

7 Views of the main parties

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Introduction

7.1. In this chapter we summarize the views of Arla and Express (the parties) put to us in joint written submissions and at hearings, supplemented where appropriate with separate evidence from each party.

Jurisdiction

7.2. The parties acknowledged that the jurisdictional thresholds for investigation under the Fair Trading Act 1973 were met in that the worldwide gross assets of Express were greater than £70 million. Furthermore, there was at least one market in Great Britain in which the parties would have a market share in excess of 25 per cent.

The rationale for the merger

7.3. The parties said that the merger would provide benefits to all stakeholders (see paragraph 4.114). The resulting cost savings would give the merged entity the ability to compete effectively and fund new investment, which was essential given the commercial pressures the parties faced. The parties said that they had not made the necessary investment over the years to be on a par with the two leading milk processors (Dairy Crest and Wiseman) in terms of efficiency. They believed that the merger would narrow the gap by allowing inefficient capacity to be replaced with new, modern and more efficient capacity. The combination of skills in the merged entity would also lead to efficiencies. The market would then consist of three strong, well-invested competitors. The parties believed, therefore, that the proposed merger was pro-competitive.

7.4. The parties said that the merger would enable Express to benefit from Arla's branded products (spanning various dairy products in which Express was not active or not active to any material degree, including yellow fats, cheese, yogurts and desserts) and Arla would benefit from the opportunity to market these products through the enlarged distribution network of the merged entity. Customers, including consumers, retailers and food service undertakings, would also gain from a broader full line product range, an efficient service and an energetic approach to product innovation. The parties had noted, both in the UK and elsewhere in Europe, a tendency on the part of retailers to reduce their number of suppliers, in order to keep costs down. There was only so much time that a retailer would want to spend on a single supplier, therefore a supplier offering a broad range of products would be attractive in terms of efficiency. The parties believed, therefore, that it would be both more efficient and an added advantage to retailers if the merged entity could offer a full range of other dairy products as well as fresh processed milk. The merger would also provide enhanced opportunities, through the enlarged distribution network, to increase sales of Arla's value-added products to non-retailer customers such as food service providers.

7.5. The parties said that they both had a history in their respective home markets of working collaboratively with their farmer suppliers. They intended that the merged entity would continue and further their relationship with farmers. Arla said that, as one of Europe's leading dairy cooperatives, it was committed to fostering closer and more inclusive working relationships with dairy farmers. Arla's established global purchasing function for all non-milk purchases would complement the UK base of both companies. Express told us that since the ending of the Milk Marketing Scheme in 1994 it had seen the benefit of having a close relationship with its direct suppliers. The need for security of supply was a major factor in the fresh processed milk market and had been a key consideration for Express, in the unpredictable era following deregulation, in developing the relationship with farmers, which had served it well. Express would bring large-scale milk purchasing, collection and distribution skills to the merged entity. Its long-standing relationship with the EMP and its strategic alliance with Milk Link had proved that cooperation and collaboration could benefit farmers.

7.6. With regard to the effect of the merger on farm-gate prices, the parties said that they would expect operational benefits for their procurement of milk from improved balancing of supply and demand and better collection densities. Although the merged entity would have greater buyer power than Arla or Express singly, it had to be remembered that a large proportion of raw milk was bought by companies other than liquid milk processors. The parties had not, therefore, projected a material decrease

in the merged entity's payments for raw milk. The parties said that the market for raw milk was determined by the CAP framework, which would always be the dominant factor in the price, whether a purchaser bought direct from farms or through a cooperative. The difference in the prices that cooperatives returned to their members and the prices that the parties paid direct to farmers arose because cooperatives supplied a range of companies operating in different markets. For example, prices were lower in long-life commodity markets than in fresh milk markets. In Arla's view, the combined effect of improved logistics and balancing and increased buyer power would have an effect of about [X] ppl on raw milk cost prices—about [X] per cent of 19p or 20p.

7.7. Most of the rationalizations and efficiencies expected from the merger (see paragraph 4.115) could not be achieved in the absence of the merger. In particular, the rationalization of dairies described in paragraph 4.115(a), which included two site closures that were merger specific, could not be achieved by each party individually, because of dairy capacity indivisibility and product range problems with further stand-alone dairy closures. These issues arose because, whilst both Arla and Express had spare capacity individually, they had insufficient spare capacity to justify each closing a further dairy. Such closures could also lessen their ability to continue to supply a full range of products.

7.8. In addition to the two dairy closures that would be feasible as a result of the merger, other rationalization opportunities in distribution, the doorstep business and head office/support functions were all merger specific.

7.9. The parties said that it was essential for them to achieve synergies because of the commercial pressures they faced from the cumulative effects of various factors, including:

- (a) Diversification by the national multiples into the doorstep and middle ground sectors through establishing home delivery and convenience store businesses. Milk processors' increasing dependence on sales to the national multiples had substantially increased the multiples' buyer power, which they used to obtain very low milk prices across all of their sales, including home delivery and convenience retailing.
- (b) Milk processors with older dairies had had to invest substantially in order to bring them to the standards required by the national multiples, whereas smaller and newer suppliers had been able to construct optimal plants from the outset. This competitive disadvantage for established milk processors (particularly those with glass bottling dairies) had created substantial opportunities for entry and expansion. The parties cited the example of Wiseman, which from the start of its business with national multiples had supplied them from modern, high-volume dairies and was now the largest supplier to that part of the market, with a 29 per cent share.
- (c) National multiples had actively encouraged Wiseman's expansion. They were able to encourage further expansion and new entry if they considered that by so doing they could achieve lower prices.
- (d) Buyer groups and smaller retail chains in the middle ground also had substantial buyer power. They tended to use professional buyers/executives recruited from national multiples or independent consultants, and increasingly procured nationally.
- (e) Farmers had announced plans to diversify into the processing of raw milk, thereby increasing overall processing capacity. The three milk cooperatives established following the break-up of Milk Marque were permitted to engage in vertical integration, which the parties commented would increase overcapacity in the industry.

Supply of fresh processed milk to national multiples

Product/customer market definition

7.10. The parties agreed with the findings of UK competition authorities in previous investigations that all liquid milk should be divided into a market for fresh liquid milk and the markets for long-life UHT and sterilized milk. They thought it uncontroversial that the market for consideration in our investigation of the proposed merger was that of the supply of fresh processed milk, which they agreed should include organic, regional and fresh extended life milk.

7.11. Previous analysis by both the OFT and the CC of fresh processed milk had related to three customer segments:

- (a) the national multiples;
- (b) middle ground customers, which had included other retailers, including smaller supermarket chains, symbol groups (for example, Spar and Londis), convenience stores, newsagents, corner shops and non-retailers such as the NHS, local authorities, the Ministry of Defence, schools, caterers, hotels and restaurants. The parties noted that in its report on the supply of milk in Scotland the CC had concluded that, from an economic viewpoint, it was appropriate to define a middle ground customers market segment that included supply to both retailers and non-retailers; and
- (c) doorstep customers who were supplied either by independent BMBs (who purchased milk from liquid milk processors) or by roundsmen, who tended to be either employed or franchised by the large liquid milk suppliers.

7.12. In the current inquiry, the OFT had examined the effects of the merger separately in each of the three segments and had concluded that there was a significant prospect of a substantial lessening of competition in relation to supply to the national multiples. The main reason given by the OFT for taking that view was that smaller dairies might not be able to meet the requirements of the national multiples, which were differentiated from other customers by their service requirements, the most important being: daily deliveries direct to store; all products clearly date coded, fully traceable and conforming to agreed quality standards; and compliance with technical audits of all factories.

7.13. The parties agreed that the requirement for daily delivery direct to individual stores differentiated fresh milk to some extent from the vast majority of other products (including dairy products) which were delivered to national multiples' RDCs, with the national multiples being responsible for onward delivery to their individual stores. However, they pointed out that two of the eight national multiples (Waitrose and Marks & Spencer) required milk to be delivered to their RDCs and not to individual stores. Furthermore, the requirement of daily deliveries to individual stores was not a particular distinguishing factor of the national multiples as many middle ground customers also required daily deliveries direct to their outlets.

7.14. More importantly, the parties considered that the distinction between the quality requirements and procurement practices of middle ground and national multiple customers was blurred and there were a number of important competitive interactions between these sectors.

7.15. As recognized by the CC in its report on supply of milk in Scotland,¹ the purchasing patterns of many larger middle ground retailers were becoming more like those of the larger supermarkets. The parties said that, in particular, the larger middle ground customers were sophisticated purchasers that procured on a national basis. This enabled them to ensure that they were not paying too high a price for their milk in any particular location, since they could compare local prices with those offered elsewhere. They required milk processors to meet exacting quality standards and were also able to exercise significant buyer power. Such customers included many smaller supermarket/grocery chains (for example, [Details omitted. See note on page iv.]), major caterers (for example, [Details omitted. See note on page iv.]), the various petrol forecourt retailers (for example, [redacted]) and buyer/symbol groups and wholesalers (for example, [Details omitted. See note on page iv.]).

7.16. The parties told us that approximately [redacted] per cent of Express's middle ground sales in 2002, and approximately [redacted] per cent of Arla's middle ground sales in the same year, were to customers that procured on a multi-regional basis.

7.17. The parties submitted that the smaller dairies that were meeting the demands of sophisticated middle ground purchasers were also increasingly able to meet the requirements of the national multiples. They told us that a number of smaller dairies had started to supply some of the national multiples and several were established suppliers to large middle ground customers such as Aldi, Booths and Lidl. The parties recognized that each dairy would have its own selling proposition and that some might focus on the local nature of their milk. Nevertheless, the key point was that the development of these alternative

¹See footnote to paragraph 2.23.

sources of supply could have a severe effect on the merged entity's sales of standard own-label milk in the hypothetical event that it failed to meet the demands of the national multiples.

7.18. The parties maintained that, against the background described above, it was inappropriate to regard the proposed merger as reducing the number of actual and potential suppliers to national multiples from four to three, as a range of other actual and potential suppliers would remain.

7.19. The parties did not accept the OFT's view that the market was stable and mature. They drew attention to the reduction in doorstep sales over the past ten years and the corresponding increase in sales of fresh milk by the national multiples, from just 32 per cent of sales to households to approximately 65 per cent now. The figure was likely to increase further with the growing diversification of the national multiples into the middle ground, for example by opening or acquiring high-street and convenience stores. The parties said that the larger national multiples paid the same wholesale price to milk processors for milk for all of their stores, regardless of size, which further extended their competitive influence in the middle ground. A number of the national multiples had diversified into home delivery services, which offered deliveries of a wide range of products, including milk.

7.20. The parties commented that the substantial buyer power enjoyed by the national multiples had allowed them to dictate the structure of the market for supply of fresh processed milk. Their power had allowed them to rationalize suppliers and encourage the expansion of others, where they so wished. At the time our inquiry started, the CC was investigating the proposed acquisitions by Asda, Morrisons, Sainsbury's and Tesco of Safeway. The parties noted that if any one of these acquisitions went ahead, then buyer power would increase yet further.

The geographic market

7.21. In the parties' view the geographic market for the supply of fresh liquid milk to the national multiples was the UK as a whole or, if not, then Great Britain, and that competition between the parties should be assessed at that level. They said that market shares for Great Britain were virtually the same as those for the UK, since only a small proportion of the national multiples' fresh processed milk sales occurred in Northern Ireland.

7.22. The OFT, in its advice to the Secretary of State, observed that in certain regions, the number of effective bidders for supermarket contracts might be reduced by the merger from three to two given the location of dairies and their individual capacity constraints. The parties submitted regional market share data indicating that there might be concerns about a reduction in the number of leading milk processors from three to two in the South-East (the London, Anglia and Southern ACNielsen regions) where Wiseman's current share of supply was less than 5 per cent and in the North of England (the Yorkshire and Tyne Tees ACNielsen regions) where Dairy Crest had a relatively limited presence (again below 5 per cent share of supply).

7.23. The parties noted the OFT's concern that the relevant geographic market for the supply of fresh processed milk to national multiples could be regional, ie a hypothetical monopolist in a particular region could increase prices profitably by 5 to 10 per cent. They also noted that the issue of possible regional dominance had been considered in detail in two previous investigations. They commented that the MMC inquiry in 1996 into the proposed merger of Wiseman and Scottish Pride had concluded that, even though the merger would give Wiseman a share of 88 per cent in the supply of fresh processed milk to national multiples in Scotland, Wiseman would be unable to raise its prices unjustifiably to the national multiples. That was because of the national multiples' buyer power, their central purchasing arrangements that enabled them readily to compare prices between different parts of the country and Wiseman's desire to make sales in England and Wales, which made it important for it to maintain the goodwill of the national multiples as major buyers of milk in other regions. The parties noted that a similar conclusion had been reached in the later CC report into the supply of milk in Scotland.¹

7.24. The parties said that the key question was whether a high regional market share conferred market power on a milk processor over national multiples. They told us that Express, via Claymore, held a single national multiple account in Scotland, with Sainsbury's, and Wiseman's market share in supplying national multiples in Scotland was approximately 94.4 per cent as at February 2003.

¹See footnote to paragraph 2.23.

Notwithstanding that fact, the parties believed that Wiseman had not been able to charge excessive prices to the national multiples in Scotland. In support of this, the parties drew our attention to evidence that there had been for many years a high correlation between national multiples' retail prices in Scotland and those in the various regions of England and Wales, and submitted recent retail pricing data in support. They said that retail prices could be expected to track wholesale prices, and these close correlations strongly suggested that Scottish wholesale prices to national multiples exhibited the same trends as regional wholesale prices in England and Wales. This would not be the case if the conditions of competition differed between regions.

7.25. The national multiples purchased their milk centrally (often on the basis of Great Britain or the UK as a whole) and generally expected to pay the same wholesale price in all regions. The parties were unaware of any regional wholesale pricing to national multiples anywhere in Great Britain. The parties considered that any attempt to bargain a higher price in one region than that which prevailed nationally would be successfully resisted by the national multiples, not least because they would punish the supplier in question by switching volumes to rivals in other regions. They also thought it implausible that, as a result of a regional duopoly, higher prices could be achieved nationally.

7.26. With regard to the OFT's concerns about lessening of competition in specific English regions, the parties noted, first, that Wiseman was already supplying middle-ground customers in the ACNielsen London, Southern and Anglia regions. Since the transport costs of serving such customers, which would require smaller drops, were likely to be higher than the costs of delivering larger volumes to national multiples, the parties considered that Wiseman would be able to compete effectively for the business of the national multiples across London and south-east England. They said that Wiseman's Droitwich dairy was only ¼ hours and 177 km (110 miles) from Express's dairy at Ruislip in west London, which supplied national multiples in the London and Southern ACNielsen regions. Moreover, Wiseman's 2002 annual report made clear its intention to be active in south-east England and London specifically. The fact that Wiseman had not, at the date of the parties' submission to us, won any national multiples' business in London or the South-East did not mean that it would not be an effective bidder, particularly given the considerable distances it already transported fresh processed milk to national multiples.

7.27. Second, the parties said that it would be incorrect to infer from the OFT's advice that Dairy Crest served only the South of England. In fact it covered all of the Midlands and all of Wales, as well as London and the South-East. It already delivered to Chester from its Severnside plant and the journey time to Manchester was comparable. In addition, the parties told us that Dairy Crest was supplying 13 per cent of Tesco's requirements in the ACNielsen Lancashire region.

7.28. Third, whilst the parties' sales in the ACNielsen Wales, West and Westward region were currently modest, no inference should be drawn from this, because in 2000/01 Arla's market share of national multiple sales (excluding Waitrose and Marks & Spencer) had been [X] per cent in the Wales, West and Westward region, but had collapsed to [X] per cent as a result of the entry of Wiseman.

7.29. Fourth, even without milk processors acquiring any local milk depots, the national multiples could use their own RDCs to sponsor milk processors' geographic expansion. The fact that six of the national multiples had chosen not to use their RDCs did not mean that they could not do so for all or part of their requirements in response to a threatened price increase, so as to expand even further the number of stores which could be served by dairies without any investment on the part of the supplier. (Use of an RDC would permit bulk deliveries by suppliers to one drop location, in an analogous way to a supplier opening its own milk depot.) In addition, the parties observed that Dairy Crest supplied Marks & Spencer's RDCs in Barnsley (Yorkshire) and Crewe (Cheshire).

7.30. The parties told us that fresh milk was already transported considerable distances, without the use of local milk depots, to supply national multiples. In support of this, they submitted maps that identified stores supplied by the different milk processors, including themselves. These revealed that, in particular, Wiseman supplied a wide range of national multiple outlets throughout Wales, the South-West and the North-East, many of which were a considerable distance from the dairy. For example, it supplied milk to the Newcastle-upon-Tyne stores of Safeway, Sainsbury's and Tesco, but its nearest dairy was some 240 km (150 miles)—or about 3½ hours—away at Trafford Park (Manchester) and for a number of years these deliveries had been made without using a local milk depot. Furthermore, Express supplied all of the North-East, including Newcastle-upon-Tyne, from Manchester without using a satellite milk depot. The parties also pointed out that, following the establishment of a milk depot in Manchester in 1991, Wiseman transported milk for a period of four years some 320 km (200 miles) from its Bellshill dairy in Glasgow.

7.31. The OFT's advice suggested that it was unclear whether Wiseman and Dairy Crest would be able to use any spare capacity they might have to supply regions where the merger would result in a fall in the number of suppliers. The parties said that they were puzzled by this point because the merged entity would face substantial competition in both the North and the South-East of England. In the North, Wiseman's Trafford Park dairy (with a capacity of 400 mlpa) had substantial spare capacity. In addition, its 500 mlpa dairy at Droitwich could supply into northern England and displace sales made to areas to the south of Manchester by the Trafford Park dairy. Wiseman also had a milk depot at Carlisle and planned to open one in Durham later in 2003, and its Scottish dairies were able to supply into northern England. Wiseman could also use its capacity at Droitwich to supply into the South, including the London area, and replace volume sold in the North from its dairy in Trafford Park. The largest dairy supplying into London would be Dairy Crest's 'super-dairy' at Chadwell Heath with current capacity of 400 mlpa and the stated ability to increase capacity to 600 mlpa.

7.32. The parties told us that Dairy Crest and Wiseman had considerable scope to increase their geographic coverage into the North and London and the South-East (in addition to that which could be achieved by direct deliveries from dairies or milk depots) by delivering milk to a central location in a region and then having different local drivers make deliveries in that region. (The increasing shelf life of milk had also made it easier for milk to be transported over longer distances.)

7.33. The parties said that the investment costs of expansion would vary according to the approach taken. On the one hand, no investment in a milk depot might be necessary. For example, Express delivered milk from Ashby de la Zouch to national multiples in Norwich, a distance of some 215 km (134 miles) and journey time of nearly 5 hours by using delivery vehicles that were 'order picked' at the dairy to contain the milk for delivery to specific stores. These vehicles were parked but not unloaded (Express did not have a milk depot in Norwich) and different local drivers were responsible for deliveries to individual stores. This approach required no more than a yard where vehicles could be parked. On the other hand, Wiseman had stated in its 2002 annual report that it had purpose-built a new milk depot on a greenfield site at Avonmouth, at a cost of £5.6 million. The parties said that Wiseman would have built this milk depot with a view to supplying considerable volumes to both the middle ground and the national multiples. All suppliers, however, had the option of building or of leasing on an appropriate and more modest scale.

7.34. The parties commented that Wiseman's development into England and Wales had been accomplished largely on the basis of organic growth and geographic leapfrogging using milk depots, and not, with a few small exceptions, through acquisition. Through a combination of deliveries from dairies and milk depots, Wiseman now supplied over a very considerable area from its dairies. For example: using a milk depot at Taunton, it supplied Somerfield stores in Helston, Cornwall, 393 km (244 miles) and more than 6 hours away from its nearest dairy at Droitwich, and Somerfield stores in Fishguard, South Wales, 310 km (193 miles) and nearly 5 hours away from Droitwich. The parties said that Wiseman currently supplied 20 per cent of national multiple business in Wales and the West of England. They considered that it would similarly be able to expand its milk depot network into the London and Anglia regions (both of which were closer than Cornwall to its Droitwich dairy). The parties said that the threat was highly credible given that Wiseman had spare capacity at Droitwich, already supplied middle ground outlets in London and the South-East (which would be more costly to serve than national multiples) and had publicly stated its aspirations to expand.

7.35. The parties commented that it would be easy for Dairy Crest to extend its reach and sales further in the North of England by opening a milk depot to supply national multiples. The parties also produced data on distribution costs and production cost savings resulting from incremental business, which indicated that the additional distribution costs incurred in serving business in a new region were substantially offset by the production cost benefits of the incremental volumes.

7.36. The parties said that the region-by-region expansion outlined above, which they noted seemed to have been accepted by the OFT as consistent with the growth strategies of all the major dairies, would provide the national multiples with at least three large suppliers across Great Britain. The transaction should not therefore be regarded as reducing the number of competitors in the supply of fresh processed milk to national multiples from three to two in any region.

Competitiveness and contestability of supply of fresh processed milk to national multiples

7.37. The parties submitted market share data for themselves and estimated data for Wiseman and Dairy Crest for each of the last three full financial years and as at April 2003 in relation to the supply of fresh processed milk to national multiples. These figures indicated that Arla and Express had each lost share in recent years, such that their combined share had fallen from 53 per cent in 1999/2000 to 45 per cent as of April 2003. The OFT's assessment that the parties' combined market share amounted to 48 per cent was based on snapshot estimates as at February 2003: the parties said that their shares had fallen by some three percentage points since then, with both Wiseman and Dairy Crest having won share from them. This represented a fall of [§] mlp_a in the parties' sales to national multiples. The parties considered that the April 2003 annualized market share estimates were a more appropriate measure of their competitive position than the 2001/02 annual shares because they took account of recent tender processes and the permanent strengthening of Dairy Crest's and Wiseman's positions by their investments in new, efficient low-cost dairies. Dairy Crest had created two of the largest UK super-dairies and Wiseman had two large dairies with capacity of 400 mlp_a and 500 mlp_a. The parties commented that these investments would be valueless unless the capacity was used intensively, and Dairy Crest and Wiseman would be open to severe criticism from shareholders if high levels of use were not achieved.

7.38. In contrast with Dairy Crest and Wiseman, the merged entity would rely largely on smaller, older dairies (most of which were, or had been, glass bottling dairies). Its new dairy at Stourton would have a capacity of only [§] mlp_a (although this could be increased).

7.39. The parties said it was clear from Dairy Crest's and Wiseman's public statements that both companies had aspirations to increase their share of supply to national multiples. The parties said that there would continue to be excess capacity in the industry even after the proposed post-merger rationalization. [

Details omitted. See note on page iv.

The parties would seek to win business back. The parties commented that Dairy Crest, Wiseman and the merged entity would have wholly incompatible market share aspirations and that all three could not achieve sustained organic growth. This was one of the key features of the market that could be expected to drive competition.]

Buyer power

7.40. The parties reminded us of the CC's conclusion, in 2000, that the supermarket groups were powerful and sophisticated purchasers that both possessed and exercised buyer power.¹ The parties said that the national multiples appeared to have a general policy of reducing their supplier bases and, as observed by the CC in 2000, own-label suppliers were generally in a position of complete dependency and in many respects were akin to toll manufacturers.

7.41. The parties said that the national multiples' buyer power was exercised through their tendering processes and award of contracts, which enabled them to dictate the milk procurement process and thereby the success or failure of the milk processors. Because almost all fresh milk sold by the national multiples bore their own labels, there was no obstacle to switching between suppliers. The national multiples could switch without customers being aware of the change, since fresh milk was supplied to a standard, statutory specification and looked and tasted the same whoever processed it. The parties said there could be no doubt that supermarkets had the power to drive competition by awarding or threatening to award substantial new business to rivals in a situation where all the milk processors had the capacity and commercial interest to win such business.

7.42. The CC's report on supermarkets² had resulted in the imposition of a code of practice in relation to certain aspects of the exercise of buyer power by supermarkets which were viewed as being

¹*Supermarkets: a report on the supply of groceries from multiple stores in the United Kingdom*, The Stationery Office, Cm 4842, October 2000.

²Op cit.

contrary to the public interest. In response to a question from the CC in the recently completed Safeway inquiry, [*Details omitted. See note on page iv.*].

7.43. Express told the OFT in February 2003 that it believed the Code of Practice was wholly ineffective. Express had experienced further examples of buyer power exercised by Safeway and considered that there had been no change in Safeway's practices since publication of the CC's report.

7.44. The parties noted the CC's comment, in the context of the Safeway inquiry, that evidence received suggested that, for the vast majority of suppliers, the Code of Practice had made no difference to their negotiating position with the large supermarkets.¹ For those who thought that it had made a difference, more thought that it had made the position worse than thought it had made it better. The CC added that if buyer power were to increase as the result of any of the mergers it was investigating in the Safeway inquiry, then the situation might worsen. The parties commented to us that an acquisition of Safeway by any of the national multiples would indeed bring about an increase in buyer power.

7.45. The parties drew attention to the conclusion of the KPMG report² that the national multiples enjoyed substantial and increasing buyer power, which had been reinforced by the net increase in liquid milk capacity as milk processors had competed for this growing distribution channel (ie the addition of new low-cost capacity had incentivized suppliers to compete vigorously for new incremental volumes). In the parties' view, buyer power had increased with the growth in the national multiples' market share as doorstep sales declined, and had been strengthened by the importance of the national multiples' own-label milk. An indication of this was the difference reported by KPMG between the supermarket retail price and the milk processor wholesale price, which had grown from index 152 in 1998 to index 187 in 2001. The KPMG report cited estimates that between £60 million to £100 million had been lost from milk processors' margins to multiple supermarkets in 2001. The report also noted the current excess capacity in the liquid milk processing sector and the significant efficiency opportunities that were available, and commented that further rationalization of processing plants and freeing up of economies would probably be facilitated by a reduction in the number of players. The parties concluded that the KPMG report supported their view that the merged entity would be unable to exercise market power vis-à-vis the national multiples.

7.46. The parties said that the national multiples would be able to punish any failure to meet their demands as regards fresh processed milk by refusing to stock suppliers' broader ranges of dairy products. This would be a major issue for the merged entity given Arla's aspirations to use the merger to facilitate and promote the sales of its broader product range.

7.47. Express said that the recent dispute between itself and Safeway provided an illustration of national multiples' ability to exercise discipline of suppliers across product ranges. Express had been reluctant to enforce its contractual rights when Safeway reduced the volume of fresh processed milk it purchased, for fear that Safeway would respond by also reducing its purchases of cream. When Safeway terminated the milk contract entirely, Express initiated legal proceedings for breach of contract. Express told us that, subsequently, its contract for the supply of cream to Safeway expired. Express further stated that Safeway's cream business was put out to tender, but Safeway did not allow Express to bid. Express said that although this example related to two own-label products, national multiples could also 'punish' a branded product (for example, cheese) by reducing the same supplier's margin on an own-label product (for example, milk). In such a case, even ownership of a strong brand might not give a supplier immunity from the demands of a national multiple.

7.48. The parties said that examination of how the national multiples negotiated would reveal the extent of their buyer power. They told us that suppliers were played off against each other, and that the national multiples were fully aware that sales to them usually formed such a significant part of a milk processor's output that loss of such sales would have serious consequences for the business as a whole. The parties provided details of switching by the national multiples, revealing that a number of large contracts had changed hands in the previous three years. Arla and Express had both lost significant business, much of which had gone to Wiseman and Dairy Crest.

¹Safeway Plc inquiry: Remedies Statement, published 24 June 2003.

²See footnote to paragraph 3.16.

7.49. The parties commented on the sophistication and continuing ability of the national multiples to exploit their power in the procurement of fresh processed milk. Express provided details of its recent experiences with Sainsbury's and Safeway. It said that both had regularly exercised buyer power:

(a) [

Details omitted. See note on page iv.

]

(b) Safeway had continually demanded better prices for reduced volumes. It had ultimately removed its entire volume from Express, which led to further costs in redundancies and the closure of dairies.

7.50. Arla provided an account of its recent experiences with [

Details omitted. See note on page iv.

].

7.51. In the parties' view, the national multiples would still be able to exploit their buyer power and drive down prices following the proposed merger; moreover, they had significant unexploited buyer power, and in particular:

(a) Since national multiples controlled the design of the procurement process they could increase the volumes they put out to tender by, for example, reducing the number of their main suppliers. (The parties pointed out that three of the national multiples—[]—already had sole supply arrangements in England. Exclusive supply arrangements were offered by [] in 2001 and [] had won this business from [].)

(b) Conversely, a national multiple could exercise buyer power by increasing the number of its suppliers, which would lead to incumbent suppliers losing share, or reallocating business between suppliers or to a smaller milk processor for part of its requirements.

(c) There would be nothing to prevent supermarkets auctioning contracts at yearly or even longer intervals. This would lead to lower prices because the greater value of such contracts to suppliers would intensify price competition. (The parties told us that [] had in the past put out to auction its requirements for UHT milk.)

(d) The national multiples could also demand that prices were determined on the basis of 'open book' accounting (ie costs plus a specified margin), as was already required by [].

7.52. In the parties' view, the current structure of supply had been determined by the national multiples, which, on the one hand, had encouraged and sponsored a new entrant to England (Wiseman) and, on the other, had rationalized their own supply bases. This rationalization had made suppliers progressively more dependent on sales to a few large customers. In 2001/02, some [] per cent of Arla's sales to national multiples were to [] customers (namely []) and [] per cent of such sales were to []. Similarly, in 2001/02 (even before the loss of the Safeway account), over [] per cent of Express's sales to national multiples were to [] (namely []) and [] per cent of such sales were to []. The parties said that this pattern of sales had further increased the bargaining power of the national multiples, because milk processors were naturally averse to taking any action that might put at risk their sales to one of their few national multiple customers, particularly as once any customer relationship was damaged it was very difficult to win back sales.

7.53. The parties said that the national multiples had considerable incentives to exercise their buyer power since milk was a known value item and one of their top-selling grocery products. The overall retail price competitiveness of such items influenced consumers' choice of supermarket for their main weekly shop and their choice of distribution channel (doorstep deliveries, large stores or small stores) for top-up shopping. The parties noted that some supermarkets had argued to the OFT that fresh processed milk was a 'must stock' item and that limiting the number of potential suppliers would weaken their negotiating position. In the parties' view, this line of argument was irrelevant in the context of an almost entirely retailer own-label product, where consumers could not even detect a change in supplier and there

was therefore little or no risk of losing customers as a result of switching from one supplier to another. The fact that own-label milk was a ‘must stock’ item was little more than a claim that there was a relevant market for milk. It did not, however, give any individual supplier any form of market power.

7.54. The parties said that, if the merger took place, the national multiples would continue to be able to exercise buyer power in a variety of ways:

- (a) by switching, or threatening to switch, volumes nationally or regionally between any of three largest milk processors, all of which would have considerable spare capacity. Even a relatively small change at the margin in the number of stores supplied could have a substantial impact on profitability;
- (b) by switching some of their requirements to a smaller regional milk processor (which might use its local milk as a marketing advantage). The parties said that in many regions some of the national multiples already bought fresh processed milk from more than one supplier. For example, in the Lancashire ACNielsen region, Dairy Crest supplied 13 per cent of Tesco’s requirements (with Wiseman supplying the remainder), Somerfield had three suppliers (Arla, Express and Wiseman), Asda had two (Arla and Wiseman) and Sainsbury’s had two (Express and Wiseman);
- (c) by encouraging the further geographic expansion of suppliers into the North and London and the South-East;
- (d) by making purchasing decisions as regards other dairy products according to the competitiveness of the terms of supply of fresh milk; and
- (e) by encouraging entry and expansion from middle ground dairies and new entrants (particularly farmer cooperatives).

Barriers to entry and expansion

7.55. The parties said that barriers to entry and expansion were low. As related in paragraph 7.32, there was considerable scope for further expansion by Dairy Crest and Wiseman.

7.56. With regard to entry or expansion by middle ground dairies, the parties had noted the views reflected in the OFT’s advice that the larger middle ground dairies would be able to supply supermarkets if they improved their quality standards, but that any single contract with a national multiple would take up a substantial proportion of capacity (around 70 to 100 mlpa), which would put such dairies at financial risk if the contract were lost.

7.57. In response, the parties said, first, that it was far from impossible for a middle ground dairy to achieve the quality standards set by the national multiples. A number of such dairies had already supplied national multiples or other supermarket groups. In addition, ACC was already capable of producing milk efficiently and meeting the national multiples’ requirements on quality, packaging etc. Second, as regards the risks of middle ground suppliers becoming dependent on contracts with national multiples or other supermarkets, we should note that:

- (a) The volumes of milk put out to tender by the national multiples were at their discretion, as was whom they invited to submit tenders and the duration of any supply arrangements. There was nothing to prevent them from awarding smaller-volume contracts to middle ground suppliers on, for example, a regional or multi-regional basis.
- (b) Over the previous three years the volumes of fresh processed milk won/lost by Express from national multiples had typically been within the range [X] to [X] mlpa, with only [X] wins/losses being for over [X] mlpa ([*Details omitted. See note on page iv.*]). Over the same period Arla’s gains/losses had typically been within the range [X] to [X] mlpa.
- (c) It was possible for national multiples to insulate smaller suppliers from risk and sponsor new entry and expansion by agreeing to buy substantial volumes from a new entrant for a period of time in order to enable the entrant to recover its investment costs.

- (d) Expansion by a middle ground dairy with an existing regional/multi-regional middle ground customer base would be less risky than Wiseman's geographic expansion with wholly new capacity.

7.58. The parties believed that farmers were likely new entrants into fresh milk processing. The scope for vertical integration had come about only recently following the break-up of Milk Marque into three cooperatives (now Dairy Farmers of Britain Limited, First Milk and Milk Link). The parties said that these cooperatives were envisaging a combination of guarantees and levies, related to raw milk production volumes, that indicated a potential for raising capital of perhaps £300 million in total, subject to the individual business cases. The parties believed that the cooperatives' entry into fresh processed milk supply would have marketing advantages as far as the national multiples were concerned. The cooperatives would also benefit from ready access to raw milk. In addition, vertical integration strengthened their competitive position as suppliers of raw milk by providing an alternative outlet to selling to independent milk processors. It might also give a cooperative a real or perceived realization benefit for the raw milk used as against long-life products. In the parties' view, these factors would give the cooperatives a competitive advantage over independent milk processors.

7.59. The OFT's advice had suggested that new entry from scratch was not particularly likely, and was likely to take a long time and be subject to large risks. The parties reiterated that market structure was in the national multiples' hands. They had ample scope to sponsor new entry through the award of substantial volumes or fixed-term contracts. The parties said that Wiseman's successful large-scale entry into England and Wales and its progressive expansion clearly illustrated that new entry was viable if national multiples decided that they would like another supplier. The parties commented that modern dairies would typically be constructed on a modular basis so that capacity could be progressively increased (as, for example, in the case of Wiseman's Droitwich dairy). This modular approach reduced risk and allowed sales to be developed progressively.

7.60. The parties said that the minimum viable scale of new entry and investment costs would depend on a number of factors:

- (a) New plants with an optional layout and locations were generally believed to enjoy a significant cost advantage over older plants.
- (b) Economies of scale in production were offset to some degree by rising transport costs, as the greater volume of milk that was produced the further afield sales would be made (as was apparent from Wiseman's Droitwich dairy supplying national multiples' stores in Cornwall). Smaller dairies would thus have lower transport costs.
- (c) Faced with even a small price increase (for example, 1 to 2 ppl), the national multiples had the ability to respond by switching purchases to a smaller dairy, which could become viable at such prices. In addition, the national multiples could facilitate new entry at a location that would benefit themselves by affording them the maximum financial leverage over the existing suppliers. It would be worth their while to pay a small premium for some of their milk in order to ensure highly competitive prices for the remainder. The parties said that the national multiples had a strategic interest in ensuring that terms of supply were not dictated to them, particularly in relation to a known value item such as fresh processed milk.

7.61. In conclusion, the parties said that entry and expansion would pose a major competitive threat if an unjustified increase in market price would trigger timely and sufficient entry. This could be achieved by one sizeable entrant or a number of smaller ones, such as existing middle ground dairies or farmer cooperatives that could fund new entry.

Competitive effects of the merger

Single firm dominance (non-coordinated effects)

7.62. The parties pointed out that the OFT had not suggested that it would be profitable for the merged entity unilaterally to increase its prices to the national multiples. The parties considered that the risk of single firm dominance should be analysed against the following background:

- (a) past findings of the CC and current evidence indicated that regional concentration did not enable a firm to set high prices to national multiples;
- (b) the pre-merger situation was self-evidently highly competitive;
- (c) post-merger, there would be three major milk processors competing on a national basis to supply an own-label homogeneous product, with actual and potential competition from smaller milk processors, and where retailers could switch supplier without customers noticing;
- (d) the merged entity would face two low-cost rivals, each of which had spare capacity following recent expansions;
- (e) smaller rivals were able to supply, and did supply, national multiples for at least some of their business;
- (f) the merged entity would face strong buyer power from national multiples (as acknowledged in previous CC reports and the recent KPMG report);
- (g) national multiples' existing buyer power had not as yet been fully exploited; and
- (h) the national multiples could sponsor entry by farmers' cooperatives, or expansion by rivals at any point.

7.63. The parties did not consider the merged entity's market share in individual regions to be of any relevance, because:

- (a) There was no evidence that even a virtual monopoly supplier in Scotland could raise prices unjustifiably to the national multiples (see paragraph 7.24).
- (b) In no region of Great Britain would the parties have a comparable monopoly position to that of Wiseman in Scotland as regards the supply of fresh processed milk to national multiples.
- (c) Prices to national multiples were bargained on a national basis and did not vary between the different regions. Any attempt by a milk processor to bargain a higher price in one region would be successfully resisted (see paragraph 7.25).
- (d) After the merger there would be three competitors capable of supplying national multiples from their existing facilities, even without any investment in milk depots.
- (e) Dairy Crest and Wiseman were able readily to expand their facilities in the North and London and the South-East respectively, to increase their sales to national multiples (see paragraph 7.31).

7.64. The parties said that in general with a homogeneous product, and spare capacity, the unilateral effects on price of a merger would be slight or non-existent even if there were only a relatively small number of major players in the market, since customers could readily respond to a price increase by switching their purchases to rivals. In the present case, there could be no doubt that Dairy Crest and Wiseman were highly effective competitors.

7.65. The parties said that, post-merger, there would continue to be material excess capacity, even after the proposed rationalization by the merged entity. As indicated in paragraph 7.39, the level of spare capacity was such that the merged entity's share of supply could fall substantially if Dairy Crest were to increase capacity at Chadwell Heath by 200 mlpa. More generally, the merged entity's new Stourton dairy would create a greater competitive constraint than the old and inefficient capacity which would be closed. The new dairy was being constructed on a modular basis with relatively low expansion costs.

7.66. The parties told us that if the merged entity were to increase its prices unilaterally to the national multiples, its sales would collapse because Dairy Crest and Wiseman (and potentially other suppliers) would use this as a valuable opportunity for expansion. As noted in paragraph 7.52, the parties thought it likely that the merged entity would find it difficult to win back sales lost in such circumstances. A hypothetical strategy of unjustified price increases would, therefore, entirely negate the rationale and cost savings benefits of the merger.

7.67. In the parties' view, any suggestion that the major milk processors would not compete vigorously after the merger ignored the fact that the parties' modest margins were sensitive to their ability to retain and win business. [

Details omitted. See note on page iv.

] It could be inferred from this that the parties and their rivals had strong incentives to retain and win customers, given the major consequence of volume changes.

7.68. The parties said that substantial unilateral effects were most likely when, for a large number of customers, the merging parties' products were closer substitutes for each other than the products/brands of other suppliers. In this case, however, there was little or no product differentiation (virtually all fresh processed milk was sold under national multiples' own labels) and any of the major milk processors could compete for the business of the national multiples.

7.69. The parties noted the OFT's view that Arla and Express could be regarded as each other's closest competitor because their distribution networks were closely aligned. The parties thought that the observation rather missed the point as to who their closest competitors were in the various localities and in Great Britain as a whole. Across Great Britain, both parties had been losing market share to Wiseman and Dairy Crest. Moreover, the parties had only two customers in common out of the eight national multiples: [] (which also bought from []) and [] (which also bought from both []). In addition, over the previous three years, Arla had only once won or lost any business from any national multiple customer served by Express (as opposed a number of instances of switching as between the parties and Dairy Crest and Wiseman). This point had been acknowledged by the OFT. This was not to say that Express and Arla did not compete, but they were clearly not each other's closest competitor.

7.70. The parties added that the current pattern of supply reflected the milk processors that were invited to the bid lists by the national multiples, which would generally invite a sufficient number to ensure that there was adequate competition for their accounts. In some cases Arla and Express had not been invited on to the bid list. Arla had not been invited by [] or [] to bid in the last couple of years, or by [] in 2002, had not been treated as a serious bidder by [] in 2002 and, more recently, had not been asked to bid when [] was choosing a supplier. Express had not been asked to bid by [] in [], when business was awarded to [], nor had it been asked to defend some of its [] volumes in [].

7.71. The parties said that there would be no reduction in bidding competition for accounts where either Express or Arla was not on the bid list. However, even where both parties made bids, any loss of competition following the merger could be mitigated by the national multiples' inviting a new milk processor on to their lists. The parties commented that in bidding markets, the identity of closest competitors was not exogenous as in consumer goods mergers (where the merger did not in general affect consumer preferences), but endogenous, and in the discretion of the buyer. Accordingly, to the extent that Arla and Express were in any instance close pre-merger competitors, the buyers would be able to structure a change in the bidding arrangements.

7.72. The parties acknowledged that an acquisition might create particular concern if the firm being acquired was a new entrant to the market or had recently shown strong growth or expansion, as such maverick firms normally posed a considerable competitive constraint on the market. However, in the current case Express's share of supply to the national multiples had been declining in recent years (31 per cent in 1999/2000, 30 per cent in 2000/01 and 2001/02 and 22 per cent as at April 2003). The parties said that Arla's market shares over the same period had been 22 per cent in 1999/2000 and 2000/01, 20 per cent in 2002/03, and 24 per cent as at April 2003. The parties commented that Wiseman had grown substantially in recent years and that both Dairy Crest and Wiseman were seeking to grow their market shares further.

7.73. The parties said that the major suppliers of milk to the national multiples faced an already concentrated customer base that might become more concentrated in future (reflecting the ongoing decline of the doorstep sector and the national multiples' diversification into the middle ground and home delivery services). As recorded in paragraphs 7.40 to 7.54, the parties' view was that the national multiples possessed overwhelming buyer power as a consequence of the scale of their purchases, the fact that fresh milk was a homogeneous product and their ability to discipline suppliers in various ways.

7.74. The parties concluded that there was no economic evidence that the merged entity would be able to raise prices unilaterally.

Coordinated effects

7.75. The parties noted the OFT's suggestion, in its advice to the Secretary of State, that the merger, by reducing the number of competitors, could increase the likelihood or stability of any tacit collusion. The possibility of tacit collusion had earlier been raised by the OFT in its Article 9 request, and the European Commission in its Article 9 decision.

7.76. The parties commented that for tacit collusion or coordination to be an issue it was necessary to assess not just the degree of market concentration (since concentrated markets could be highly competitive) but also a variety of factors which would affect the ability of the firms in question first to perceive that tacit coordination were possible and then reach and credibly sustain a tacit coordination which would permit prices to be raised unjustifiably. The OFT's concern was based on its view that the market had a number of the characteristics that would enable coordination to occur, such as homogeneity, stability, maturity and also, possibly, similarity of cost structures. However, the OFT had acknowledged obstacles to coordination such as the position of Wiseman as an aggressive competitor in England and Wales and the buyer power of the national multiples.

7.77. The parties said that neither the OFT or the European Commission had suggested coordination was currently taking place in the supply of milk to national multiples. They had, however, suggested that customers, or parts of customer requirements, were shared between suppliers and the suppliers refrained from soliciting business from each other's customers.

7.78. The parties commented that in order for coordinated behaviour to arise after the merger, each of six necessary conditions would have to be satisfied:

- (a) *Coordination*. The firms concerned would have to be able to coordinate on prices or customer allocations.
- (b) *Transition*. They would have to be able to elevate prices from the pre-merger level to the post-merger coordinated level, or establish the customer allocations.
- (c) *Detection*. It would have to be possible for firms to detect cheating.
- (d) *Credible punishment mechanism*. There would have to be a credible mechanism through which deviating firms could be punished, in particular so that the short-run increase in profits obtained through cheating on the agreement would be outweighed by the losses imposed by punishment (ie the discounted value of the future profits which would be foregone once cheating was detected and punished by rivals).
- (e) *Stability against competitor disruption*. Coordination would have to be sustainable in the face of competition from any current non-coordinating competitors and also from actual or potential entrants.
- (f) *Stability against buyer disruption*. Coordination would have to be sustainable in the face of any disruption from customers of the coordinating firms.

7.79. With regard to *coordination*, the parties noted the OFT's suggestion that the remaining milk processors would have similar cost structures and that this would facilitate coordination of prices. The parties said that UK milk processing facilities currently consisted of a mixture of low-cost 'super-dairies' operating alongside higher-cost older plants. Under the post-merger rationalization plans production of Arla and Express would be concentrated at lower-cost plants in order to fund investment and thereby catch up with Wiseman and Dairy Crest. By so doing, the merged entity would pose a greater competitive threat to its rivals. In the parties' view, it was almost perverse to suggest that a cost-reducing merger would lead to higher prices by virtue of the fact that costs (particularly where the parties had suffered declining market share for a number of years), though lower, were more symmetric. They suggested that, by contrast, since the costs of the marginal firm tended to drive a market, the proposed merger would if anything sharpen competition.

7.80. With regard to *transition*, the parties said that milk processors' prices were negotiated with national multiples rather than simply being posted. Therefore any price rise must be bargained with those customers rather than simply being announced. Accordingly, the implicit assumption made by economic

models, that the parties could simply raise prices, was not valid. If one milk processor attempted to bargain a significant price rise with a national multiple that was not justified by any cost increase, that customer would react by refusing to agree the price rise and inviting other suppliers to bid for the business. The hypothesis of customer allocation was that other milk processors would refrain from bidding for this business even though it would be profitable to do so. However, both Dairy Crest and Wiseman would have considerable spare capacity after the merger and the commercial incentive to supply a national multiple which was faced with a demand for higher prices by the merged entity.

7.81. The parties said that virtually all their sales to the national multiples were concentrated in the hands of [X] customers (as at April 2003): [

Details omitted. See note on page iv.

]. As noted in paragraph 7.41, with an own-label product there was no barrier to switching between suppliers by the national multiples.

7.82. Furthermore, the parties commented that in standard price-setting markets, firms could raise prices incrementally, and observe whether competitors followed suit, but that was more difficult where prices were bargained: even relatively small price rises would have to be negotiated and might result in complete or partial loss of the business of the customer. Therefore the transition to a coordinated outcome was generally more difficult.

7.83. On the question of *detection*, the parties said that although prices were not transparent, some information was available about which dairies were currently supplying which customers and the volumes of milk supplied to national multiples were also available in industry publications. The merger would not increase the degree of transparency and since there was currently no evidence of tacit coordination, clearly the existing degree of transparency could not be the essential factor for such coordination.

7.84. With regard to a *credible punishment mechanism*, the parties drew attention to the work of Compte, Jenny and Rey,¹ who pointed out that the firm with the largest capacity had the greatest incentive to deviate from a coordinated arrangement, since it could win the highest market share by competing independently.

7.85. The parties said the key point was that before the merger any combination of three firms was able to supply the entire market and therefore (in the event of coordinated behaviour) inflict the strongest punishment on any firm that competed independently and failed to adhere to the coordinated terms. After the merger, however, the remaining competitors (Wiseman and Dairy Crest) would not be able to supply the entire market on their own, so the punishment they could inflict on Arla/Express would be weaker and coordination would be less likely.

7.86. Commenting on *stability against competitor disruption*, the parties said that effective coordination after the merger would need to cover all three remaining participants. Given the history of Wiseman's expansion to date and its stated further expansion plans, together with Dairy Crest's substantial investment in super-dairies and stated intention to secure its position as the leading supplier of milk to multiples in England and Wales, this was implausible. Furthermore, in the absence of high barriers to entry (see paragraphs 7.55 to 7.61) coordination would attract entry.

7.87. With regard to *stability against buyer disruption*, the parties said that the relevant market was a bidding market, ie prices were determined by a trading mechanism whose design and time of implementation was chosen by the buyer of the product. A national multiple could use its buyer power to alter the tender process in response to any coordination. Coordination was more difficult in bidding markets the larger the size of individual tenders were relative to the overall size of the market and the less frequently transactions took place. Transactions were already large relative to the size of the market, but since national multiples controlled the design of the procurement process they could make them even larger, for example by reducing the number of suppliers. As noted in paragraph 7.51, three national multiples already had sole supply arrangements in England. As regards frequency, the parties said that whilst national multiples at present normally gave only three months' notice, there would be nothing to

¹Olivier Compte, Frederic Jenny and Patrick Rey, *Capacity constraints, mergers, and collusion*, European Economic Review 46 (2002), 1–29.

prevent them from auctioning yearly or at even longer intervals. In general, they had unexploited buyer power that they could use to neutralize any attempt by milk processors to raise prices.

7.88. The parties concluded that the conditions under which coordinated behaviour could be achieved were demanding. Failure of any one of the six conditions listed in paragraph 7.78 would prevent the occurrence of coordination. The parties said that on the basis of the facts of the dairy processing industry, it was unlikely that, post-merger, all the necessary conditions would be satisfied. Indeed it appeared that most of the conditions were not satisfied either before or after the merger.

Supply of fresh processed milk to middle ground customers

7.89. The parties noted that the OFT had reviewed supply to middle ground customers in some detail and had concluded that the merger was not likely to lead to a substantial lessening of competition in respect of that sector of the market. Although it appeared that some middle ground customers had expressed concern about the merger, many customers seemed unconcerned. Furthermore, the OFT appeared to have acknowledged that specific concerns expressed in relation to supply to schools were not well founded. The parties submitted that, in the light of the evidence and the OFT's finding, there was a clear case for us to conclude that the merger might not be expected to operate against the public interest in relation to supply to the middle ground.

Market definition

7.90. As noted in paragraphs 7.14 and 7.15, the parties considered that the product/customer market definition for the supply of fresh processed milk was becoming blurred. They said that no clear distinction could be drawn between the national multiples and the larger middle ground customers, which procured milk on a national basis, required milk processors to meet exacting quality standards and had significant buyer power. Many of the parties' largest middle ground customers (the smaller supermarket chains, national buying groups, major catering customers such as [X], petrol forecourt retailers and public sector purchasers such as schools and hospitals) bought substantial volumes of fresh processed milk on a multi-regional basis from a number of suppliers. The parties also pointed out that the national multiples' diversification into the middle ground had extended their competitive influence, as described in paragraph 7.19.

Effects of the merger

7.91. The parties drew our attention to the OFT's comment that although competition was likely to be regional for some middle ground customers, larger ones procured milk on a multi-regional basis, and it was possible that a chain of substitution linked the different regions of England and Wales. The parties said that they considered the scope of the middle ground sector to be all of England and Wales.

7.92. We put to the parties the hypothesis that the chain of substitution linking all regional and middle ground markets was impeded by a lack of price transparency in certain parts of the middle ground, which enabled suppliers to discriminate on price. This would suggest a series of regional markets rather than a national one.

7.93. In response, Arla said that the middle ground was made up of many different elements. It was clear from pricing information it had provided that there was no obvious pattern linking price to customer size, location or other factors. In Arla's view, prices were determined by matters such as the respective negotiating skills and market power of the buyer and the seller. It commented that not only were prices not transparent but also there were many alternative suppliers which made it even more difficult for one supplier to guess the intentions of its competitors.

7.94. Arla thought it was more rational, when considering market definition, to look at the proximity of dairies to customers rather than having regard to the boundaries of the ACNielsen regions. It said that middle ground milk was often moved considerable distances and sometimes, if bought by a wholesaler, from one region to another and, occasionally, back again. For example, a wholesaler based in the Midlands might buy milk processed in Lancashire and then sell it on to retail outlets in a number of

regions, including Lancashire. Arla thought it would be very difficult to define the market on the basis of customer requirements, such as drop sizes, frequency and distribution areas, because the middle ground was such a wide category, encompassing many different types of customer. Although every middle ground supplier might have a different geographic pattern of customers that it could supply economically, that would not necessarily lead to a specific definition of geographic markets.

7.95. Express said that the chain of substitution argument was that there were a large number of dairies which were active throughout England and Wales. Although the catchment area of each of them might not cover all of England and Wales, each was capable of competing across quite large areas, such that no area was completely separate. Many dairies were capable of supplying across much wider areas than the ACNielsen regions. If, for instance, Lancashire was defined as a separate geographic market, then there should be few imports to or exports from that market, whereas many of the parties' sales from dairies in Lancashire were to customers in other regions.

7.96. In terms of different customers paying different prices, Express said that this resulted from a combination of volumes purchased, size of drops, type of packaging (glass bottles and 0.189 litre (one-third of a pint) containers were more expensive than other containers) and the purchasing skill and power of the customer.

National aspects

7.97. The parties told us that their combined share of final sale supply to middle ground customers (excluding sales to BMBs) would be 20 per cent in England and Wales, and 18 per cent in Great Britain. Comparable figures with sales to BMBs included were 25 per cent and 23 per cent respectively. They included sales of NRCs to wholesalers/BMBs for onward sale to the middle ground market. They said that there was strong competition from other major milk processors (Wiseman, Dairy Crest and ACC, details of whose market shares are included in Table 5.4). In addition, there were many small local dairies meeting local needs.

Regional aspects

7.98. As the OFT noted, there were three ACNielsen regions where both parties had milk depots from which fresh processed milk was supplied to middle ground customers, namely London, Yorkshire and Lancashire. In London, where the OFT described supply as vigorous and contestable, the parties estimated their combined share as around 22 per cent (32 per cent if sales to independent BMBs were included). In Yorkshire the combined share would be around [redacted] per cent ([redacted] per cent if sales to independent BMBs were included). The OFT noted that the parties' combined share of supply in Lancashire would be 62 per cent if sales to wholesalers and independent BMBs were included, but around 50 per cent if such sales were excluded. (The parties told us that the combined share would be 46 per cent.) The parties said that middle ground BMBs, which were independent wholesalers, made the final sale to the customer and had the relationship with the final customer, were responsible for local distribution and had access to many suppliers (including suppliers outside the region) from which they could buy fresh processed milk. The parties believed that their competitive positions as regional suppliers were overstated by the inclusion of sales to BMBs in calculations of their share of supply.

7.99. The parties had informed the OFT that the figures for Lancashire included sales by Express that were delivered to two customers whose RDCs were both in the Midlands and whose volumes should not, therefore, have been included as part of the ACNielsen Lancashire region. These sales accounted for [redacted] percentage points of Express's share of supply. The figures also included sales by Arla in respect of which the final sales were made by outlets outside Lancashire. These sales accounted for [redacted] percentage points of Arla's share of supply. If these two groups of sales were excluded, the parties' combined share of supply would fall to [redacted] per cent including sales to BMBs and [redacted] per cent excluding them. In addition, [Details omitted. See note on page iv.], the parties' combined share should fall by a further [redacted] percentage points.

7.100. The parties told us that they were both heavily dependent on a few large middle ground customers in Lancashire ([redacted] in the case of Arla and [redacted] in the case of Express). [redacted] received deliveries of milk to a central distribution centre and could easily obtain supplies from other sources. Two years ago, [redacted] per cent of Express's final sales in Lancashire had been to Aldi and United North

West Co-operative, but the latter customer had been lost to ACC. The parties said that this loss indicated the intensity of competition. They noted that if sales to [] were excluded from the calculation then the parties' combined share of supply in Lancashire would be [] per cent including sale to BMBs and [] per cent excluding them.

7.101. The OFT commented that it was unclear to what extent it was reasonable to regard Lancashire as a distinct area for competition purposes, given that milk processors based outside a region could supply into it. Express told us that it accounted for around [] per cent of supply to the middle ground in Yorkshire although its dairies were in Liverpool and Manchester. It pointed out that Wiseman also supplied into Yorkshire from Manchester. The parties' combined share of supply would be substantially lower if calculated over any wider area than Lancashire.

Market dynamics

7.102. In its advice, the OFT had noted that some middle ground customers were worried about loss of choice and competition if the merger took place, but the OFT had found it was likely that they would still have a range of options for supply. Smaller customers, in particular, would have a wide choice of supplier since their standards and volume requirements were not as high as those of the multiples. The parties believed that vigorous competition would continue in Lancashire and Yorkshire after the merger. There were a number of sizeable competitors capable of supplying into those regions (including Wiseman, ACC, Creamline (which had entered the region in 1997 with a new dairy in Eccles), Longslow Dairy Group Limited (Longslow) and Taylors) and there was also competition from smaller dairies, milk producers that engage in milk processing and independent distributors. The parties said that the decline in doorstep sales gave smaller dairies a commercial imperative to increase sales in the middle ground. The parties told us that it was easy for milk processors outside the region to supply into Lancashire, especially as much of the final sales and distribution were carried out by independent wholesalers. The existence of large conurbations in Lancashire and Yorkshire increased the number of viable middle ground delivery businesses, and fruit and vegetable distributors had also become important milk suppliers.

Barriers to entry

7.103. The parties noted the OFT's view that barriers to small-scale entry did not appear significant but it was unclear to what extent such entrants were able to compete for large-scale business. The parties said that such entrants had clear incentives to compete and that middle ground multiples had demonstrated their willingness to switch between suppliers. It would be possible for them to switch to regional suppliers and for those suppliers to meet their requirements for capacity, quality of service and distribution. Examples of smaller dairies that had secured business with multiples were Longslow, which supplied Aldi, and Grahams, Taylors and Watsons, all of which supplied Lidl. The parties said that all that was needed to constrain post-merger behaviour was the credible threat of customer switching, and the OFT had noted the existence of that threat.

Buyer power

7.104. As recorded in paragraph 7.14, the parties believed that distinctions between middle ground customers and the national multiples, in terms of buyer power and sophistication, were becoming blurred. This point was equally valid in Lancashire as elsewhere. The parties said that whilst the OFT had noted that smaller middle ground customers were more likely than larger ones to be price takers, it had recognized that because their demands were smaller, they had a greater number of potential local suppliers.

Supply to schools

7.105. In its advice, the OFT noted that some local authorities in Lancashire and Yorkshire had expressed concern about the effects of the merger on supply of milk for schools. The OFT said that it was unclear whether the main effect of the merger would be on the number of bidders for local council

contacts or on access for other potential bidders to the BMB network as a means of delivery. There had been a suggestion that milk floats were the only economic means of delivery to schools requiring small drops, and that Arla and Express were the only competitors in certain areas.

7.106. The parties did not accept that milk floats were the only economic means of delivery. They provided us with a breakdown of various school milk contracts in the Lancashire and Yorkshire ACNielsen regions (see paragraph 5.142), which indicated that few of the contracts were served exclusively by milk floats. In Lancashire, for example, milk floats were the sole means of delivery in only two of the contracts, seven did not use floats at all and eight used a mixture of floats and other vehicles. The parties suggested that the use of milk floats in some cases would simply reflect the fact that the successful bidder had such vehicles rather than that they were indispensable.

7.107. Turning to the effects of the merger on the number of bidders, the parties said that there was no local area in Lancashire or Yorkshire where their franchised or managed delivery rounds overlapped. Therefore, no school could procure from both parties' doorstep delivery services. Furthermore, across both Lancashire and Yorkshire Arla's share of doorstep delivery by franchised and managed rounds was no more than [§] per cent. Consequently, the parties' doorstep delivery services using milk floats were not competing bidders for the majority of school contracts in Lancashire and Yorkshire.

7.108. The parties pointed out that the vast majority of bids for school contracts were subject to competitive tendering. They believed that a number of other companies were likely to be rival bidders for such contracts, including other dairies, fruit and vegetable wholesalers and other wholesalers. The parties said that milk delivered to schools was usually in cartons (not glass bottles), a type of packaging that was widely available from competing dairies. In northern England these included Wiseman, ACC, Longslow and Cotteswold.

7.109. We asked the parties to provide further details of public sector supply characteristics, including delivery to schools.

7.110. Arla told us that public sector requirements and purchasing procedures varied widely in regard to products, volumes, drop size and delivery area. Some public sector bodies operated a formal tendering process while others had less formal arrangements. Some entered into a single contract for all their requirements and others had separate contracts for different districts. Some negotiated directly with suppliers and some via purchasing organizations. Some were supplied with milk by dairies and some by wholesalers, including milk wholesalers, fruit and vegetable suppliers and food service operators. Wholesalers often supplied milk along with other products and did not always deliver daily. Arla said that suppliers were increasingly turning to dedicated middle ground delivery vehicles, though some still used the services of BMBs who combined deliveries with their doorstep activities. Drop sizes were generally small and delivery areas concentrated, or capable of being concentrated by contract splitting. Arla said that school contracts would be attractive to suppliers with distribution capacity in the area. This capacity was easy to establish using middle ground delivery vehicles.

7.111. Express told us that tenders for the delivery of milk to schools were usually on a local authority basis and accordingly the geographical spread could vary widely, for example as between a county council and a city council area. Drop sizes could also vary according to the demographics of the area, for example a village school might take ten 0.189 litre cartons a day whereas an urban school might take 300 cartons a day. The time window for deliveries to schools was usually between 7.00 am and 9.30 am. Express said that there could be considerable variations in drop sizes within a single tender. For example, in part of Liverpool, Express had a contract for delivery to 63 schools within some 62 sq km. The smallest drop size was 12 0.189 litre cartons a day and the largest was 434 cartons a day. The total daily volume for this tender was approximately 8,300 cartons a day, an average drop size of 132.

7.112. Express told us that schools in Lancashire and Yorkshire were served using a mixture of milk floats and other vehicles. There was an additional cost if delivery was to be by a franchised roundsman (ie doorstep delivery) because in those circumstances, the dairy companies had to pay a handling charge which was agreed in the franchisee's contract.

7.113. Express said that, because so many variables were involved, contracts for supply to schools could differ vastly in terms of volumes and the costs associated with servicing them. Such contracts amounted to only a very small part of Express's fresh milk sales (less than 1 per cent): furthermore the school year was only 39 weeks.

7.114. Express told us that suppliers to schools tended, in the main, to be dairy companies that had coverage in the geographic area and food service companies or fruit and vegetable suppliers that were regularly calling on the schools. As Arla and Express did not have overlapping franchised or managed rounds, they were not competing bidders for the vast majority of school contracts in Lancashire and Yorkshire. In addition, the parties believed that there were a number of rival bidders for these various contracts. The various suppliers of school contracts would be serving a wide range of other middle ground customers, including retailers and other non-retailers.

Supply of fresh processed milk to doorstep customers

Market definition

7.115. In the parties' view, sales to doorstep customers did not represent a separate market from the national multiple and middle ground segments. Consumers had many choices as to where to buy milk, including supermarkets, local stores, petrol stations and even online, and this range of options imposed a competitive constraint on the doorstep sector. Furthermore, the entry of the national multiples into the middle ground sector and also into home deliveries indicated a considerable blurring of the distinctions between the different market sectors.

7.116. There was, therefore, no longer a compelling case for regarding doorstep as a distinct market but, if it was to be considered separately, the parties considered that there were two main groups of customers within the segment: independent BMBs, who were free to purchase milk from any milk processor; and roundsmen (either franchised or managed) who supplied milk exclusively on behalf of one milk processor. The parties said that they both sold fresh processed milk to BMBs and directly to doorstep customers via milk roundsmen. Arla, however, was active in direct doorstep sales to only a minor extent as over [] per cent of its bottled milk sales were to independent BMBs.

7.117. The parties said that it was also appropriate to consider the conditions of doorstep supply on a local basis. The parties were both active in supply to BMBs and doorstep customers in three ACNielsen regions in Great Britain: London, Lancashire and Yorkshire. They did not believe that the proposed merger raised any local competition concerns in this market sector in any of the three regions concerned, because:

- (a) in all three regions there was no overlap between the parties' franchised or managed doorstep rounds and there were only a few instances within each region of the parties' serving adjoining areas;
- (b) in each area where the parties' franchised or managed doorstep business adjoined, several other businesses were also active, including those managed or franchised by other milk processors and independent BMBs;
- (c) there were numerous alternative sources of supply, including the other large milk processors, smaller milk processors and farmer milk processors; and
- (d) in the localities in Lancashire and Yorkshire where the parties' milk depots were relatively close together, both parties' sales of fresh milk via franchised or managed roundsmen were de minimis compared with both parties' sales to independent BMBs.

Effects of the merger

7.118. The parties noted that the OFT had raised the concern that the merger might reduce the number of potential suppliers to BMBs in some areas. The OFT had, however, recognized that there were alternative sources of bottled milk in the areas where both parties were active. Furthermore, it seemed that no concerns had been raised by BMBs.

7.119. In relation to doorstep delivery by roundsmen, the progressive fall in customer numbers over a lengthy period (see paragraph 5.61) had necessitated substantial rationalization of rounds, milk depots and glass-bottling facilities, with only those areas with a sufficient density of customers continuing to be

served by doorstep rounds. The OFT had acknowledged that, as a result, rounds operated in effect as local monopolies. Comments from BMBs to the OFT had suggested that true competition for customers at the margins of rounds was unlikely because of fears of retaliation if customers were encouraged to switch rounds. The parties thought it was more plausible that the cost of extending rounds was prohibitive, particularly as the decline in sales and resulting rationalization meant there were few roundsmen covering each area, and the cost would not be covered by the likely modest gain in customers, given the continuing decline in doorstep sales and the growth of the national multiples' home delivery services.

7.120. The parties submitted, therefore, that there was no evidence that the merger would result in a substantial lessening of competition in relation to doorstep customers, as there were no areas where the parties overlapped. They noted that this was the conclusion reached by the OFT.

D P B KINGSMILL (*Chairman*)

G H HADLEY

C R SMALLWOOD

C WADDAMS

S R M WILKS

R FOSTER (*Secretary*)

23 September 2003