

STONEGATE/DEANS MERGER INQUIRY

Issues Statement

Background

1. Our terms of reference require us to consider the completed merger of Stonegate Farmers Limited (Stonegate) and Deans Food Group Limited (Deans). The transaction was completed on 23 June 2006 by the creation of a new company, Noble Foods Limited (Noble Foods), which acquired the majority of the shares of Deans and Clifford Kent Holdings Limited (Clifford Kent) which in turn holds the majority of shares in Stonegate. The principal shareholders in Stonegate and Deans prior to the transaction (respectively, Mr Michael Kent and Mr Peter Deans) each acquired 50 per cent of the shareholding in Noble Foods.

2. As noted in the Office of Fair Trading (OFT)'s decision document (available via a link on the website:

www.offt.gov.uk/Business/Mergers+EA02/Decisions/Clearances+and+referrals/Stonegate.htm)

setting out the reasons for making the reference, we understand that:

(a) Stonegate supplies eggs in both shell (shell eggs) and processed forms (processed eggs). It sources the majority of its eggs from independent third parties and outsources the processing of its eggs. Whilst Stonegate has no processing capacity of its own, it operates at all stages of the shell egg supply chain, from the hatching and rearing of chicks, the collection of laid eggs through to packing and onward supply.

(b) Deans also supplies shell eggs and processed egg. It too sources the majority of its shell eggs from third party producers and operates at all stages of the shell egg supply chain. However, unlike Stonegate, Deans has processing facilities of its own and produces all of its supplies of processed egg in-house.

3. The parties are the largest pre- and post-merger suppliers of shell eggs in the UK. Their combined shares of the UK supply of shell and processed eggs in 2005 amounted to over 40 per cent and over 35 per cent respectively, but with over 60 per cent of supply of shell eggs to retailers. They gave initial undertakings to the OFT on 22 August. We are currently discussing replacing these with interim undertakings of our own.

4. The Competition Commission is required to determine, within a period ending on 27 February 2007, the following questions in accordance with section 35 of the Enterprise Act 2002:

(a) whether a relevant merger situation has been created; and

(b) if so, whether the creation of that situation has resulted or may be expected to result in a substantial lessening of competition within any market or markets in the UK.

5. The issues which we intend to consider are set out in the following paragraphs.

Definition of the relevant economic market(s) affected by the merger

6. We need to consider the appropriate definition of the markets affected by the merger (the relevant markets), and in particular, in relation to the extent of supply-side and demand-side substitution, whether:
 - (a) there are separate product markets for (i) organic free range eggs; (ii) non-organic free range eggs; (iii) barn eggs; and (iv) cage eggs; and/or
 - (b) there are separate product markets for (i) shell eggs bearing the Lion mark; (ii) and for non-Lion or unbranded shell eggs; and/or
 - (c) there are separate product markets for the supply of shell eggs to (i) retailers; (ii) caterers/wholesalers; and (iii) processors; or
 - (d) the relevant market is the supply of shell eggs to all types of customer.
7. For the supply of processed eggs, we need to consider whether, for the purposes of this investigation, there is/are:
 - (a) separate product markets for the supply of (i) liquid egg; (ii) hardboiled egg; and (iii) powdered egg;
 - (b) a product market for the supply of all types of processed egg; and
 - (c) a single market for the supply of all types of shell and processed eggs.
8. Finally, as to the definition of the product market, we should consider the nature of the upstream market, whether it consists of:
 - (a) the supply of pullets to egg producers;
 - (b) the supply of animal feed to egg producers;
 - (c) the supply of spent hen processing services (or the purchasing of spent hens);
 - (d) the production of shell eggs;
 - (e) the supply of egg packing services; and/or
 - (f) the supply of egg processing services.
9. To refine the market definition process, we need to consider whether there is:
 - (a) limited demand-side substitutability between shell eggs and processed eggs;
 - (b) limited supply-side substitutability between shell eggs and processed eggs;
 - (c) limited demand-side substitutability between liquid egg and other types of processed egg (powdered and hardboiled);
 - (d) limited supply-side substitutability between liquid egg and other types of processed egg; and
 - (e) limited demand and/or supply side substitutability between eggs (shell and liquid) produced in the UK and imported eggs.

10. We will need to consider the geographic extent of the relevant product market(s) and, in particular, whether each relevant geographic market is regional/local, Great Britain, the UK or wider.

The counterfactual

11. We also need to consider what would have been expected to happen in the absence of the merger (known as the counterfactual), in particular whether we would be right in assuming that Deans and Stonegate would be actively competing in the same market or markets and would have continued to do so.

Assessment of the competitive effects of the merger

12. We need to consider the effects of the merger on what we conclude to be the relevant economic market compared with the counterfactual. We need to consider the competitive conditions in the relevant market(s) identified and, in particular:
 - (a) the potential for customer switching, other than between Stonegate and Deans;
 - (b) the threat of entry by new participants and expansion by smaller participants;
 - (c) the level of capacity in the industry in the short or long term and/or the existence of long-term contracts with producers and the merged entity's ability to restrict entry or expansion by other suppliers and the degree to which any barriers to entry/expansion can be overcome by sponsored entry;
 - (d) barriers to entry to the market, including regulation (both current and proposed), and the likelihood and potential impact of entry to the market;
 - (e) barriers to expansion within the market, including regulation (both current and proposed), and the timescale over which these operate;
 - (f) effect of health, environmental and trade regulation;
 - (g) the effects of diseases in chicken stocks and health issues;
 - (h) the extent of actual or potential competition from imports, or whether this could be limited by, for example, the importance to retailers or consumers of the Lion brand and whether imports or the threat of imports differ between shell eggs and processed/liquid eggs;
 - (i) the extent of any buyer power in the relevant market(s) and whether there are identifiable groups of customers (eg smaller customers) whose bargaining position may be relatively weak; and
 - (j) the possibility and profitability of bundling by suppliers of feed, pullets and/or spent hen processing with supply contracts for shell eggs with producers.
13. On the basis of the underlying factors outlined above, we would wish to consider possible theories of harm relating to the effects of the merger, including whether:
 - (a) the reduction in the number of suppliers and the absence of alternative suppliers is leading or may be expected to lead to a loss of rivalry (either nationally—ie Great Britain or UK—or regionally/locally) which allows the merged entity to push up prices to all customers unilaterally for: shell eggs as a whole; or at least one of the separate categories of shell eggs listed in paragraph 6(a) or (b); and/or

processed eggs as a whole; or at least one of the separate categories of processed eggs listed in paragraph 7(a) above;

- (b) alternatively, the merged entity may be able to put up prices unilaterally but only to some customers as others (eg the large retailers) may have countervailing buyer power;
- (c) the loss of rivalry could also thereby allow the merged entity to act in a way that adversely affects the range, quality, innovation or service levels in the supply of any category of shell or processed eggs, including to customers of different types;
- (d) the merged entity will use its market power in the purchasing of eggs and the supply of eggs to retailers and make the purchase of other products (animal feed, spent hen processing etc) a condition of its supply contracts;
- (e) any reduction in competition between suppliers of eggs could adversely affect egg producers, including the prices paid to them, with possible adverse effects on competition in the market for unpacked eggs or other markets and the final prices paid by consumers;
- (f) the merged entity will use its market power in the purchasing of eggs to the detriment of producers by contracts, or otherwise jeopardize the position of other suppliers (for example, by branding of eggs); and
- (g) the merged entity would be in a position to refuse to supply certain retailers or wholesalers.

If (a), (b) or (c) holds, then it is possible that the best response of competitors is also to increase prices unilaterally, so that the merger results in a market-wide (multi-lateral) price increase, rather than a unilateral price increase. We may also need to consider whether the merger could increase the likelihood of coordinated effects in any category of shell or processed eggs.

Possible remedies

14. The above issues will form the basis of hearings with a number of parties. Should we subsequently conclude that the merger results or may be expected to result in a substantial lessening of competition, we shall consider whether and, if so, what remedies might be appropriate, and will issue a further statement at a later date.
15. If we conclude that remedies are necessary, we shall consider the effect of our chosen remedies on any relevant customer benefits expected to arise from the merger. We would therefore like to explore whether any relevant customer benefits might be expected to arise as a result of the merger and, if so, what these benefits are likely to be and which customers would benefit. Customer benefits are benefits to customers at any point in the chain of production and distribution and are therefore not limited to benefits to final consumers. One possible benefit we may wish to consider, for example, is whether the merger could result in economies of scale or other improvements in efficiency in production or distribution, and, if so, whether any prospective cost reductions could be expected to result in prices lower than if the merger had not taken place.