operate at lower margins than in the consumer side of the business. RB already has existing NHS supply relationships and would be likely to continue to supply K-Y to the NHS if the transaction goes ahead. Continued supply to the NHS should therefore be considered a relevant customer benefit for the purposes of the CMA's remedies assessment as it is merger specific and unlikely to arise without the transaction proceeding.

3 Prohibition

3.1 In its Remedies Notice, the CMA suggests that prohibition on its own may be insufficient to remedy the SLC because of a risk that Johnson & Johnson (**J&J**) may have a reduced incentive to continue to support the UK K-Y business following the completion of the transaction in most other jurisdictions. The CMA considers that this could lead to the UK K-Y business no longer competing effectively.

3.2 RB finds it difficult to understand how, having reached this conclusion in the Remedies Notice, the CMA could decide in the Provisional Findings that the relevant counterfactual is that the global K-Y business would have been sold to an alternative purchaser. In the Remedies Notice the CMA accepts that this would not happen, which entirely undermines the CMA's conclusion that such an outcome is the "*most likely*" counterfactual.[7] RB believes that such an approach is incorrect and will address this in greater detail in its response to the Provisional Findings.

3.3 However, even leaving aside this major internal inconsistency in the CMA's approach, if the CMA considers that it needs to go as far as effectively prohibiting the transaction then prohibition alone should be the appropriate remedy. The CMA should not seek to impose further costs or obligations on J&J to either sell the brand to a third party or enter into a long term licence. Both remedies are akin to prohibition. Imposing such remedies is unjustifiable for two main reasons: first, it would be ultra vires and disproportionate in the circumstances; and second, it would be fraught with practical difficulties. These points are elaborated upon below.

Legality and Proportionality

3.4 The CMA's review is focused on the acquisition of the UK K-Y business by RB – this is the relevant merger situation identified in the CMA's Provisional Findings.[8] Even if one accepts that the CMA's proposed counterfactual is correct (which RB does not), imposing a requirement that J&J sells or licenses the K-Y brand in the UK (instead of prohibiting the acquisition of the brand in the UK by RB) would be a remedy driven not by the SLC identified in respect of the relevant merger situation in the UK but by the fact that RB now owns the K-Y brand elsewhere in the world. Imposing such a remedy on this basis would be ultra vires and disproportionate because it would go beyond what is necessary to deal with the effects of the UK merger and would instead be aimed at addressing a perceived change of commercial incentive as a response to a global transaction which has completed outside the UK.

[7] Provisional Findings, para 7.31.
[8] Provisional Findings para 5.11.

3.5 Further, to force J&J to sell or license the brand to a third party would require J&J (and possibly RB) to bear additional costs that are wholly disproportionate to the size of the market, the size of the transaction in the UK and the nature of the SLC to be remedied. This is, as has been clear from the outset of the CMA's review, a small acquisition of a business with a total UK turnover of less than [✂] in 2013. As noted above, the relevant market is small, and the provisional finding of the SLC is based on fine judgements in one retail channel – in a situation where, for example, a significant number of the parties' customers in that channel do not object to the deal.[9]

3.6 Against this background, the parties have already undergone significant cost and considerable delay as a result of the CMA process, and would of course face further cost if the transaction is prohibited. Imposing additional costs on the parties above and beyond this would be disproportionate – we would note that it is exactly to avoid these sorts of costs that RB in this case has chosen not to complete the transaction in the UK pending the CMA's review.

Practical difficulties

3.7 There are significant practical difficulties with requiring the sale or licence of the K-Y brand in this case because the UK transaction has not completed. As a result, the CMA is considering imposing such a remedy on J&J as the seller – which we believe would be unprecedented. Other practical difficulties with designing the remedy in this context include determining what would happen if no suitable purchaser or licensee could be found for the UK K-Y business.

4 Alternative proposals

4.1 Although the Remedies Notice has not done so, RB considers that it is possible to idenfity legitimate, proportionate and practical alternatives to prohibition. RB sets out two alternative proposals in this regard below: a behavioural remedy or a short-term licence by RB of the K-Y brand to a third party.

Option 1: Behavioural remedy

4.2 This remedy would take the form of an undertaking from RB not to alter the current commercial offering of K-Y for five years. In detail, this would mean RB would not implement a cost price increase (subject to an allowance for inflation) and would maintain the existing pack sizes and formula of the K-Y products. It would also commit not to introduce any new K-Y products. This would ensure that K-Y continues to be sold as it is now and as it would be expected to be sold absent the merger (using the CMA's counterfactual, which makes clear that the CMA does not expect any major changes to the way K-Y is sold in the UK).

4.3 The remedy would be effective because the Provisional Findings suggest that the incentive to raise prices is greater in respect of K-Y than for Durex.[10] This remedy therefore addresses the main concern expressed by the CMA but goes further and addresses a further concern expressed by some third parties that RB might seek to expand the K-Y range and raise barriers to entry to this channel. The remedy is time limited because RB believes that the growth of the lubricant sector, the ability for others to enter the grocery and national pharmacy channel (free from any concern about RB expanding its shelf space allocation through K-Y), the growth of multi-channel shopping and increasing constraints from the online segment in particular mean that the competitive conditions in the market are likely to develop significantly within the next five years, such that the remedy will no longer be necessary. With the relevant customer benefits outlined in section 2 above, RB considers that a behavioural remedy such as this is both an attractive and a proportionate response to the CMA's concerns, given that they are limited to grocery and national pharmacy channel retailers only, whilst preserving important customer benefits arising in the supply of K-Y to the NHS.

[9] Provisional Findings, para. 8.42.
[10] Provisional Findings, para. 8.75 and para. 8.135.

4.4 The CMA has indicated in paragraph 14 of its Remedies Notice that it believes a price cap or similar behavioural remedy would be unlikely to be an appropriate remedy in this case for a number of reasons. RB believes that these points are incorrect in a number of respects, as follows:

(a) The existing rivalry between Durex and K-Y is, at most, limited. The CMA itself has accepted that the two products are only "*to some extent substitutes*".[11] A significant constraint will continue from own label products. In addition, the CMA accepts that K-Y is a stagnant brand, with no marketing behind it and that this is unlikely to change even in the counterfactual situation. This remedy therefore ensures that the positioning of K-Y remains as it would in the CMA's counterfactual scenario (i.e. the K-Y brand continuing as it is today).[12] It also ensures that RB is prevented from exercising any perceived market power in respect of K-Y and would also allay fears that RB might use this merger to raise barriers to entry in this channel.

(b) The current conditions of supply are clear and observable – the price of K-Y, the pack size and the formula have been unchanged for a number of years. The commitment is designed to ensure that RB would not be able to introduce price rises through reducing pack sizes or reducing the quality of the product.

(c) RB would expect monitoring to require no more than RB providing regular confirmation that the commercial conditions of supply of the two K-Y products that are sold to the major grocers and pharmacies have not been changed. Compliance will be straightforward to establish and could easily be verified with the small group of sophisticated retailers included in the CMA's relevant market.

Option 2: Short-term licence to facilitate entry

4.5 The purpose of such a remedy would be to allow RB to acquire the K-Y brand in the UK in due course but to provide for a short-term licence to a third party to overcome the perceived barriers to entry and to enable a third party to establish lubricant sales in the grocery and national pharmacy stores, creating an independent supplier/competitor in this channel going forwards.

4.6 In detail, the remedy would allow a licensee to supply the K-Y branded products currently sold in the UK for a period of four years, plus a black-out period of a further year during which RB could not use the K-Y brand in the UK.[13] The licensee is intended to be an existing or potential supplier of SWB products in the UK, which would be capable of supplying products under the licence immediately or after a short transitional period. RB would commit to procuring from Johnson & Johnson (or providing itself) certain transitional services and, if required, to contract manufacture the existing K-Y consumer products in the UK for the licensee for the period of the licence. This would remove any concerns that the CMA might have about incentives of the licensee to invest in the production of K-Y.

4.7 RB envisages that, during the four year period, the licensee would transition away from the K-Y brand to its own brand, in order to be in a position to continue to compete with RB post-licence (no longer using the K-Y brand). This would be a condition of the remedy. The licensee would receive further protection against competition from RB by the addition of a one year black-out period at the end of the licence term before RB can begin to use the K-Y brand.

4.8 Once the K-Y brand has reverted to RB, the licensee would be entitled to continue to use the K-Y formula ([✂]) – in other words, the same product would remain on the retailer's shelf under the licensee's own brand and consumers that purchase K-Y would be moved to the new

[11] Provisional Findings, para. 8.142.
[12] Provisional Findings, para. 7.31.
[13] Subject to a possible exception for supply to the NHS, see paragraph 4.13 below.

branded product. The remedy would thus create a new branded competitor in the grocery multiple and national pharmacy chain channel.

4.9 Such brand transitions are not unusual in fast-moving consumer goods markets and often take place in a far shorter timescale than is being proposed here. Moreover, according to the CMA's own survey, a significant percentage of consumers are likely to buy this product on at least an annual basis (and often more frequently than that), meaning that over a five year period, the licensee will be able to generate a significant number of repeat purchases of its new branded product, generating consumer awareness and loyalty. It is RB's expectation that, as a result, this new supplier would be likely to retain its listings with major retailers during the black-out period at the end of the licence and after the K-Y brand reverts to RB (not least because those retailers will not have been selling the K-Y brand for a period and consumers will have transferred to the new brand).

4.10 The CMA has previously accepted that licences of IP rights can constitute an acceptable remedy to competition concerns, without requiring any further assets to be divested, provided there are other manufacturers/suppliers that can use the IP to compete effectively. Moreover, the European Commission's remedies notice,[14] envisages that it is open for regulators to accept time-limited licences for a brand with the purpose of allowing the licensee to re-brand the product in the period foreseen.

4.11 RB's believes that this remedy will be effective here because RB's expectation is that grocery multiples and national pharmacy chains will wish to continue to obtain supply of these K-Y products from the licensee during the period of the licence.[15] The licensee can then benefit from the relationships and infrastructure it has developed through its access to the K-Y brand to transition consumers across to its own brand and, potentially, promote the listing of other brands in the channel. The CMA accepts that production of lubricant products is easy. Therefore, there is no concern about a need to invest significantly in the production of K-Y (or its successor brand). Similarly, distribution to this channel is straightforward. Given that J&J has not marketed K-Y in recent years, there would be no need for the licensee to invest in any promotional funding of K-Y. Any promotional expenditure could be targeted at the new brand (and the licensee would have every incentive to do so as this would be the brand that it would retain long-term).

4.12 Given the likely growth of the lubricant market and the increasing popularity of multi-channel and online shopping in the near future, RB believes that grocery multiples and national pharmacy chains will become less relevant as a separate "channel" to market and, moreover, it will become even easier over the next five years for new suppliers to obtain listings in grocery retailers and national pharmacy chains. However, regardless of these expected trends, the short cut offered by this proposed remedy immediately overcomes any perceived barriers for the third party licensee, immediately creating a new branded supplier to replace J&J.

4.13 The CMA has only identified concerns in respect of the grocery multiple and national pharmacy chain channel. However, to ensure that the licensee is successful in its re-branding and to avoid difficult questions relating to split IP rights and incentives within a single territory, RB proposes to license the entire range of K-Y branded products currently sold in the UK (the two SKUs currently sold to grocery retailers and national pharmacy chains, as well as to wholesalers serving the independent pharmacies, online and adult store retailers and two SKUs in the medical professional channel) and to transfer any relevant contracts in relation to customers in the UK (i.e. the NHS), to the extent that this is desired by the licensee. If, as is likely, the licensee does not want to supply the NHS, the advantage of this short-term licence remedy is that it preserves RB's incentive to continue the NHS supply of K-Y in the knowledge that the K-Y brand will revert to it in due course. It should be feasible to design the remedy so that SKUs

[14] Commission notice on remedies acceptable under Council Regulation (EC) No 139/2004 and under Commission Regulation (EC) No 802/2004, paragraphs 39-42.
[15] This is even more likely on the CMA's reasoning that K-Y is a "must stock" brand, although RB disagrees with this conclusion.

supplied to the NHS do not spill-over into the consumer retail channels, not least because the "sterile" K-Y supplied to the NHS is very different in form and packaging from the consumer version of K-Y.

4.14 In the CMA's Remedies Notice, questions are raised regarding possible protections that might be built into any licence to a third party and potential conflicts between IP rights holders and territories. In RB's view, certain protections will be required to preserve the brand value of K-Y. The CMA should not be overly concerned with this. Any remedy should only seek to restore the pre-merger conditions of competition. On the basis of the CMA's counterfactual, this means simply ensuring that the existing K-Y SKUs are available to be purchased from the grocery and national pharmacy channel. There is no need to provide the ability or incentive for a licensee to use the K-Y brand to introduce new products. Any such innovation should be concentrated on the licensee's new brand (over which RB would have no control). Indeed, an advantage of this proposed remedy is that it avoids the issues listed in paragraph 13 of the Remedies Notice, which would arise in any other remedy that sought to license or divest the K-Y brand on a long-term basis.