

STONEGATE/DEANS MERGER INQUIRY

Provisional findings report

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The Competition Commission has excluded from this published version of the provisional findings report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by ✂.

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Stonegate/Deans merger inquiry

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Summary

1. On 13 September 2006,¹ the Competition Commission (CC) was asked to investigate the completed merger of Clifford Kent Holdings Limited (Clifford Kent), parent company of Stonegate Farmers Limited (Stonegate), and Deans Food Group Limited (Deans) through Noble Foods Limited (Noble), both Stonegate and Deans being suppliers of shell and processed eggs. Shell eggs are fresh eggs in their shells and are categorized according to different processes of production: cage (battery) eggs, barn eggs (produced by hens in enclosed barns without access to outdoor areas), and free range eggs (including organic eggs). Processed eggs are usually second quality eggs that have been broken and pasteurised to supply to food manufacturers in liquid or powdered form; and small eggs which have been hard-boiled. The OFT said that the merger had given Noble Foods around 60-70 per cent of the supply of shell eggs to retailers and over half of the supply of liquid eggs to processors, and it was concerned about the reduction of competition as a result.
2. Deans is a company with national coverage currently operating at almost all levels of the shell and processed egg supply chain. Stonegate is less vertically integrated than Deans. In 2004/5, Deans had a turnover of £314 million and an operating profit of £7.2 million; turnover of Stonegate was £103 million with an operating profit of £2.4 million.
3. We have considered the counterfactual—that is, what would have happened had there been no merger. Both companies were profitable before the merger. And both showed that they had strong prospects as independent companies. We have seen nothing to suggest that in the absence of the merger Deans and Stonegate would not have continued as separate companies and to compete with each other.

¹The terms of reference were revised on 12 December 2006 in order to clarify the merging entities, in particular including a reference to Clifford Kent Holdings Limited. Other minor typographical changes were also made.

4. During the inquiry we received views from retailers and other customers, egg processors, egg producers, packers and suppliers. Among the main concerns expressed by some retailers were that there would be difficulty in switching due to limited availability of eggs and to no other suppliers having sufficient capacity to provide an alternative to Noble; and hence that there would be a loss of competition and adverse effects on prices and innovation. Concerns expressed by some liquid egg customers were chiefly about the effect of the merger on competition given the large capacity and market share of Noble, and the disadvantages of using smaller competitors or imports or powdered eggs as an alternative. Among the main concerns of some producers were that there would be limited options after the merger, that Noble could reduce egg prices and that it had the ability to tie up producers in long-term contracts that would include supply of input such as feed and pullets.

5. Deans and Stonegate argued that first, the bargaining power of their customers and their ability to switch business to smaller competitors or to imports and second, the existence of such smaller competitors with the ability to access eggs would ensure the merged company would not have market power in supplying retail customers. As to the concerns of producers, they said that the merged business was dependent on egg producers; and that to drive prices down would also encourage producers to supply Noble's competitors instead. As for processed eggs, they argued that customers could switch to powdered eggs, imports, or to other UK suppliers.

6. For shell eggs we found four relevant product markets for the supply of these eggs, namely, the supply to retailers of each of the three categories of: cage and barn eggs, of non-organic free range eggs, and of organic eggs; and the supply of all shell eggs to catering and wholesale customers.

7. As to the geographical market for shell eggs, on balance, the considerations suggest that the relevant markets are likely to be national; most retailers appear reluctant to switch from Lion marked eggs (a scheme for UK-produced eggs) unless they can otherwise be assured about their provenance and safety and have 'buy British' policies; and state that they would be unlikely to switch to imports in the event of a 5 per cent increase in price.

8. For processed eggs, Deans and Stonegate agreed that there was a separate market for hard-boiled eggs, these being used for different purposes than other processed eggs. But they argued that liquid and powdered eggs were functionally identical. However, responses we received indicated that a significant number of customers consider that powdered eggs produced an inferior product, and that they would be likely to absorb a 5 per cent increase in liquid egg prices. In our view, even if there were sufficient marginal customers to render a general price rise profitable, the merged company may be able to discriminate between those who would and would not switch in response to a price increase; this would suggest that there are also likely to be separate product markets for the supply of liquid eggs and powdered eggs. As to the geographical market for liquid eggs, a number of customers from whom we heard said there were disadvantages in using imported liquid eggs and were reluctant to do so. We do not therefore believe it appropriate to regard supply of liquid eggs as a market wider than the UK for those customers for whom imports provide a poor substitute.

9. Finally on market definition, the parties agreed that upstream activities could be regarded as relevant markets, each essential to the supply of eggs, for example, the production of shell eggs and the supply of animal feed to egg producers.

Shell eggs

10. **Competitive effects: switching.** Following the merger of Deans and Stonegate, OFT said, as noted above, that Noble accounts for over 60 per cent of sales of shell egg to retailers. The next largest supplier is significantly smaller than the merged company. The potential for customer switching would appear likely to be much reduced as a result of the merger. Although the parties argued that all customers use smaller competitors, and that they could easily switch sufficient volumes to these smaller customers to defeat a price rise by Noble, most of the switching by the largest multiple retailers that has occurred has been to or from, and often between, Deans and Stonegate. In our view the loss of business likely to be incurred by the merged company in response to any price rise is likely to be low; that is, price rises would be profitable.

11. Effective competition in our view is also more likely to require the ability to switch a significant part of a retailer's business. Customer switching would also seem to be dependent not only on there being alternative suppliers to whom to switch but also on the availability of surplus eggs. The surpluses of eggs previously available, however, may not be expected to continue. The parties argued that if a retailer switches supplier, the supplier that lost the contract would have to dispose of the surplus eggs to the wholesale (spot) market to minimise its losses. Competitors, however, said that they currently had a shortage of eggs, and could not compete for new business merely on the assumption that eggs would become available. And it is not clear to us, on balance, that the revenue loss of withholding eggs from the wholesale market would be sufficient to rule this out as a tactical choice. In our view, therefore, the merger is likely significantly to have reduced the ability for retailers to switch to alternative suppliers of all three categories of shell eggs (see paragraph 6 above).

12. **Entry and expansion.** The other suppliers to retailers would need to expand significantly and rapidly for retailers to have confidence that they had adequate sources of supply and to replace the lost rivalry between Deans and Stonegate. Entry and expansion by suppliers of eggs appears to be constrained primarily by the availability of eggs to pack. Also, entry or expansion of free range production is likely to be a lengthy process, given the need for planning permission, possible construction of facilities, the time required for a flock to come fully into production and the need to have the facilities approved against regulatory and quality standards. Sufficiently rapid expansion in sufficient timescale to prevent the merged company increasing prices or worsening quality is, in our view, on balance unlikely.

13. **Competition from imports.** The percentage of retail sales accounted for by imports appears to be less than 7 per cent. The main constraints on imports of shell eggs include the importance to retailers of the Lion mark, the 'buy British' policy of many multiple retailers and the need for security of supply. Actual or potential competition from imports therefore in our view appears unlikely to offset any reduction in competition resulting from the merger in any of the three identified categories of supply of shell eggs to retailers.

14. **Bargaining power.** Multiple retailers account for the overwhelming majority of retail sales of shell eggs. The parties argue that the bargaining power of retailers together with the presence of other suppliers would be sufficient to ensure the merged company would not have market power in supply to any category of retailer. We undertook our own analysis which found no clear evidence that large customers were any less profitable to the supplier than smaller multiple retailers or any other customer group. Given the difficulty in switching supplier, the limited prospects for entry and expansion we have noted above and the reluctance to import, the effects of the merger would therefore appear likely materially to reduce retailers' bargaining

power which may be expected in this particular instance adversely to affect final consumers.

15. In our provisional view, the merger may therefore be expected to result in a substantial lessening of competition (SLC) in the supply of cage and barn eggs, of free range eggs and of organic shell eggs to retailers. This may in turn be expected to lead to higher prices being faced by retailers and, ultimately, by the final consumers of shell eggs.

Supply of shell eggs to catering and wholesale customers

16. The merged company's share of supply to catering and wholesale customers—about 25 per cent—is significantly below that to retailers and the use of other suppliers is more significant than for the multiple retailers. In our provisional view, therefore, the merger may not be expected to result in an SLC in supply of shell egg to catering and wholesale customers.

Processed eggs

17. **Liquid and powdered eggs.** On our estimates the merged company accounts for around half or more of the total supply of UK liquid eggs. The overlap between the parties is only in pasteurised eggs. The parties argued that many customers were prepared to switch to powdered eggs, or to imports. A number of liquid egg customers, however, expressed concerns. Some customers argued that any plan to shift volume to smaller processors or outside the UK was likely to take at least a year to implement effectively. Availability of eggs was also thought to be a likely constraint. Disadvantages from use of imports quoted to us included higher transport costs, longer transport lead-times and the inherent quality and food safety issues associated with eggs from the Continent. Powdered eggs were also said by some customers from whom we heard to result in an inferior product, to make little

economic sense and were not what retailers wanted. The amount of powdered eggs (in their liquid equivalent) used in the UK is currently about one-third that of liquid eggs, suggesting that there is a degree of substitutability for some, but not all customers in the UK. However, this is not in our view sufficient to establish demand substitutability given the strong preference of some customers not to use powdered eggs or imported shell eggs. The bargaining power of customers dependent on liquid eggs and reluctant to import is likely to be reduced by the merger given the limited number of other suppliers and their limited scale. Given the high market share of the merged company, the merger would appear likely significantly to have reduced the opportunities to switch supplier for those liquid egg customers unable or unwilling to use powdered or imported liquid eggs. In our provisional view, therefore, the merger may be expected to result in an SLC in the supply of liquid eggs to customers in the UK for whom the use of imported eggs provides a poor substitute.

18. **Hard-boiled eggs.** We are less concerned about the effects of the merger on the supply of hard-boiled eggs. They are not currently supplied by Stonegate. Given the presence of other suppliers, we saw insufficient reason to expect that the merger could result in a material loss of potential competition from Stonegate.

Upstream effects

19. Many farmers have raised concerns regarding the upstream bargaining power of the Deans and Stonegate merged entity fearing that Noble's increased bargaining power vis-à-vis its contracted producers would result in lower prices paid to producers and/or reduction in the quantity of eggs produced. We are concerned about the monopsony buying power of the merged company and consider that its strong buying power would give it the ability as well as the incentive to buy from producers on less favourable terms in a number of ways: to cut back prices to producers; to fail to pass on any increases in price it may receive from retailers; or to bundle its purchases with

sales of inputs such as animal feed, pullets or spent hen facilities; and to offer less favourable contracts to producers in non-price terms, such as payment terms. Lower prices to producers of eggs could benefit consumers if passed on to them but ultimately reduction in the quantity of eggs produced would raise prices to retailers and final consumers. Hence, in our provisional view the merger may be expected to result in an SLC in the procurement of shell eggs from producers.

Provisional findings

20. We have therefore provisionally found that the merger may be expected to result in an SLC in the:
- (a) supply of cage and barn, of free range and of organic shell eggs to retailers;
 - (b) supply of free range liquid eggs and of cage liquid eggs to those customers in the UK for whom the use of imported liquid eggs provides a poor substitute; and
 - (c) procurement of shell eggs from producers in the UK.
21. As a result of the SLCs provisionally identified, the merger would also be expected to have the following adverse effects:
- (a) the reduction in the number of suppliers and the absence of alternative suppliers of equivalent scale may be expected to lead to a loss of rivalry which allows the merged entity to increase prices to retail customers unilaterally for cage and barn, free range and organic shell eggs;
 - (b) 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 to retailers of cage and barn, free range or organic eggs, including to customers of different types;
 - (c) the merged entity would be in a position to refuse to supply certain retailers;
 - (d) the parties are also in a position to increase prices to some customers for liquid eggs, by price discrimination in the supply of liquid eggs, in particular between

those customers willing to source outside the UK or use powdered eggs and those for whom imported eggs or powdered eggs provide a poor substitute, and reduce the range, quality, innovation or service levels in the supply of liquid egg to such users;

- (e) the merged entity could use its market power in the purchasing of eggs to buy from producers on less favourable terms, including, for example, reducing the prices paid to them, or making the purchase of other products (pullets, animal feed, spent hen processing etc) a condition of its supply contracts, reducing the number of eggs produced and raising prices to retailers; and
- (f) by long term contracts with producers, the merged entity could jeopardize the position of other suppliers and/or limit the opportunities for entry thereby or in other ways, for example, by pricing policies, price discrimination or own branding of eggs.

The effect of the above would, in our view, be to increase final prices to consumers and to reduce the range, quality, innovation and service levels available to them.

Multilateral effects

22. In addition to the unilateral effects of the merger we considered whether the merger could result in a multilateral increase in prices—ie increased prices not only by the merged company but also by other suppliers and/or coordinated effects. It is likely to be in the interests of other suppliers of shell eggs to retailers and of liquid eggs, particularly given their difficulty in acquiring eggs in the short term, partly to follow a price increase by the merged company rather than maintain, or reduce, their prices to increase market share. In our provisional view, therefore, the merger may be expected to have the effect of enabling other suppliers of shell, of free range and of organic eggs to retailers and of liquid eggs to attain higher prices than would otherwise be the case. Given our provisional conclusion that the merger may be expected to result in an SLC through its unilateral and multi-lateral effects, we have

not needed to reach a final view on whether, on balance, coordinated effects may also be expected.

23. We are therefore required to consider whether action should be taken for the purpose of remedying, mitigating or preventing the SLC or any adverse effects which may be expected to result from such an SLC, having regard to the effect of any action on any relevant customer benefits (as defined in the Act) in relation to the merger.

Provisional findings

1. The reference

- 1.1 By a reference made by the Office of Fair Trading (OFT) on 13 September 2006,² the Competition Commission (CC) was asked to investigate the completed merger of Clifford Kent Holdings Limited (Clifford Kent), the parent company of Stonegate Farms Limited (Stonegate), and Deans Food Group Limited (Deans) through Noble Foods Limited (Noble). The reference was made under section 22(1) of the Enterprise Act 2002 (the Act). Our terms of reference are set out in Appendix A together with an explanation of how we have conducted our inquiry. These require the CC to consider whether ‘a relevant merger situation’ has been created; and if so, whether the creation of that situation has resulted or may be expected to result in a substantial lessening of competition (SLC) within any market or markets in the UK or parts of the UK. We are required to publish our final report by 27 February 2007.
- 1.2 In order to decide whether a relevant merger situation has been created, we are required under section 23 of the Act to consider, first, whether two or more enterprises have ceased to be distinct within the meaning of the Act; and second, whether the turnover test in the Act (namely whether the value of the turnover in the UK of the enterprise being taken over exceeds £70 million) or the share of supply test (namely whether the merger creates or enhances a share of supply of 25 per cent or more of goods and services of any description in the UK or any substantial part of the UK) is satisfied. For this purpose, the terms of reference referred to the supply in the UK of shell eggs (that is, eggs in their shells) and the supply of processed eggs.
- 1.3 Any two enterprises cease to be distinct if they are brought under common ownership or control. The transaction was completed on 23 June 2006 by the creation of a new

²The terms of reference were revised on 12 December 2006 in order to clarify the merging entities, in particular including a reference to Clifford Kent Holdings Limited. Other minor typographical changes were also made.

company, Noble Foods Limited (Noble Foods), which acquired the majority of the shares of Deans and Clifford Kent which in turn holds the majority of shares in Stonegate Farmers Limited (Stonegate), the main subsidiary of Clifford Kent that deals in eggs. The principal shareholders in Clifford Kent and Deans prior to the transaction (respectively, Mr Michael Kent and Mr Peter Dean) each received 50 per cent of the ordinary shares of Noble Foods.³ Enterprises carried on by or under the control of Clifford Kent have therefore ceased to be distinct from enterprises carried on by or under the control of Deans.

- 1.4 The reference to us, on 13 September 2006, was made before the statutory deadline for the making of the reference.
- 1.5 The application of the share of supply test is different from the definition of market shares undertaken as part of any analysis of competition within an economic market. As noted in paragraph 6.3, after the merger the share of Noble Foods of the UK supply of shell and processed eggs would amount to [X] per cent and over [X] per cent respectively, but with higher shares in particular categories of supply; before the merger the shares of Deans and Clifford Kent were each below those levels. The shares of supply are above the 25 per cent threshold of the Act, and the share of supply test is satisfied.
- 1.6 Hence we conclude that a relevant merger situation within the meaning of the Act qualifying for investigation has been created and we do not have to consider whether the turnover test is met. This was not disputed by any party.
- 1.7 The main parties (whom we refer to as the parties in this report) gave initial undertakings to the OFT on 22 August 2006 and these were adopted by the CC on

³Initially incorporated as Goodmix Limited (see paragraph 2.16).

14 September 2006. Revised undertakings that replaced these earlier undertakings were given to the CC on 20 November 2006 and published on our web site (<http://www.competition-commission.org.uk/inquiries/ref2006/stonegate/index.htm>).

2. Background to the inquiry

The UK egg industry

2.1 The UK is largely self sufficient in egg production. Almost 9 billion eggs are produced in the UK, which represents about 93 per cent of total usage.⁴ The remaining 7 per cent is imported from other European Union (EU) countries. Exports are minimal. At current prices, the farm gate value of UK production in 2005 was about £340 million; retail value [✂].⁵

2.2 Production standards are set by EU egg market regulations⁶ which recognize three main egg production systems—laying (battery) cages, barn eggs (produced by hens in enclosed barns without access to an outdoor area), and free range (including organic production).⁷ One of the most consistent features of the market in recent years has been the swing from cage to non-cage production systems, particularly free range.⁸

TABLE 1 UK egg production 2005

	<i>Eggs bn</i>	<i>% volume</i>	<i>£m</i>	<i>% value</i>
Cage	5.60	63.3	161	48.0
Barn	0.56	6.3	24	7.1
Free range (including organic)	<u>2.69</u>	<u>30.4</u>	<u>152</u>	<u>45.1</u>
Total	8.85	100.0	337	100.0

Source: Defra.

⁴The parties said that including imports of egg products, UK egg production would represent 86 per cent of usage in the UK, with 14 per cent imported.

⁵Defra statistics; the parties presentation to banks and Deans 2004-2007 Shell Egg Division Business Plan.

⁶The main regulation is Regulation (EEC) No 2771/75 of the Council on 29 October 1975 of the common organization of the market in eggs (as amended). This covers eggs in shell (fresh, processed or cooked) and other eggs not in shell. See also Council Regulations (EEC) 2782/75 and 1868/77 covering eggs for hatching and chicks.

⁷Organic eggs are produced in similar conditions to free range eggs but on land free from chemicals for the previous two years and which meet other organic certification standards.

⁸Defra statistics; parties' presentation to banks.

As shown in Table 1, in 2005, cage eggs accounted for 63 per cent of the volume of UK production, barn approximately 6 per cent and free range (including organic) 30 per cent. By producer⁹ value, however, cage accounts for 48 per cent of production, barn 7 per cent and free range (including organic) 45 per cent.

2.3 We saw estimates from the parties and other sources¹⁰ that over 50 per cent of available eggs are supplied to retailers,¹¹ the bulk of these sales being direct sales by suppliers¹² to retailers. However, [redacted] of the combined sales volumes of Deans and Stonegate, are supplied to retailers. The multiple retailers (operators of chains of supermarkets) account for over [redacted] of sales; and the four major multiple retailers¹³ alone for some [redacted] of such sales. The bulk of sales by retailers [redacted] are of retailers' own brands, although both Deans and Stonegate have increased the share of their sales accounted for by their own brands.

2.4 During our inquiry, there were shortages of free range eggs, variously attributed to the rapid growth of demand, the hot summer reducing the number of eggs laid, disease (which the parties regarded as the main factor), and, some other parties suggested,¹⁴ an investigation by Defra into the possible mis-labelling of eggs by a smaller egg supplier, including the apparent labelling of cage eggs as free-range. In response to this shortage, there have been increasing imports of free-range eggs, not only by suppliers but also by some retailers direct.

⁹Producers are egg farmers who provide eggs to egg suppliers and other third parties.

¹⁰Parties' presentation to banks: Mintel Eggs, Market Intelligence, June 2006 also estimates UK retail sales of eggs of about 5 billion in 2005, compared to production of almost 9 billion in Table 1.

¹¹Organizations providing food for domestic consumption, including supermarkets, symbol groups and independent grocery stores.

¹²Suppliers are firms who contract to supply eggs to retail and other commercial customers. But see paragraph 2.10.

¹³Tesco plc (Tesco), J Sainsbury plc (Sainsbury's), Asda Group Limited (Asda), Wm Morrison Supermarkets plc (Morrisons).

¹⁴For example, by one major retailer ([redacted]) and the CEA.

- 2.5 Almost 25 per cent¹⁵ of the total volume of eggs was estimated to be sold through wholesalers. With the increasing share of retailing accounted for by multiple retailers, the bulk of the wholesale sector was believed now to be accounted for by foodservice companies or companies serving restaurants or caterers. (We use the term catering and wholesale customers to refer to foodservice companies, to companies serving restaurants or caterers and to general wholesalers.)
- 2.6 The remaining use for shell eggs was estimated to be in processing. Traditionally second quality¹⁶ and ungraded eggs have been broken and pasteurised to supply food manufacturers, and small eggs, for which there is limited retail demand, have been hard-boiled. Demand has grown, and now exceeds the volume of second quality and small eggs that UK production can supply, which has led to a growth in imports and increased use by the processing industry of surplus first quality eggs. The egg product industry produces four categories of product: pasteurised eggs; egg powder (primarily imported, with no production in the UK); hard-boiled eggs; and convenience added value products such as pre-cooked scrambled eggs and omelettes.

Regulation

- 2.7 The egg industry is subject to a considerable degree of legislation, including legislation to ensure adequate standards for animal welfare.¹⁷ Improvements in those standards, particularly a ban by 2012 on conventional cage egg production and the introduction of 'enriched cage' egg production are estimated by the parties¹⁸ to

¹⁵BEIC estimated the food service industry to account for 23 per cent of the market.

¹⁶Second quality eggs, or seconds are eggs which have blemishes or other defects, such as in shell thickness, or which do not meet the size, shape or other standards required for supply to retailers. In the UK these eggs are usually processed in liquid form, and/or sold to processors.

¹⁷We understand there are around 80 different sets of legislation covering poultry production and marketing, relating to; animal housing; town and country planning; animal welfare; animal health, including salmonella, avian influenza and Newcastle disease; transport of poultry; animal markets; animal slaughter; food safety; environmental protection and integrated pollution control; and health and safety. [Source: ADAS Poultry legislation factsheet update prepared for Defra, March 2006.]

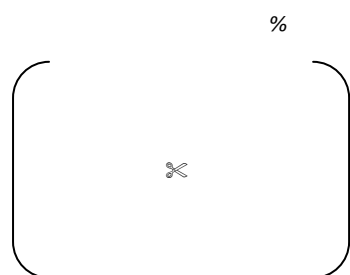
¹⁸[

be likely to increase costs by [X] per cent. There could also be significant increases in costs of organic eggs by about [X] per cent, as a result of organic regulations.

2.8 The Lion scheme, administered by the British Egg Industry Council (BEIC), operates in addition to the legal requirements referred to above. It was introduced in 1993 to reassure consumers about the safety of eggs and was updated in 1998 to include a vaccination programme against salmonella enteritidis. 85 per cent of eggs sold in the UK ([X]) are branded with the Lion mark. The Lion mark provides a guarantee that production quality and food safety standards have been met, including vaccination against salmonella, traceability of eggs and a best-before date. Several parties from whom we heard¹⁹ also referred to the Lion scheme as having helped to protect the UK market from imports.

2.9 The BEIC is itself an organisation of egg suppliers. There are 31 subscribers to the BEIC; the volume percentages of these members based on their declared throughputs of Lion shell eggs through their packing station, is summarised in Table 2.

TABLE 2 Percentage of Lion branded eggs, 2005



Source: BEIC statistics, supplied to us by the parties.

These figures overstate the parties' total share of egg supply in the UK, since they exclude the 15 per cent of production that is not of the Lion brand and the 7 per cent

¹⁹Including the British Free Range Egg Producers Association, and the main parties in the Parties' presentation to banks.

of consumption that is imported, but are nonetheless indicative of the relative scale of the main suppliers in the industry.

The role of the suppliers

- 2.10 The stages of egg supply are illustrated in Appendix C. Broadly they involve:
- (a) the production of eggs at farms, with associated activities including the supply of pullets (young hens); the supply of feed for hens; and, once the hen has reached the end of its economic laying life of about 75 weeks, the removal and processing of so-called 'spent hens';
 - (b) the sorting, grading and packing of eggs;
 - (c) the supply of eggs to retailers, catering and wholesale customers, or their use in processing (we refer to commercial egg processors as processors) to be sold on as processed eggs. There is also some supply via a wholesale (spot) market operated by the Central Egg Agency (CEA), particularly of surpluses of eggs; and
 - (d) the sale of eggs or egg products by those retailers, by foodservice customers and wholesalers and their end-customers, or by users of processed eggs to their end-customers.
- 2.11 As we discuss in paragraphs 2.14 and 2.15, Deans and Stonegate differed in the extent to which they produced their own eggs and undertook the other activities set out in paragraph 2.10(a), or contracted with independent producers or other companies to do so. The main activities of Noble, the combined company, are, therefore, in (b) and (c) above, namely to sort, grade and pack eggs from independent producers and its own farms for onward delivery to food retailers, wholesalers and foodservice distributors; and to process eggs for the catering and foodservice manufacturing market. Their role was described to us as to a large

extent one of consolidation and coordination of the various stages of egg supply to meet the demands of customers.

The companies

2.12 As suggested in Table 2, before the merger Deans was the largest supplier, and Stonegate the second largest supplier of shell eggs and processed eggs in the UK.

2.13 As noted in Appendix B on the companies and the merger transaction, in the year to September 2005, Deans, based on its statutory accounts, had a turnover of £314 million, an operating profit of £7.2 million, and average operating assets of £50 million. The turnover of Stonegate was £103 million, with an operating profit of £2.4 million and average operating assets of £24.4 million. As also noted in Appendix B, the growth of both companies had been primarily as a result of acquisition—there had been five main acquisitions by Deans since 1997, and three by Stonegate since 2001—but they had also grown organically.

2.14 Deans is a company with national coverage and currently operating at almost all levels of the shell and processed egg supply chain. Deans produces its own feed, and owns or contracts: farms that produce fertile eggs, pullets or shell eggs; hatcheries producing day old chicks; egg packing centres; factories for producing egg products; and a hen processing factory for producing poultry meat from spent hens. It also supplies pullets, feed and spent hen processing to other producers. Almost [redacted] of Deans eggs are produced for it by independent producers. [redacted]

2.15 Stonegate is less vertically integrated than Deans. It has no breeding farms or hatcheries, so it buys in day-old chicks from third parties; nor does it have any spent hen facilities, and it has limited feed production. [redacted] per cent of the eggs supplied by Stonegate are produced for it by independent producers. [redacted] It also no longer has

its own egg processing facilities, all of the processed eggs it supplies being processed for it by third parties. It supplies shell eggs to only one retailer in [X] and one in [X].

2.16 Goodmix Limited was incorporated for the purpose of effecting the merger between Deans and Stonegate. It changed its name to Noble Foods Limited soon after the merger.

Parties' rationale for the merger

2.17 As the parties told us in their submission (reproduced on our web site) both Deans and Stonegate aimed to be least cost operators seeking cost efficiencies across their respective businesses in order to respond to the demands of what they regarded as a fiercely competitive retail environment and to enable them to pay producers a price which allowed them to cover their increasing costs and make a sufficient return for the future.

2.18 For Deans, one of the stated objectives of the merger was to facilitate Peter Dean's move from the day-to-day running of the Deans business to the role of Chairman of the merged business going forward, while also realising part of the value of his investment. [X] But also as part of its objective to be a least cost operator Deans believed a combination with Stonegate would provide further scope for rationalization, permitting larger cost reductions (through reductions in egg wastage, reduced central overheads and packing costs) than could otherwise be achieved.

2.19 For Stonegate, one of its stated strategies was to seek volume growth to allow fixed costs to be spread as widely as possible throughout its operations. The application of its new model [X] to the large packing operations of Deans would provide scope for increased efficiencies; reductions in wastage could also be achieved by

concentrating the packing of higher value eggs at one centre. In turn the business could pass on these efficiencies to satisfy what it regarded as the inevitable demands from retailers for lower prices and to enable it to pay producers a price which sustained long-term investment.

2.20 Among the benefits the parties cited to us were savings that could be made by better matching the profile of egg purchases to the profile of demand (each company previously having to buy more eggs than needed, to ensure they had sufficient eggs of the right type to meet customer demand). The larger entity would be able to manage the risks of mismatches with a proportionately smaller buffer stock.

2.21 [✂]

3. The counterfactual

3.1 In order to assess the effects of the merger, we have to consider the counterfactual, ie what would have happened in the absence of the merger. As evident from the recent financial performance of the companies summarised above, they were both profitable before the merger. Deans' recent business plans showed it had a clear strategy as an independent company. [✂]

3.2 We have therefore seen nothing to suggest that in the absence of the merger Deans and Stonegate would not have continued as separate companies and to compete with each other. Even had Deans been sold to or merged with another company or even another egg supplier, there is no reason to expect that this could have resulted in any change in the structure of supply of shell eggs or liquid eggs similar to that which results from the current merger. There is therefore no reason to believe that, in the absence of the merger, the market structure prevailing before the merger could not have been sustained.

4. Issues

- 4.1 In its press notice issued at the time of the reference, the OFT said that the merger had given Noble Foods around 60-70 per cent of supply to retailers and over half of the supply of liquid eggs to processors, and it was concerned about the reduction of competition as a result.
- 4.2 During the course of the inquiry, as well as almost 30 letters commenting on the merger in response to a general request for views, we received 15 responses to a questionnaire sent to shell egg customers (retailers, and catering and wholesale customers), 11 responses to a questionnaire sent to larger liquid egg customers;²⁰ 10 responses to questionnaires sent to smaller liquid egg customers; and about 70 responses to a questionnaire sent to producers. We also had a number of hearings with trade associations, competitors and customers. As well as the information provided, we received a wide range of views on the effects of the merger.
- 4.3 A minority of the retailers from whom we heard expressed concern about the effects of the merger, in particular, [redacted], [redacted] and [redacted]; [redacted] also expressed concern about the merger removing a large participant from the market and an element of choice. Among the main concerns of those retailers were that before the merger, Deans and Stonegate were the two largest packers with a high degree of rivalry between them; in negotiations this was used to play off one against the other, and hence created competition. Amongst the comments from the retailers who were concerned were that there were cost and coverage disadvantages of using suppliers other than Deans and Stonegate; that there would be difficulty in switching, due to limited availability of eggs and to no other suppliers having sufficient capacity to provide an alternative to Noble; that they had a strong preference to offer British eggs and were

²⁰These customers were among the 30 largest customers of Deans and equivalent size for Stonegate.

reluctant to import; and hence that there would be a loss of competition and adverse effects on prices and innovation.

- 4.4 Of 10 small liquid egg customers who responded to questionnaires, three were to some extent concerned, referring to the resulting highly concentrated market, effects on service levels, [§]. However, the majority (eight of twelve) large liquid egg customers responding to our questionnaire were concerned about the effect of the merger on competition given the large capacity and market share of Noble compared to its competitors, and the disadvantages of using smaller competitors, imports, or powdered eggs as an alternative.
- 4.5 Some concern was also expressed by 43 producers or associations of producers, including 31 of about 70 respondents to a questionnaire sent to farmers (although several other producers were more concerned about the power of retailers rather than the effects of the merger and some were positive about the effects of the merger). Among the main concerns were that there would be limited options after the merger, particularly if local packing centres were closed, with particular concern from a number of producers in parts of the South West; that Noble could dictate how it wanted a business operated—it could reduce egg prices, competition to buy from producers having been lost, and require various rules and regulations to be met; that it had the ability to tie up producers in long-term contracts that would include supply of input such as feed and pullets; that new competition would require new production facilities, leading to surplus; and that it could exercise undue influence on the BEIC, the main trade association.
- 4.6 The parties argued that two main factors would ensure the merged company would not have market power in supplying retail customers. First, the bargaining power of their customers, and their ability to switch, or threaten to switch business to smaller

competitors or to imports. Secondly, the existence of such smaller competitors with the ability to access eggs. These two factors applied across the board; even marginal switches of supply, for example to individual depots of major retailers, would prevent the merged company increasing prices or reducing service. As to concerns from some farmers, it said that the merged business was dependent on egg producers; increased prices particularly to free range and organic producers would be necessary to ensure adequate growth in egg supply, while driving prices down would encourage producers to supply Noble's competitors instead. As to concerns about processed eggs, it argued that customers could switch to powdered eggs, to imports, or to other UK suppliers.

4.7 In order to consider the effects of the merger on competition, we first examine the relevant markets affected by the merger; then the effect of the merger on competition within these markets; and finally the possible adverse effects of any SLC by which the merger could adversely affect competition.

5. The relevant economic market(s) affected by the merger

5.1 We discuss definition of the relevant markets affected by the merger in more detail in Appendix D. As stated in the CC's merger guidelines,²¹ the generally accepted conceptual approach to identifying the relevant market is to consider whether a hypothetical supplier of a certain product or service could profitably implement a small but significant non-transitory increase in price (SSNIP) (for which a 5 per cent price increase is taken). If any such small price increase were profitable and could be sustained, the product/service could be regarded as capable of being monopolized and would therefore be considered a distinct market. Against this criterion, we examine in turn the possible relevant markets for shell eggs, firstly primarily in the context of supply to retailers about which, as noted in paragraph 4.1, the OFT was

²¹ CC2, *Merger References: Competition Commission Guidelines*, June 2003, paragraph 2.4.

primarily concerned; and then in the context of supply to catering and wholesale customers, including whether this can be regarded as a separate market from supply to retailers. We then consider the relevant markets for processed eggs, although recognising, as we also discuss further below, that supply of shell eggs and supply of processed eggs may themselves to some extent be related; and finally upstream markets.

Shell eggs

- 5.2 As noted above, there have been significant differences in the growth of demand for different types of eggs, particularly for retail sale. The demand for cage eggs has been gradually declining, although they still account for about 60 per cent of retail sales.²² Demand for free range eggs, on the other hand, although more expensive to produce and with substantially higher retail prices than cage eggs, has been growing at about 10 per cent a year for at least the last 7 years, and they now account for about 30 per cent of retail sales. The balance is accounted for by barn eggs, about 6 per cent of demand and recently growing at about 3 per cent a year; and organic eggs, about 3 per cent of demand but recently growing at about 7 per cent a year.
- 5.3 We consider in Appendix D whether there could be separate product markets for each of these four categories of shell eggs—cage eggs; barn eggs; non-organic free range eggs; and organic free range eggs—particularly for supply to retailers.
- 5.4 We considered demand both by final consumers in purchasing eggs from retailers, and by retailers in purchasing eggs from suppliers. As noted in Appendix D, at the retail level, customer responses appear to indicate that final consumers generally do not substitute between different types of eggs in response to small changes in price, suggesting that the SSNIP test would therefore reveal different markets for those

²²As shown, for example, in Mintel Eggs, Market Intelligence, June 2006.

separate types of eggs. In particular, some consumers strongly prefer free range eggs, for which they are prepared to pay a price premium, given their concern for animal welfare; or organic eggs, with an even greater price premium, given their general preference for organic products. One retailer, for example, confirmed that, in its view, an increase in the price of organic eggs would not reduce demand. Although the parties did not agree with different categories of eggs being regarded as separate markets, we noted that, during the current shortage of free range eggs to which we referred in paragraph 2.4, cage egg orders had been largely unaffected, contrary to what might be expected if there were substitutability of demand between cage and free range eggs. We also note in Appendix D, that when one retailer reduced the price of organic eggs it had no impact on the share of organic eggs as a proportion of all egg sales. We also note in Appendix D, Annex A clear evidence that [redacted] in free range eggs have no impact on sales of cage eggs or vice versa. (However, we have no clear quantitative evidence on barn eggs.)

- 5.5 This does not preclude that there may be greater substitutability at the level at which the parties operate, namely of supply to retailers. However, retailers' responses to our questionnaire indicate that their choices are largely driven by consumer preferences, and that most types of eggs (with the likely exception of barn) are Known Value Items (KVIs)²³ and/or must-stock Items. Analysis in Annex 2 of Appendix D of Deans' prices and volumes to one multiple retailer, [redacted], showed that [redacted] free range egg prices did not appear to impact on sales of cage eggs or vice versa. It also showed that the retailer's demand for one free range pack size appeared to be largely unaffected by an increase in prices it paid over that period. This analysis suggests separate markets for different categories of eggs also at the level of supply to retailers.

²³A product which is high profile or well known, where price awareness among consumers may be higher than for most products. The perception of which products are KVIs may vary among retailers.

- 5.6 But of the four types of eggs, the evidence on the extent to which consumers would substitute between barn eggs and cage eggs in response to changes in their relative prices was less conclusive. Barn eggs and cage eggs are both regarded as 'intensive' forms of production, unlike free range and organic products, although barn hens require significantly more space than cage hens; it was also suggested to us by a trade association and one supplier that consumers did not understand the concept of barn eggs as much as free range. We have also noted above that there has been less growth in demand for barn than for free range eggs; and they are not regarded by retailers as a KVI or must-stock item to the same extent as other types of eggs, some retailers not stocking them.
- 5.7 On the supply side, substitution at the supplier/packer level with which we are primarily concerned would appear to be relatively easy, but only if supplies of contracted eggs are available, or if production—whether the in-house production of a supplier with its own production facilities, or production by farmers contracted to a supplier—could be switched between different types of eggs in response to changes in relative prices. Supply-side substitution at the packer level depends to a large extent therefore on supply-side substitution at the producer level. The difficulty for a packer in switching between different types of eggs is illustrated by current shortages of free range eggs.
- 5.8 As shown in Table 3 different types of eggs have different cost structures—in particular free range and organic eggs requiring more land than cage or barn eggs—resulting in significant differences in production costs.

TABLE 3 Deans Foods production costs for the year to end of August

	Organic	Free range	Barn	Cage
Feed				
Bird depreciation				
Mortality				
Wages				
Direct expenses				
Capital depreciation				
Total p/dozen				

Source: Deans.

Notes:

1. Feed: [X]. Feed consumption increases with bird activity and exposure to lower temperatures.
2. Mortality: Is higher in free range situations where there is greater risk of predators.
3. Wages: As flock size and level of automation decreases there is a steep rise in the wage cost.
4. Direct expenses: A similar effect to that on wages.
5. Capital depreciation: The high organic cost reflects the recent heavy investment in production and the high initial cost per bird due to the low enforced stocking densities.

5.9 Switching production between different types of eggs is generally difficult, at least within the one-year timeframe referred to by CC guidance, and costly (which we discuss in paragraph 6.34). Conversion of cage or barn egg facilities to free range requires availability of surrounding land, and can require planning permission. Conversion to production of organic eggs can require a further period of up to two years for the land to meet the requirements of the organic certification bodies.

5.10 Converting a facility currently used for cage eggs to use for barn eggs may, however, be more straightforward if it were economic to do so. On the other hand, the figures in Table 3 suggest that, given the significantly different costs of cage and barn eggs, supply side substitutability between them may nonetheless be limited in response to smaller changes in price. The evidence as to whether barn eggs are a separate relevant market is therefore inconclusive on both demand-side and supply-side substitutability. Whether or not there is a distinction between barn and cage eggs does not affect our conclusions of whether the merger may be expected to result in an SLC: hence we did not need to take a final view on whether barn eggs can be regarded as a distinct relevant market, but for the purpose of our analysis and given the possibility of greater, if still limited, supply-side substitutability between barn and

cage than between barn and free range eggs, we treat them in the same market as cage eggs.

5.11 The above factors suggest to us that, on the basis of demand-side or supply-side substitutability, it is valid to distinguish relevant markets, in each of which a hypothetical monopolist would be able profitably to implement a 5 per cent price increase (the SSNIP test) for supply to retailers of: cage eggs (with which, for the purpose of our analysis, we include barn eggs); non-organic free-range eggs; and organic eggs.

5.12 We noted in paragraph 2.8 the role of the Lion mark, and considered whether there are separate product markets in each of the three categories specified above for shell eggs bearing the Lion mark; and for non-Lion or unbranded shell eggs. Retailers appear reluctant to switch to non-Lion eggs, unless they can otherwise be assured about their provenance and safety, but have sometimes done so. There is also one other quality assurance scheme—Laid in Britain—formed from a consortium of independent egg producers who market their produce on a regional or local basis. The treatment of Lion or non-Lion eggs as separate markets or otherwise is unlikely to have a significant impact on the analysis of competitive effects as all of the parties' major competitors supply Lion brand eggs, hence we have included non-Lion eggs in the same market as Lion eggs in our analysis below. We discuss the Lion mark, however, in our consideration of potential import competition.

5.13 It is also in our view appropriate to distinguish a relevant market for catering and wholesale customers (the bulk of which, as noted in paragraph 2.5, is believed to be accounted for by foodservice customers or companies serving restaurants or caterers) separate from those for supply of shell eggs to retailers, although the parties did not accept this. As noted in Table 4 below, although smaller suppliers can

and do supply large retailers, at least to a limited extent, Deans and Stonegate supply a significantly larger share of eggs to retailers than to catering and wholesale customers, suggesting significant differences in the requirements to supply the two markets. The parties themselves said that their processes and staffing levels were more geared up to packing of eggs as required by retailers, rather than merely putting them on trays as required, for example, for the catering sector.²⁴ Security of supply is particularly important to retailers, for which they maintain longer-term relationships with suppliers than, we were told by the parties, is the case with foodservice customers. [REDACTED] Most foodservice customers and wholesalers also give less importance to the category of eggs supplied, predominantly using cage eggs although we are aware of some customers only using free range eggs. We do not, however, preclude there being an asymmetric market definition: in the event of a 5 per cent price rise, suppliers to retailers could expand their supply to catering and wholesale customers, but not necessarily vice-versa; however, this would not affect the conclusion we reach below on the effects of the merger on the catering and wholesale markets.

- 5.14 We therefore distinguish four relevant product markets for the supply of shell eggs which, in our view, would satisfy the criterion set out in paragraph 5.1; namely, the supply to retailers of each of the three categories of cage and barn eggs, of non-organic free range eggs, and of organic eggs; and the supply of all shell eggs to catering and wholesale customers. But, although there are such different markets particularly for supply to retailers, some of the factors discussed below apply across many of those categories, and for current purposes are to some extent treated together; we will consider factors which may not apply across the board separately

²⁴[REDACTED]

as appropriate. In practice, moreover, the statistics available for the industry do not fully distinguish between these markets.²⁵

Geographical markets for shell eggs

Supply to retailers

5.15 For the reasons set out in Appendix D, it is unlikely that the relevant geographic market for any of the above three categories of shell eggs to retailers is currently any wider than the UK. This is because:

- (a) Only a small proportion of shell eggs used in the UK—some 7 per cent—are imported (although, as noted above, the level of imports has recently increased due to the shortage of free range eggs). But even that limited level of imports is believed to be primarily for non-retail use—particularly for processing.
- (b) Most retailers state that they are committed to the Lion brand and have buy British policies.
- (c) Retailers put a high premium on security of supply, and state that they would be unlikely to switch to imports in the event of a 5 per cent increase in price in any of the three categories of shell eggs.
- (d) Although we are aware of one of the smaller multiple retailers which has imported eggs intermittently for some time, most retailers have not sourced from abroad in the past nor, they told us, threatened to do so in negotiation, in any of the three categories of shell eggs.
- (e) The recent initiative, by Noble and by a retailer, to import French eggs is in response to an unprecedented shortage of eggs, to which we referred in paragraph 2.4 and which the parties acknowledged was exceptional; this stimulus would appear greater than the small price increases we use for the purposes of market definition.

²⁵The Mintel report does distinguish supply to retailers of the total number of cage, free range, organic and barn eggs, but was believed by Noble to underestimate the total size of the retail market.

- (f) The parties agreed that the relevant geographic market for supply to retailers is no wider than the UK, given, as they put it, the realities of the market. Nonetheless they believed there was significant potential competition from imports, which we discuss below in our consideration of the competitive effects of the merger.

However, our conclusion that there is a UK market does not preclude our consideration of competition and potential competition from imports within the UK market, which we discuss in paragraph 6.44 et seq.

5.16 We also considered whether geographic markets for the supply to retailers of any of the three categories of shell eggs described above could be somewhat narrower than the UK as a whole. The evidence was not consistent on this point.

- (a) Transport costs vary to some extent by distance,²⁶ but also depend on whether delivery is to depots or individual stores and frequency of delivery. [REDACTED] But we have been told pallet size—and therefore transport costs—may vary for different types of eggs: for example transport costs may be larger for more specialist eggs.
- (b) On the other hand, multiple retailers contract volume (but not price) distribution depot by depot.
- (c) There is a 28 day window between egg laying and the ‘use by’ date, hence a longer transport time could slightly reduce the available display time. But an additional half day transport time is unlikely significantly to limit the ability of customers to substitute to suppliers located further away.
- (d) Competitors appear to supply the depots nearest to them, but also appear relatively confident that (for depot delivery) they can supply over a wide area.

²⁶The parties quoted average transport costs of [REDACTED] per dozen eggs, but less—[REDACTED]—for a full lorry; and suggested that these costs could vary by about [REDACTED] according to distance. Other suppliers quoted a significantly larger cost for transporting, for example, to Scotland.

- (e) There are significant differences in the geographical pattern of supply of Deans and Stonegate, which appear to reflect the location of their packing stations: [redacted].
- (f) We understand there is some sale of 'Scottish' eggs in Scotland and have also seen published estimates²⁷ of one of the other suppliers, Glenrath which is based in Scotland, accounting for the majority of supply in Scotland; although we are also aware of Scottish suppliers supplying depots in Yorkshire and English suppliers supplying retail outlets in Scotland.
- (g) Although we are aware of a Northern Irish supplier shipping eggs to GB, we understand few, if any, GB suppliers send eggs to Northern Ireland, which could suggest an asymmetrical market definition. But [redacted] supply Northern Ireland, hence it is not necessary for us to reach a view on whether it is a separate retail market, but supply by the Northern Irish supplier to GB is clearly relevant in our consideration of competition.

5.17 The above considerations apply to each of the three categories of shell eggs. On balance, they suggest that the relevant markets for the three categories of shell eggs described above are more likely to be national rather than regional. [redacted] and Stonegate only supplies to Scotland on a limited scale, so whether either Northern Ireland or Scotland are separate markets does not materially affect our analysis.

Supply to catering and wholesale customers

5.18 The factors set out in paragraph 5.15 suggesting that the relevant geographic market for supply of shell eggs to retailers is unlikely to be wider than the UK also to a large extent apply to supply of shell eggs to catering and wholesale customers. Of five catering and wholesale customers responding to our questionnaire, four had not imported nor threatened to do so; and the other gave no answer. Three said they

²⁷Mintel: Eggs, Market Intelligence, June 2006.

would not switch to a supplier outside the UK in the event of a price rise, one gave no answer, and one said all options would be considered. The market for catering and wholesale customers would therefore also seem likely to be a UK rather than a wider market. We saw no evidence to suggest it would be narrower than the UK.

Processed eggs

- 5.19 The parties agreed there was a separate market for hard-boiled eggs, these being used for different purposes than other processed eggs, and, as noted in paragraph 2.6, tending to use different, ie small, eggs.
- 5.20 The parties also argued that liquid and powdered eggs are functionally identical across a wide range of applications, that price is a factor in the decision to substitute, and therefore that on the demand side, substitution to powdered eggs by customers would prevent a SSNIP in liquid eggs. They appear to concede that supply side substitution from liquid to powder egg is not easy.
- 5.21 The parties provided us with details of customers using both powder and liquid egg, but this does not necessarily mean such customers would switch between them in response to changes in relative prices. Their evidence included internal memoranda referring to [REDACTED].
- 5.22 Responses we received to a questionnaire we sent to Deans and Stonegate liquid egg customers indicated that for many customers liquid and powdered eggs are not substitutable. Only [REDACTED] per cent by value of Deans and Stonegate customers responding said they would switch to powdered egg in response to a 5 per cent price increase, while [REDACTED] said they would not do so (the remainder giving no answer); the respondents represented [REDACTED] the value of the parties' liquid egg sales. Some customers stated that powdered eggs produced an inferior final product, others that

they did not have the facilities to use powdered eggs, so it is likely that they would absorb a 5 per cent increase in liquid egg prices. A further disadvantage of powdered eggs for some manufacturers and retailers is that their use has to be specified on a product's labelling. The parties themselves acknowledged the preference of some customers to use powdered eggs, and of others to use liquid eggs.

5.23 The parties estimated that sales volumes would need to decrease by approximately [X] per cent to render a 5 per cent increase in price unprofitable. But on the basis of the above evidence, the number who would switch in response to a 5 per cent price increase would be small, and likely to be insufficient to prevent such a price increase being profitable given that costs would be to some extent variable with the volume of liquid egg supplied. In addition, there are no list prices for liquid eggs, all prices being negotiated. Even if there were sufficient marginal customers to render a general price rise profitable, a hypothetical monopolist may be able to price discriminate between marginal and non-marginal customers. Given the individual negotiation of terms with customers, and the limited shelf life of liquid eggs which limits the scope for arbitrage between customers, the parties may be able to discriminate between those who would and would not switch in response to a price increase.

5.24 The parties also provided pricing data that showed that prices of liquid egg and powdered egg were correlated over time. However, as we discuss in Appendix D, correlation in prices can be as a result either of substitution between the two products in response to small changes in relative prices, or can reflect common cost or demand movements. In the absence of strong evidence, from customers, of substitution by customers between liquid and powdered eggs it would seem more likely that the observed correlation in prices is as a result of common cost

movements, since both liquid and powdered egg use shell eggs as their main input. The parties argued that if the observed correlation in prices of liquid egg and powdered egg was as a result of common cost movements, then there must be a wider geographic market for second quality eggs which are used as a main ingredient for liquid and powdered egg since all powdered egg is imported from outside the UK. However this is not necessarily the case, as common cost movements may also result from common fluctuations in feed prices, power costs or other costs.

5.25 We acknowledge, as indeed shown in the responses by one customer to our survey, that there may be some customers who purchase both liquid and powdered eggs, and would substitute between them in response to changes in relative prices. For those customers, liquid and powdered eggs could be regarded as constituting the same relevant market. But in our view, the scope for price discrimination, the extent of negotiation and the knowledge of the customer base that would result suggest that, from the perspective of many other customers, there are also likely to be separate product markets for the supply of liquid eggs and powdered eggs—ie that it would be profitable for a hypothetical monopoly supplier either of liquid egg or of powdered egg to implement a SSNIP—of which our main concern is the market for liquid eggs.

5.26 Information we received from the parties suggested that processed eggs had lagged behind retail shell eggs in the swing away from cage to free range but is increasing. Deans estimated that free range accounted in [redacted] for about [redacted] per cent of UK liquid egg sales, [redacted], but [redacted] multiple retailers now only stock free range egg products. [redacted]; such a price differential also suggests that free range liquid eggs and cage liquid eggs cannot be regarded as a perfect substitute. It is therefore also in our view

appropriate to distinguish between cage and free range liquid eggs as relevant markets; but we are not aware of any significant barn or organic liquid eggs products.

5.27 However, the production of eggs for processing, including processing liquid eggs, generally using ‘seconds’ not appropriate for retail sale or surplus eggs when available, is itself complementary to production of eggs ultimately for retail sale. Such eggs are procured from producers by parties/suppliers either for their own processing, or processing by other processors.

5.28 We have noted in paragraph 2.14 that Deans has its own processing activities and in paragraph 2.15 that Stonegate subcontracts its processing to [redacted] other companies. As we discuss in paragraph 6.71, the evidence we saw suggested that there may also be some economies of scope from supplying both shell cage eggs and cage eggs for processing; or both shell free range eggs and free range eggs for processing. However, while there would seem to be some advantage to supplying both shell and liquid eggs, it would not seem necessary to be a supplier of both.

Geographical market for liquid eggs

5.29 We accept that the market for powdered eggs, little of which is produced in the UK, is wider than the UK. But the parties also argued that the relevant geographic market for liquid eggs is at least as wide as the UK and Northern Europe, referring to low transport costs and the fact that they themselves supply customers in continental Europe. They also showed us internal memoranda of [redacted] customers who were importing or threatening to import liquid eggs, and other internal papers referring to the growing significance of competition from the Continent.

5.30 But the level of imports of liquid eggs is also low—about 9 per cent of the UK consumption of liquid eggs excluding liquid equivalent of powdered egg imports.

Customer responses to our questionnaire also again did not consistently support the parties' views. Some customers stated that they used a supplier from outside the UK. But somewhat [X] per cent of respondents by value said they would switch to a supplier outside the UK in response to a 5 per cent increase in price, and [X] said they would not do so. Most had not imported and others were reluctant to do so. The disadvantages of imported liquid eggs quoted to us include quality and food safety issues, the preference of some of their own customers for UK eggs, higher transport costs and longer transport lead times with the lesser flexibility of overseas suppliers to meet short-term fluctuations in demand, and the more limited supplies of free range eggs on the Continent. The need for reliability of supply seems partly attributable to the limited shelf life of some liquid eggs, nine to twelve days being quoted to us for some types of liquid eggs, reducing the amount that can be kept in stock.

5.31 In our view, given the negotiation of prices to users of liquid eggs and, [X], the parties would be in a position to [X] discriminate between customers on that basis. It is therefore in our view also appropriate to regard the supply of liquid eggs as a UK market for those customers for whom imports provide a poor substitute. We are aware of no substantial regional factors in supply of liquid eggs.

Upstream markets

5.32 We noted in paragraph 2.10 four upstream activities, each essential to the supply of eggs namely:

(a) The production of shell eggs and, conversely, the procurement of shell eggs from those producers. As discussed in paragraph 6.35, there are several hundred producers of free-range eggs in the UK, but a smaller number of cage egg producers. We noted in paragraphs 2.14 and 2.15 that the majority of the parties' supply of eggs are produced for it by independent producers. There

are minimal exports of eggs from the UK, and the majority of eggs produced by producers are supplied to the UK market via the parties or by other packers/suppliers, although some eggs are sold direct by independent producers to retailers, wholesalers or consumers.²⁸ As noted in paragraph 18 of Appendix F, the parties estimated that only some [X] per cent of the free range flock was not under exclusive contract.

- (b) The supply of pullets to egg producers. We noted in paragraph 2.14 that Deans' activities include the supply of pullets for its own use and, to a limited extent, to other producers. But smaller producers are particularly dependent on purchasing pullets.²⁰
- (c) The supply of animal feed to egg producers. We noted in paragraph 2.14 that Deans also supplies animal feed for its own use and, again to a limited extent, to other parties. Small producers are again particularly dependent on purchasing feed; we are aware of only six suppliers of feed in the UK.²⁰
- (d) The supply of spent hen processing services (or the purchasing of spent hens). We noted in paragraph 2.14 that Deans supplies such services; we are aware of only three other suppliers.

5.33 We saw no evidence on the extent to which demand for any of the above activities was responsive to prices:

- (a) The price paid to producers for eggs—and the rate of return on investment on egg production—does to some extent influence the level of production over time: we refer in paragraph 6.38, for example, to concerns that current levels of prices are insufficient to encourage expansion of free range egg products. The value of egg production is also to some extent sensitive to the relative profitability of producing eggs compared to other agricultural activities. But we

²⁸The structure of egg production in England: Report on a national survey of egg producers, University of Manchester, School of Economics Studies Farm Business Unit, April 2003.

note in paragraph 6.35 et seq, that the extent to which egg production could be expanded in response to higher prices is likely to be limited in the short-term; hence the degree of responsiveness in the short term to changes in relative prices is likely to be insufficient to satisfy the criteria of the SSNIP test.

- (b) The effect on the volume of egg production of changes in prices for pullet, feed or spent hen processing services is also likely to be limited, since these each represent only a minority of production costs. Nor have we seen any suggestion that smaller producers in particular would, in response to relative price changes, substitute purchases of pullet, feed or spent hen services by supplying their requirements themselves.

For the purpose of our analysis, as the parties agreed, it would seem appropriate to regard these as relevant markets.

- 5.34 However, in considering upstream markets, particularly of egg production, and the relationship between producers and suppliers, concern was also expressed to us that only Deans and Stonegate acquire eggs from producers in parts of the South West. The parties argued that there was one other supplier in Cornwall, but its market share remains small. It also referred to another packer/supplier competing to acquire eggs from the west of Wiltshire, which is, however, still a considerable distance from Cornwall and Devon which was the source of most concerns. The distances noted above between producer and packer would suggest a limited range over which eggs could be supplied from parts of the South West, consistent with a narrower geographic market for supply of shell eggs by producers to suppliers in parts of the South West.

6. Assessment of the competitive effects of the merger

- 6.1 We need to consider whether the merger compared with the counterfactual may be expected to result in an SLC within the relevant economic markets.

6.2 The analysis of market shares can provide important indicators of the nature of competition within a relevant market, and the impact of a merger on that market. We have noted in paragraph 3.2 that there is no reason to believe that, in the absence of the merger, the market structure prevailing before the merger could not have been sustained. Deans and Stonegate also confirmed that before the merger they were effective competitors to each other and to other suppliers in the industry. [REDACTED]

6.3 Table 4 summarises the estimated share of supply of different types of eggs, by different types of customer, and by different stages of production before the merger (although, given available statistics, these do not correspond exactly to the relevant markets defined above). On the basis of market shares in 2005, the merged company would, for example, account for about [REDACTED] per cent of total shell egg supply in the UK. It would also account for over [REDACTED] per cent of liquid egg, and powdered egg equivalent supply in the UK, but over [REDACTED] per cent excluding such powdered eggs. There are higher market shares in several categories of supply. However, these estimates are primarily based on those of the parties, which in turn assume imports of each type of egg—statistics for imports only being available for shell eggs as a whole—in proportion to the share of each type of egg in UK production. Since we have been told that imports are primarily of cage eggs, this may overstate the level of imports, and somewhat understate the parties' shares, of free range eggs. Hence we also show alternative estimates of their share by type of egg based on their supply in relation to UK production which may be a more accurate measure of their share of supply for free range eggs. The percentage of UK egg production of all types supplied by the parties (whose imports of eggs have previously been very limited) is itself, however, of interest in considering the possible upstream effects of the merger.

TABLE 4 Estimated shares of supply, 2005

per cent

	Parties' estimates based on UK production plus imports			Alternative estimate based on UK production			
	Stonegate	Deans	Total	Stonegate	Deans	Total	
Total shell egg supply	<div style="border: 1px solid black; border-radius: 50%; width: 100%; height: 100%; display: flex; align-items: center; justify-content: center;"> } </div>						
Lion branded shell eggs							
<i>By type of eggs</i>							
Free range egg (including organic)					<div style="border: 1px solid black; border-radius: 50%; width: 100%; height: 100%; display: flex; align-items: center; justify-content: center;"> } </div>		
Barn eggs*							
Cage eggs							
Lion brand free range (including organic eggs)						✂	
Lion brand barn eggs							
Lion brand cage							
<i>By customer</i>							
Supply to retailers							
Supply to catering and wholesale Customers			✂				
Supply to processors							
<i>Processed eggs</i>							
Supply of liquid eggs and powdered egg equivalent							
Supply of liquid eggs (excluding powder egg equivalent imports)†							
Supply of hard-boiled eggs							
<i>By stages of production</i>							
Production of shell eggs							
Supply of pullets (external market)							
Spent hen processing							
Supply of animal feed‡ (external market)							
Egg packing							

Source: CC from Deans and Stonegate data.

*[redacted]

†Deans and Stonegate also provided estimates of their shares of liquid and powdered eggs in Northern Europe of [redacted] per cent and [redacted] per cent respectively.

‡[redacted]

Note: The alternative estimates are based on UK production. This may be appropriate for free range eggs, for which the level of imports is likely to be very low.

6.4 As noted in Appendix E on Competitive Effects, the shares of supply show that the post-merger market share is high in many markets and the increment to that share significant. Larger market shares may be indicative of greater market power, loss of rivalry, and the ability of a merged firm to increase prices without a sustained reaction, in circumstances where the merging firms would not have had a similar incentive had they continued as separate independent firms, and the loss of business following a price increase would be greater. Such increases in market shares after the merger can therefore provide important indicators of the nature of competition within the relevant market, and the impact of a merger on that market. But the

increase of market shares is only one factor in our analysis of whether the merger has resulted or may be expected to result in an SLC. We also consider, for each of the relevant markets identified:

- (a) whether customers are able to switch to other, smaller suppliers to the extent necessary to provide a source of effective competition;
- (b) whether the potential for entry and expansion (by current suppliers) into supply of shell and processed eggs will act as a competitive constraint;
- (c) whether there is potential competition from imports; and
- (d) whether the bargaining power of customers will prevent the exercise of any market power of the merged company.

We consider each of the above for the three categories of supply of shell eggs to retailers, the evidence from retailers we received applying to a large extent to all three categories; then for supply to wholesalers; and finally for liquid and hard-boiled eggs. We then consider the possible upstream effects of the merger.

Supply of shell eggs to retailers

Switching

6.5 As shown in Table 4 and as noted by the OFT, following the merger Deans and Stonegate would account for over 60 per cent of sales of shell eggs to retailers ([X] per cent, as shown in Table 4).²⁹ We do not have separate figures for shares of supply of different categories of eggs to retailers, but based on the varying shares of supply of shell eggs as a whole, shares could be somewhat higher for free range eggs. Before the merger, a customer of Stonegate would have the choice of

²⁹We noted estimates by Mintel of the merged entity having a somewhat higher share of—72 per cent—of supply to retailers, as shown below. The parties believed the Mintel report underestimated the total size of the market.

Mintel estimates of leading suppliers' share of UK retail egg market, per cent	
Deans	44
Stonegate	28
Glenrath	7
Friday	6
Oaklands	6
Others	9

switching, or threatening to switch, to Deans, a company more than double Stonegate's size. Although Stonegate, in comparison, may appear a weaker alternative for an existing customer of Deans, it was nonetheless the largest supplier to one major retailer ([REDACTED]) and had previously supplied between 40 and 50 per cent of supply to others ([REDACTED]). As indicated in Table 2, the next largest supplier [REDACTED] is less than [REDACTED] the size of Stonegate in terms of total supply of Lion branded eggs, and less than ([REDACTED]) the size of the merged company. Switching a significant proportion of a retailer's requirements to a smaller supplier would, particularly for larger retailers, require confidence that the supplier could demonstrate it had adequate supplies, since, if it proved unable to supply, retailers would be inadequately stocked; we also note in paragraph 87 of Appendix E that the majority of retailers responding to our customer questionnaire said it would not be viable to switch to a range of smaller suppliers and that they would have to accept less favourable terms from the merged company. The potential for customer switching, particularly on the figures in Table 4 by retailers, would therefore appear likely to be much reduced as a result of the merger. Such an effect of the merger on market shares would therefore suggest that it has resulted in a significant loss of rivalry between the two major suppliers, with no alternative supplier of remotely equivalent scale or able to offer an equivalent source of rivalry or competition.

6.6 The parties, however, argued that all customers use smaller competitors, and that they could easily switch sufficient volumes to these smaller customers in the face of a price rise by Noble.

6.7 However, as we note in Appendix E, the parties' shares have been largely stable over time, except for acquisition, as the parties acknowledged.³⁰ The parties have argued there has been considerable churn—ie losses and gains—within the overall

³⁰RBB Economics, paper to OFT, Evidence of No SLC from Creation of Noble Foods.

market share figures. The parties' sales data and customers' purchasing data suggest, consistent with other evidence, that Deans and Stonegate have been close competitors; but we saw no clear evidence that switching to smaller competitors is any larger than would be expected on the basis of their market shares.

6.8 The parties provided us with a series of examples, before and after the merger, of retailers switching part of their requirements (often for specific depots) from themselves to smaller suppliers, or threatening to do so, in order to improve terms or ensure that adequate supplies were maintained during the recent shortage of free range eggs. They also provided us with an analysis of the proportion of Deans and Stonegate business won from or lost to the other since 2001: some [redacted] per cent of Deans' business won or lost in that time was won from or lost to Stonegate; and [redacted] per cent of Stonegate business won or lost was won from or lost to Deans. But we noted that:

- (a) [redacted] per cent by volume of Deans business won or lost in [redacted] was won from or lost to Stonegate; in [redacted] it was [redacted] per cent. [redacted] per cent of Stonegate business won or lost in [redacted] was won from or lost to Deans; in [redacted] it was [redacted] per cent. [redacted] As noted in Appendix B, however, contact between Deans and Stonegate concerning a merger had first been made in [redacted], and discussion with advisers commenced in [redacted]. But the information provided to us by the parties also showed that the switching in [redacted] included one multiple retailer ([redacted]) transferring [redacted] of its business, over a [redacted] year period, from Stonegate to Deans; another ([redacted]) transferring over a [redacted] year period [redacted] of its business from Stonegate to Deans; and a third ([redacted]) transferring [redacted] per cent of its business in [redacted] from Stonegate to Deans;
- (b) the analysis also included supply to wholesalers ([redacted]). For supply to retailers alone, [redacted] of Deans' business won or lost over the period was from or to

Stonegate,³¹ [REDACTED]. [REDACTED] and which therefore is no longer a competitor to the merged company. About [REDACTED] per cent of Stonegate's supply to retailers won or lost over the period was won from or lost to Deans, as was about [REDACTED] per cent of its supply to the largest retailers; and

- (c) on the parties' analysis, therefore, most of the switching by the largest multiple retailers that has occurred has been to or from, and often between, Deans and Stonegate, as have been the largest cases of switching.

6.9 We also asked customers for information about their suppliers. As we note in Appendix E:

- (a) it appears that there has been some large-scale switching between Deans and Stonegate, in particular, for the larger retailers. There is clear evidence of large-scale switches in supply between the parties for [REDACTED].³² There is also evidence of smaller-scale switching between Deans and Stonegate for [REDACTED].
- (b) There are also some examples of relatively large-scale switching to other suppliers; however, the use of smaller suppliers such as Fridays and Oaklands is more apparent for smaller customers. We have one clear example of a customer switching a substantial proportion of its requirements to a smaller supplier, when [REDACTED] switched approximately 2,000 cases a week from Stonegate to Oaklands in December 2005.
- (c) The majority of respondents in the large retailer and middle-ground customer groups indicated that switching, other than between Deans and Stonegate, was relatively difficult, took time to implement and would require careful planning.

³¹[REDACTED]

³²[REDACTED] switched away from Stonegate to a combination of Deans and Glenrath.

This was particularly the case when attempting to switch large volumes between suppliers.³³

6.10 The parties claimed that several multiple retailers preferred to be supplied by either Deans or Stonegate plus one or more smaller suppliers and argued that this showed that they relied on the smaller suppliers as a competitive discipline: [REDACTED]. But we find it difficult to accept that the presence of another main supplier, to whom the majority of business can be switched, is not a powerful competitive discipline should performance prove unsatisfactory: as evidenced by the switching of particular multiple retailers between the two main suppliers that has on several occasions occurred.

6.11 The parties acknowledged that as a result of this merger the ability to switch material volumes between Deans and Stonegate had been lost: [REDACTED]. But in our view switching between Deans and Stonegate remained a key competitive response for multiple retailers before the merger, particularly the largest, and one that has been exercised, notably on several occasions in 2004 as the parties' figures showed, and on two occasions shortly after the time of the merger. The option of switching a large volume of business from one major supplier—for example, all or the majority of a major retailer's business—to another has effectively been removed by the merger.

6.12 Switching by multiple retailers between suppliers is indeed infrequent and when it occurs is based, not on price competition, or any tender results alone, but on the negotiation of a full supply package including reliability of supply, confidence in the suppliers' own supply chain and in some cases the need for a main supplier to offer additional services such as help with category management, as well as price. The

³³Some middle-ground customers, [REDACTED] and [REDACTED], said that it would be relatively easy to switch to an alternative supplier. However, neither had been through the process of switching egg supplier in the past five years.

requirements of retailers for both high volumes and high standards of supply, themselves limit the number of alternative suppliers available to them, and the frequency with which they would wish to switch between suppliers.

6.13 The parties argued that, for retailers to be able to impose effective discipline on them after the merger, it would be sufficient for them to be able to switch relatively small volumes of eggs to another supplier—for example, an individual depot—as in their view evidenced by the specific examples, before and after the merger, to which we referred in paragraph 6.8. (As we noted in paragraph 6.8, however, the majority of switching of large retailers has previously been between Deans and Stonegate.) They argued that any loss of business would have serious financial consequences since, in the short-term a supplier could not reduce its output of eggs—its hens or those of its contracted farmers would still lay eggs—and those losses could only be partially reduced by other means of disposing of the eggs (for example, to the wholesale market, which we discuss further below). They provided us with extensive calculations of the ‘critical loss’ of business, at or beyond which a price rise would be unprofitable; in their view the actual loss of business from switching to smaller suppliers in response to any price rises would exceed this figure.

6.14 The parties having put forward this analysis, we consider it in some detail in Appendix E. Noble’s own calculations suggested that for a 5 per cent price rise across all categories of shell eggs to be unprofitable, the ‘critical loss’, could be high—on one analysis it provided to us, [redacted] per cent or above for an across-the-board increase in egg prices—but they later suggested this could be somewhat lower—[redacted] per cent or above for an increase in prices of separate categories of egg—depending on how the resulting surplus eggs following a loss of business were disposed of. But, as we discuss in Appendix E, in overall terms the volumes switched by individual customers, often at individual depots, to other suppliers have

been small, and within the supply capabilities of smaller competitors. This would not apply to a more general increase in prices to retailers in which the volumes of egg implied by the critical loss analysis would not be available to alternative egg suppliers. In our view, given the difficulties of switching supplier following the merger, the loss of business likely to be incurred in response to any more general price rise is likely to be below any reasonable figure for 'critical loss' it put forward, ie, price rises would, in our view, be profitable.

6.15 Effective competition in our view is also more likely to require the retailer being able to switch not a small amount of a retailer's business such as part of the supply to an individual depot, but to switch a significant part of its business to another supplier. The ability to switch is essential to ensure a threat to switch is credible. No supplier other than Deans or Stonegate currently supplies more than [X] per cent of the retail market as a whole; or more than about a [X] of supplies to any major retailer.³⁴

6.16 Customer switching would seem to be dependent not only on there being alternative suppliers to whom to switch, but also on the availability of surplus eggs for such an alternative supplier which we now discuss; or on being able to gain access to egg supplies from the incumbent supplier which we discuss in paragraph 6.21 et seq.

6.17 Egg availability is discussed in Appendix E on Competitive Effects. Competitors who responded to us have all told us they are capacity constrained: two suppliers said they had some capacity in cage eggs, but with very limited volumes.

6.18 There are in particular currently clearly serious shortages of supply of free range eggs: we noted in paragraph 2.4 that they have been variously attributed to growth in

³⁴One of the smaller competitors supplies a majority of supplies to one of the 'middle ground' multiple retailers and a number of smaller competitors together supply the majority of supplies to one of the larger multiple retailers: but we do not see scope for other major retailers being able readily to adopt such patterns of supply.

demand; the hot summer; disease; and concerns about other aspects of supply now subject to the Defra investigation. The parties suggested to us that these circumstances were unique, and that generally there had been surpluses even of free-range eggs: but following the merger, the merged company would itself, in our view, as we discuss below, be in a position to reduce the extent of any surpluses that previously occurred.

6.19 In contrast, there may potentially be more availability of cage eggs given the reduction in demand. However, we have noted above [REDACTED]. We were also told that the requirements for use of enriched cages with an associated increase in costs could further reduce the number of caged birds stocked, and that uncertainty over the precise nature of these requirements as well as the likely costs was currently deterring investment in new caged bird facilities.

6.20 [REDACTED] This would apply to some extent to all categories of eggs: organic and barn, as well as cage and free range. Availability of cage, barn and organic eggs are all therefore likely to be more restricted than previously, even if not to the same extent as free range eggs.

6.21 The parties argued, however, that irrespective of whether there was any current surplus of eggs, it would also be possible, on winning a new contract, for a competitor to gain access to egg surplus from the incumbent supplier. They argued, as noted above, that, if a retailer switches supplier, the supplier who lost the contract could not, in the short term, reduce its production of eggs—in effect, its short run marginal production costs were zero—hence would have to dispose of the surplus eggs to the wholesale (spot) market to minimise losses. The eggs would therefore become available however indirectly to the new supplier who would, consequently,

have no capacity problems. [✂] However, the option for a competitor of going to the second main supplier for surplus eggs will now have gone as a result of the merger.

6.22 The parties provided us with extensive analyses to show why, on losing a contract with a customer, they would make surplus eggs available to the market, rather than disposing of them in other ways, and which we have therefore discussed in more detail in Appendix E on competitive effects. As noted in that appendix, it is not clear to us on balance that the revenue loss of withholding eggs from the wholesale market is sufficient to rule this out as a tactical choice.

6.23 The scenario put forward by the parties is one of a large volume of eggs being switched between suppliers. The parties argued that if a large volume of surplus eggs were to be placed onto the wholesale market at short notice, the wholesale price would fall. However, in this scenario there would also be a concurrent increase in demand, as the new supplier would need to source eggs from the wholesale market in order to fulfil the contract. It is difficult therefore to predict the impact on the wholesale price and hence for a supplier to assess the profitability of a supply contract backed by wholesale market purchases.

6.24 Although the parties argued that there had been previous instances in which competitors had contracted to supply retailers without having eggs available, by relying on the wholesale market, their previous ability to do so is also likely to have been permitted by the surpluses of eggs previously available, and which, as we have noted above, may not be expected to continue.

6.25 Even to the extent there has been a release of eggs to the wholesale market by the previous supplier in past examples of customer switching, it is also unclear to us that this would be maintained by the parties in future, given that the merger may have

changed their incentives to withhold eggs in the event of a customer attempting to switch.

6.26 The reaction of several competitors and retailers to the parties arguments that smaller suppliers could compete by acquiring surplus egg in the way put forward by the parties is important. The perception of the parties that competitors could compete on this basis to take business away from Noble was quite contrary to that of their competitors, who all said they currently had a shortage of eggs, and could not compete for new business merely on the assumption that eggs would become available. Furthermore, several retailers themselves told us that they would seek assurances as to the availability of supply before switching to a new supplier. Some retailers also have an approved list of producers whose eggs they are prepared to accept. It was also suggested to us that it would not be sensible for a supplier of any scale to rely on wholesale (spot) markets other than as 'a short term fix'; but that it is important to develop longer-term relationships with producers. Thus even if the previous supplier chose to make the surplus eggs available on the wholesale market, this is unlikely to offer sufficient security of supply to satisfy the requirements of retailers in the longer-term.

6.27 The scenario put forward by the parties is, moreover, based on them having to respond instantly to a loss of business. Even if this were a sufficient threat to constrain them from raising prices in the short-term, on the longer timescales we are considering they would be in a position over time to plan to reduce their own capacity and then negotiate for higher prices. As shown in Table 4, the merged company itself accounts for [redacted] per cent of shell eggs production, but with a far greater share of supply—[redacted] per cent of all shell egg supplies and [redacted] of free range egg supplies—the bulk of which are accounted for by its own production or production by farmers currently under contract to it. [redacted] It showed us information, for example,

that over the next [X] month period, between [X] per cent of the cage and free range flocks of the contracted producers would become due for replacement, as would between [X] per cent of their own cage flock (although substantially less of their free range flock).³⁵ Alternatively, it could drop any higher cost producers currently contracted to it, who would be unattractive to other suppliers. If demand is growing, however, as with free range eggs, it is only necessary for the merged company to grow by somewhat less than this expected growth in demand to introduce tightness to the market. [X]; we have also noted that an intended benefit of the merger is to reduce the surplus of eggs—also requiring a reduction in production and with a shift to free range products. The parties objected that any such reduction in production was inconsistent with the increase in free range production it was currently introducing: but in our view its conduct during the period the merger is under investigation is no guide to the longer-term effect of the merger on its incentives and future strategy. The merged company is therefore in our view in a position, by reducing the production of eggs, to bring about a sustained and profitable increase in prices. The losses associated with such a strategy would be considerably less than those put forward by the parties and less than the benefit to the parties of raising prices.

- 6.28 The effect of the merger on the ability of multiple retailers to switch supplier is greatest in the case of free range eggs, for which there is growing demand and, at least recently, serious shortages of supply. But although some smaller suppliers told us they did have available supplies of cage egg, the total volume of cage egg available is limited, and insufficient to allow switching of significant volumes of cage eggs after the merger. In our view, therefore, the merger is likely significantly to have reduced the ability for retailers to switch to alternative suppliers of all three categories

³⁵In the case of Stonegate, its internal free range eggs are produced [X]. With a 60 week laying period, about 7 per cent of a flock would be replaced on average in any one month; although the parties told us a producer is financially committed to a certain level of production from a particular flock up to 6 months in advance of hatching the egg.

of shell eggs—cage plus barn eggs, free range eggs, and organic eggs—unless new suppliers could enter the market, or existing suppliers expand the scale of their operation, which we now discuss.

Prospects for entry and expansion

6.29 We noted in Table 4 that the merged company would account for over 60 per cent of sales of shell eggs to retailers. In contrast, existing competitors are small, none having shares of over 10 per cent of supply to retailers. Although there are many other suppliers to retailers, most of whom supply only on a regional basis, they would need to expand significantly and rapidly for retailers to have confidence that they had adequate sources of supply and to replace the lost rivalry between Deans and Stonegate.

6.30 Deans and Stonegate said that recent and earlier history demonstrated that entry and expansion in supply of eggs was easy and could be rapid, listing six new entrants since 1999.³⁶ One ([REDACTED]) built up a share, on Deans' figures, of over [REDACTED] per cent of the market, but its business was then acquired for [REDACTED], about £[REDACTED] million by Deans, and we were also told that a lot of its accounts were not profitable, suggesting its strategy had not been fully successful. The market share of the remaining entrants is, however, relatively small: the largest, [REDACTED] (previously a producer and contract packer) having a share of almost [REDACTED] per cent of Lion egg supply, as shown in Table 2. The parties have also stated that major entry is not expected, but believe there could be expansion or downward integration (eg from contracted producers becoming packers or suppliers). The limited market shares of other suppliers, some built up over several decades, also suggest, however, that there have been few examples of rapid expansion in the industry, other than, as with Deans and Stonegate, by acquisition.

³⁶Although they also listed six exits as a result of acquisition, directly or indirectly by themselves in that period.

6.31 There appears to be abundant packing capacity but entry and expansion by suppliers of eggs appears to be constrained primarily by the availability of eggs to pack as discussed in the previous section. As noted in the previous section, the previous surplus of eggs is unlikely to continue: and we do not accept the parties' arguments that, should they lose a contract, the eggs previously supplied under that contract would be released to the spot market and thereby made available, however, indirectly, to the new supplier. In this section, we consider other ways by which new or existing suppliers could expand the scope of their operation within, as our guidelines set out, the timescale necessary to bear on decisions in the market.

6.32 As noted in paragraph 5.32(a), the parties estimated that some [redacted] per cent of the free range flock was not under exclusive contract. As discussed in Appendix F on the parties' contracted supply base, almost [redacted] per cent of the parties' producers are contracted on 12 month rolling contracts or longer, the others having oral contracts or contracts for the shorter remaining life of the flock. Contracts tend to be for exclusive supply, or with a relatively limited maximum percentage of output which can be sold elsewhere. The underlying supply base also appears to be relatively immobile:

- (a) Very few producers break contracts within the period of a contract, only one example being quoted to us.
- (b) The level of churn in supply contracts is low (but not insignificant). Over three years, Stonegate has on average lost between [redacted] (for barn eggs) and [redacted] per cent (for free range eggs) of its contracted volume each year; Deans between [redacted] per cent (for cage) and [redacted] per cent (for barn eggs). The parties argued that the full churn rate, including gains as well as losses of producers, was significantly higher than this; as noted in Appendix F gains of producers average between [redacted] per cent and [redacted] per cent for Stonegate and [redacted] per cent and [redacted] per cent for Deans: but the merged company is likely to be at a

significant advantage in recruiting new producers given its scale and access to retail contracts (see paragraph 6.33).

- (c) The parties appear to have had very long supply relationships with their producers. [X] per cent of Stonegate's cage eggs, [X] per cent of its free range, [X] per cent of its organic, and [X] per cent of its barn volumes have been with Stonegate for more than [X] years, although the figures for Deans are somewhat lower ([X] per cent, [X] per cent, [X] per cent and [X] per cent respectively).

6.33 Nonetheless, the parties drew our attention to the efforts being made by other suppliers to recruit new producers, including existing Deans and Stonegate producers. But we noted in paragraph 6.32 the parties' estimate that only about four per cent of free range production is not subject to exclusive contract to particular packers/suppliers. Existing producers are in our view likely to be wary of switching to a new packer/supplier; they would need confidence in the supplier's ability not only to continue to acquire the producers' eggs, but also to supply those eggs to retailers. It is therefore not surprising that the producer base remains relatively immobile; and additional payments and/or higher unit prices may be necessary to recruit existing producers in order to overcome the perceived uncertainties of changing supplier, adding to the costs of entry or expansion.

6.34 An alternative means of ensuring availability of eggs for a packer/supplier to supply to retailers would be to become an egg producer, or to encourage new entry by producers. [X]³⁷

6.35 Prospects of entry to some extent differ between production of free range/organic and production of cage/barn eggs. Free range production is a smaller scale activity,

³⁷The case is a standard unit of quantity measurement in the egg packing industry. A case is 30 dozen eggs.

the parties producing only a limited proportion of their requirements, and with several hundred producers. Significant expansion of free range production would therefore require entry or expansion by a considerable number of independent producers, or by the suppliers themselves. Entry or expansion of free range production is also likely to be a lengthy process, given the need for planning permission, possible construction of facilities, the time required for a flock to come fully into production, and the need to have the facilities approved against the regulatory and quality standards of, for example, the BEIC's Lion mark and, sometimes, individual retailers.

6.36 About half the individual producers from whom we heard, as well as the trade associations to which we spoke, pointed to the requirement for planning permission, including requirements for pollution control. It was regarded by them as difficult or likely to take 12 months or longer, though depending on the nature and location of proposed developments, the attitude of nearby residents, and the varying requirements of particular planning authorities. Some said planning permission was 'impossible' to obtain in these circumstances: others that it could take 6-24 months, with a further year or so required to construct new facilities and commence production. The parties argued that expansion through use of smaller 'mobile sheds' would not require planning permission, but other evidence we saw suggested that this may be required by some planning authorities. The parties also, however, showed us press articles referring to a very large scale free range development being proposed by a competitor, which had led to a 'storm of protest' from local residents, confirming in our view the difficulties which new entrants or smaller producers expanding their production particularly on any scale may face in gaining planning permission. A firm of solicitors experienced in planning issues also told us that the planning process could take as little as 18 weeks if there was no appeal; or up to almost 80 weeks if there was an appeal, the chance of success varying with the development, being more difficult the larger the development. Typical costs to the

applicant, if there was an appeal, could be up to £80,000. It also told us that, in its experience, there was generally no problem in gaining planning permission for smaller mobile units, and it was possible to get permission for larger units, it being quite likely that the prior notification process would mean planning permission was not required in some areas. But the scale of the use again mattered.

6.37 As well as the significant up-front costs of investment referred to in paragraph 6.34, several producers from whom we heard said that uncertainty about future returns from egg production and the effects of diseases in chicken flocks reduced the prospect of entry or expansion, for example by reducing the willingness of banks to finance such new egg production facilities. Producers are likely to be particularly unwilling to invest in new facilities, or expand existing facilities, without reasonable confidence, through contract or otherwise, that they will be able to sell all their eggs to a supplier, and that the supplier in turn will continue to have a sufficient customer base to be able to dispose of those eggs.

6.38 Production of free range eggs has nonetheless increased by over 10 per cent a year³⁸ over the last seven years, to meet the increase in demand. But we received a considerable amount of evidence from farmers that, at current level of prices to producers, there may now be insufficient incentive to maintain that expansion. A rival supplier, wishing to increase its share of supply, would have to achieve an even greater increase in production; to achieve this, it may have to contract with a large number of new free range producers, given the generally smaller scale of such producers. We noted in paragraph 6.33 the additional price a competing supplier may have to pay to attract existing producers. Sufficiently rapid expansion, in sufficient timescale to prevent the merged company increasing prices or worsening quality, is, in our view, on balance unlikely.

³⁸Defra statistics.

6.39 In contrast, the production of cage eggs is a more capital intensive, high volume activity, with a significantly greater proportion of production carried out by the parties themselves, and with a far smaller number of producers. The declining market for cage eggs is itself likely to deter investment in caged egg production. Furthermore, we have also been told the cost and uncertainty as to future regulatory changes relating to cage birds, in particular many of the current cages becoming illegal, is a significant factor deterring entry.

6.40 On the other hand, the decline in demand for cage eggs may itself to some extent increase the availability of surplus cage eggs for new entry or expansion by other suppliers or packers of cage eggs. We have, however, noted above the previous intention of Deans to reduce substantially both its own cage capacity, and that of producers under contract to it. Even to the extent that there may be greater availability of cage eggs to other suppliers from other producers, this would not in our view be sufficient to enable significant entry or expansion by other suppliers given the other difficulties noted above in their competing on any scale for the business of multiple retailers. [REDACTED]³⁹

6.41 Among further possible barriers to entry and expansion may be the existence of regional or other egg brands. We noted in paragraph 2.3 that some [REDACTED] per cent of retail sales are of retailers' own brands, but that both Deans and Stonegate have been increasing the proportion of their sales accounted for by their own brands. [REDACTED] New suppliers to some retailers in some cases have been required to pay an existing supplier for use of a brand name; [REDACTED].⁴⁰ The parties argued that branded eggs could be easily replicated and patents could be easily circumvented: but this argument is difficult to reconcile with their strategy of developing brands. Brands could therefore,

³⁹The parties pointed out that this document was now a year old, and these other suppliers had subsequently competed for, and won, business from them.

⁴⁰[REDACTED]

in our view, become increasingly effective in reinforcing the position of the merged company and in disadvantaging smaller competitors and new entrants.

6.42 We also saw no firm indication from any retailers that they would sponsor entry to overcome any of the barriers identified above. As noted in paragraph 78 of Appendix E, retailers' responses indicated that retailers were reluctant to sponsor new entry, and few said they would do so in the event of 5 per cent increase in price; as noted in paragraph 88 of that Appendix, the majority of respondents also said that sponsoring the growth of a smaller supplier was likely to take a considerable amount of time.

6.43 In our view, therefore, actual entry or the threat of entry by new participants and expansion by smaller participants are unlikely to be sufficient to offset any reduction in competition resulting from the merger in supply to retailers of any of the three shell egg categories—cage plus barn eggs; free range; and organic eggs—listed above within the time frame relevant to this inquiry.

Competition from imports

6.44 Although the parties, as noted in paragraph 5.15, did not dispute that the supply of shell eggs to retailers could be regarded as a UK market, they drew our attention to the recent increase in imports, by retailers and by themselves, in response to the shortage of free range eggs. This, they argued, could much reduce the inhibition on retailers to import shell eggs in future should there be any reduction in competition in the UK. But the parties themselves described current circumstances as exceptional. We do not believe that any more general inferences can be drawn from the response to such extreme, and probably temporary, conditions in the UK market; indeed we noted that some supermarkets currently selling imported eggs were displaying notices saying they hoped soon to be restocking with British eggs.

6.45 We noted in paragraph 2.1 that about 7 per cent of shell eggs were imported. We were told⁴¹ that imports are predominantly of cage eggs, there being less use and production of free range eggs elsewhere in the EU than in the UK. We were also told (by the BEIC), that about half the imports were for processing,⁴² although processing accounts for only a quarter of egg demand; the percentage of retail sales accounted for by imports would therefore be less than 7 per cent.

6.46 As noted in paragraph 5.15, the main constraints on imports of shell eggs quoted to us by others include:

- (a) the importance to most retailers of the Lion mark;
- (b) the 'buy British' policy of many multiple retailers who had a strong preference to source from within the UK and, as put to us, support British agriculture, and which is likely to be sustained by the preferences of consumers. One multiple retailer, for example, referred to a survey which showed 80 per cent of customers regarded purchase of British eggs as important; and
- (c) the need for security of supply.

6.47 The information we received from retailers suggests that the limitation on actual and potential competition from imports applies equally to the three categories of cage and barn eggs; free range eggs; and organic eggs. Actual or potential competition from imports (as discussed in the context of market definition above) also therefore in our view appears unlikely to offset any reduction in competition resulting from the merger in any of the three categories of supply of shell eggs to retailers.

⁴¹For example, by the parties, and Northern Foods.

⁴²The main parties said there was no independent data to support this.

Bargaining power of customers

6.48 We noted in paragraph 2.3 that multiple retailers account for about [X] per cent of retail sales of shell eggs. Four leading retailers account for about [X] of retail sales (of which, on the parties' figures, [X] was estimated to account for [X] per cent; [X] per cent; [X] per cent and [X] per cent). A further five retailers account for about a further [X] per cent of sales. We also noted in paragraph 4.6 the parties' argument that the bargaining power of retailers together with the presence of other suppliers would be sufficient to ensure the merged company would not have market power in supply to any category of retailer.

6.49 As noted in our merger guidelines, the fact that the market is characterised by buyers that are large relative to the size of the suppliers does not necessarily mean that there is countervailing buyer power. For instance, factors that will affect the ability of buyers to constrain suppliers include:

- (a) the buyers' ability to find alternative suppliers in the case of a price rise;
- (b) the ease with which buyers can switch supplier;
- (c) the extent to which buyers possess a credible threat of setting up their own supply arrangements;
- (d) the extent to which buyers can credibly threaten to stop purchasing other products sourced from the supplier; and
- (e) the extent to which buyers can impose costs on suppliers (for instance by delaying purchases).

We have to a large extent considered these points in discussing the effect of the merger on retailers' ability to switch supplier; the remaining points are covered below.

6.50 The parties referred to recent CC inquiries which examined the issue of the buying power of multiple retailers. The current case differs, however, in a number of

respects from earlier cases, so that they cannot, in our view, give us directly useful guidance.

- 6.51 The parties referred extensively to previous examples of multiple retailers using bargaining power against them. But most of those related to the market prior to the merger and which are unlikely to be relevant to relative bargaining power in the future given the major change in structure resulting from the merger. But even in that period, prices were subject to negotiation between the suppliers and the multiple retailers, rather than either being able to dictate to the other. There also seem to have been fairly stable relationships between suppliers and retailers, with smaller suppliers only able to supply a minority (in the case of most of the smaller suppliers, only a very small minority) of requirements of larger retailers.
- 6.52 Although the parties also provided evidence of retailers' use of bargaining power after the merger, some of the evidence they provided [REDACTED]. The parties gave us evidence showing that there had been no increases in their margins since the merger: but we cannot regard a period in which the merger has been under consideration by the OFT and ourselves as indicative of what may happen in the longer term.
- 6.53 The parties also suggested that smaller customers have wide choice, [REDACTED]. In some cases, their figures showed that [REDACTED], as was supply to the customer overall, which could be entirely consistent with profit-maximising behaviour (as the parties acknowledged). Conversely, however, this would imply that the bargaining power of larger customers is already to some extent constrained by the nature and scale of their requirements, including a greater need for security of supply, [REDACTED]. We undertook our own analysis of the relative profitability of a selection of Deans' customer accounts, which found no clear evidence [REDACTED].

- 6.54 All retailers from whom we heard confirmed that eggs are a KVI and/or must-stock item. Generally, the multiple retailers denied they had bargaining power in their relationships with egg suppliers. Although most retailers did not express concern about the merger, others said that switching would be difficult due to the scale of their business relative to that of other suppliers; and, except in the current exceptional circumstances, that they were reluctant to import eggs. As noted in paragraph 6.42 and Appendix E, all of the retailers were reluctant to sponsor new suppliers; nor were they likely to set up their own supply arrangements or threaten to do so.
- 6.55 Price increases negotiated with some major retailers since the merger also suggest the parties' negotiating position is far from weak. Limitation of the multiple retailers' bargaining power is also shown in the ability of the parties selectively to reduce supplies of free range eggs to particular retailers following their recent shortage. [X]
- 6.56 The relationship between suppliers and retailers is, in our view, one of mutual dependence, both exerting a degree of bargaining power in negotiating price and other terms of supply. But the options available to such retailers—given the difficulty in switching supplier, the limited prospects for entry and expansion we have noted above and the reluctance to import—are, in our view, likely to be much reduced by the merger. As we note in paragraphs 98 to 99 of Appendix E, prior to the merger, it is likely that the next best option for any customer of Deans was likely to have been Stonegate and vice-versa; following the merger the next best option, to attempt to switch to a number of smaller suppliers and attempt to grow them over time, would be relatively costly, retailers would have to accept less favourable terms, and switching a sizeable volume would take a considerable amount of time. The effects of the merger would therefore appear likely materially to reduce retailers' bargaining power, their ability to make and carry out threats having been much reduced by the

merger, which may be expected in this particular instance adversely to affect final consumers.

6.57 We referred in paragraph 6.49 to the factors set out in our guidelines that would affect the ability of buyers to constrain suppliers. In our view therefore:

- (a) the options available particularly to the larger multiple retailers to find alternative and adequate supplies by switching supplier have been much reduced by the merger for the reasons set out in paragraphs 6.5 to 6.28 and 6.56.⁴³
- (b) those retailers are unlikely credibly to threaten to set up their own supply arrangements given their reluctance to sponsor new suppliers (paragraphs 6.42 and 6.54);
- (c) they are generally in no position to threaten to stop purchasing other products, given the importance to them of stocking all shell eggs supplied by the merged company, it being very damaging to them to have shortages of eggs as this may induce consumers to go to a rival store.⁴⁴ As we set out in paragraphs 6.61 to 6.72 we are indeed also concerned about the effect of the merger on the other main products supplied by Noble—liquid eggs; and
- (d) they are in no position to impose costs on Noble, given their own dependence on Noble to keep their shelves stocked with eggs.

In our view, therefore, the extent of bargaining power of retailers in the relevant market(s) is insufficient to offset any reduction in competition as a result of the merger. We saw nothing to suggest that this conclusion did not apply to each of the three categories of cage and barn eggs, free range eggs and organic eggs.

⁴³The parties quoted to us one example since the merger of a mid-range multiple retailer, to whom they supplied a minority of its egg purchases, withdrawing its remaining business from them. But the scale of that business was relatively limited.

⁴⁴The parties did quote to us one example since the merger of a retailer withdrawing orders from them for some cage eggs for one depot in response to short supplies of free range eggs: but in our view such threats can be made or carried out only on a limited scale.

Overall assessment on supply of shell eggs to retailers

6.58 We have therefore concluded that:

- (a) the merger is likely significantly to have reduced the ability for retail customers to switch to alternative suppliers of:
 - (i) cage and barn eggs,
 - (ii) free range eggs, and
 - (iii) organic eggs (paragraph 6.28);
- (b) the threat of entry by new participants or expansion by smaller competitors is unlikely to be sufficient to offset such a reduction in competition (paragraph 6.43);
- (c) actual or potential competition from imports is also unlikely to offset such a reduction in competition (paragraph 6.47); and
- (d) the bargaining power of retailers is also insufficient to offset any such reduction in competition (paragraph 6.57).

In our provisional view, the merger may therefore be expected to result in an SLC in supply of cage and barn eggs, of free range eggs and of organic shell eggs to retailers. The reduction in number of suppliers and absence of alternative suppliers of equivalent scale may in turn be expected to lead to a loss of rivalry, thereby allowing the merged company to increase prices to retailers, and resulting ultimately in higher prices to the final consumers of shell eggs. That loss of rivalry could also thereby adversely affect the range, quality, innovation or service levels in the supply to retailers of cage and barn, free range or organic eggs, including to customers of different types. The merged entity would also be in a position to refuse to supply certain retailers, as has to some extent occurred in response to the current shortage of free range eggs (see paragraph 6.55).

Supply of shell eggs to catering and wholesale customers

6.59 We noted above that supply of eggs to catering and wholesale customers accounts for almost 25 per cent of egg supply in the UK. Although, as discussed in paragraph 5.18, catering and wholesale customers from whom we heard are also reluctant to import shell eggs, supply to those customers differs significantly in other respects from that of supply to retailers.

- (a) We received few expressions of concern from catering and wholesale customers.
- (b) The merged company's share of supply to catering and wholesale customers—about 25 per cent—is significantly below that to retailers, as is the increment in market share, Stonegate accounting for only [redacted] per cent of that supply.
- (c) The parties suggested to us that catering and wholesale customers bought almost exclusively on price, with little concern for service factors.
- (d) Responses we received from such customers suggested their use of other suppliers was more significant than for the multiple retailers (consistent with the lower market share estimates for supply to catering and wholesale customers).
- (e) Catering and wholesale customers also appear more optimistic about their ability to switch and more regularly did so and a number of them responded that switching supplier would be relatively easy. This would appear to be because catering and wholesale customers buy in much smaller quantities, and so their requirements are more easily accommodated by smaller suppliers. In addition, catering and wholesale customers, with the exception of McDonald's Restaurants Ltd, purchase mainly cage eggs.⁴⁵
- (f) The merger is unlikely therefore to have reduced significantly the opportunities for such customers to switch to other suppliers, smaller suppliers clearly having a larger share of supply to that sector.

⁴⁵In this context, it is interesting to note that McDonald's indicated that switching supplier would be relatively difficult.

6.60 In our provisional view, the merger may not be expected to result in an SLC in the supply of shell eggs to catering and wholesale customers.

Supply of liquid eggs

6.61 We discuss the competitive effects on the market for liquid eggs in Appendix G. As noted in Table 4, the merged company accounts for over half (about [X] per cent) of UK liquid eggs. The overlap between the parties is only in pasteurised eggs. Deans also produce value added products—egg mayonnaise, precooked scrambled egg and precooked omelettes—but these are not produced by Stonegate, nor are foodservice customers supplied by Stonegate. [X]⁴⁶

6.62 Some third parties from whom we heard also noted that Stonegate contracted its production of liquid eggs to [X] ([X]), which on the parties' figures, is the [X] supplier after the merger of liquid eggs with a market share of almost [X] per cent, and also to [X], the third largest supplier. The parties acknowledged that [X] was unlikely to compete aggressively for the customers of the merged company, suggesting that the effect of the merger could be somewhat greater than the increases in market share imply. [X] own production is, however, primarily of value added products, which are not supplied by Stonegate. The parties also told us that [X] had given notice to terminate its contract with Stonegate. We do not therefore see the arrangement with [X] as further exacerbating the effects of the merger.

6.63 The parties argued that there was relatively little switching between them: since [X] per cent of switching to or from Stonegate had been from or to Deans; and [X] per cent of switching to or from Deans had been from or to Stonegate. The parties did not however at any point argue that Stonegate and Deans products (aside from those mentioned in paragraph 6.61) were in different markets, but rather that they were in

⁴⁶[X]

the same market, but one which was European in character. As such, and as evident in Deans' Business Plan we referred to in paragraph 6.61, Deans and Stonegate would be expected to provide a competitive constraint on each other. The extent of switching by customers is generally low and the merger removes the prospect of switching between the previous two largest suppliers, which is, in our view, a significant competitive constraint.

6.64 The parties argued that the main competition it faced was from other suppliers of liquid eggs in the UK, from imports of liquid eggs, and from substituting powdered eggs, which we now consider in turn.

6.65 On the remaining competition from other suppliers in the UK, as noted in paragraph 4.4, a number of liquid egg customers expressed concerns to us about the effects of the merger on competition. Among the main points made to us was that the merger combined the UK's two leading egg processors which met retail standards into one business with a significantly higher processing capacity than that of any of the remaining egg processors, and thereby reduced competition.

6.66 The parties' internal documents showed that their combined production (including that of Stonegate outsourced to other processors) is [REDACTED]. On the other hand, they suggested there was significant excess capacity among other suppliers which would allow other suppliers effectively to compete. But of the 10 other suppliers of liquid egg listed by the parties, three are overseas producers, currently with limited market shares and, as we discuss below, with some UK customers reluctant to import liquid egg. The Deans 2005 Egg Products Business Plan and the parties presentation to the banks referred to a number of possible weaknesses of some of the other suppliers, including: [REDACTED]. These comments also suggest, as with the other comment from the Business Plan referred to in paragraph 6.61, that competition is likely to be

less effective as a result of the merger, despite the existence of excess capacity. Given the high market share of the merged company, similar to that for supply of shell eggs to retailers, the merger would appear likely in our view to have reduced significantly the opportunities to switch supplier for those liquid egg customers unable or unwilling to use powdered or imported liquid eggs.

6.67 Some customers themselves expressed doubts as to the prospects of new entry or expansion of smaller producers of liquid eggs. It was, for example, argued that the demands of the UK retailers were very exacting and smaller UK based suppliers still had some way to go before they reached the level whereby they would readily meet current standards for quality, reliability, security of supply and economies of scale that would allow them to compete on all fronts. Any plan to shift volume to smaller processors (or outside the UK) was likely to take at least a year to implement effectively: one processor, indeed, referred to it having taken [redacted] for one of its retail customers to approve a particular European supplier. As with supply of shell eggs to retailers, availability of eggs was also thought to be a likely constraint.

6.68 We have noted in paragraphs 5.20 and 5.29 the parties' arguments that many customers were prepared to switch to powdered eggs, or to imports, but we concluded that it was appropriate to regard the supply of liquid eggs in the UK as a relevant market because of limited functional substitutability for many customers and price discrimination. Several of the customers from whom we heard were also reluctant to import liquid eggs. Among the points made to us was that, in some cases, UK eggs had to be used for customers; this merger, it was argued, therefore gave Noble Foods a controlling interest in this market. Other disadvantages from use of imports quoted to us included higher transport costs, longer transport lead-times, the inherent quality and food safety issues associated with eggs from the Continent, and limited Continental supplies of free range eggs, which were used

more in the UK than elsewhere in Europe. Hence for some suppliers their customer demand for egg products in the UK was for UK sourced material above all else.

6.69 Powdered eggs were also said by some customers from whom we heard to make little economic sense, and was not what retailers wanted. It was not an option for some manufacturers to use powder, since they had no facilities to liquefy and some customers said powder could not be used in their products. These comments clearly conflict with the views of the parties that many customers can readily import and can and do switch between liquid and powdered eggs: indeed the parties gave us internal memoranda carefully documenting when seven of its customers appeared likely to switch to or from powder. The amount of powdered eggs (in its liquid equivalent) used in the UK is currently about one-third that of liquid eggs, suggesting that there is a degree of functional substitutability for some, but not all customers in the UK. But whereas the parties argued that this confirmed that liquid and processed eggs were functionally substitutable, this is not in our view sufficient to establish demand substitutability given the strong preference of some customers not to use powdered eggs, nor imported shell eggs. We accept that, in some cases, liquid and powdered egg may be genuinely substitutable, but from the evidence we received from customers, to which we referred in paragraph 5.22, such cases may be limited.

6.70 The bargaining power of customers dependent on liquid eggs and reluctant to import is, in our view, likely to be reduced by the merger given the limited number of other suppliers, and their limited scale. The parties argued that they were not in a position to distinguish between customers according to their willingness or ability to import or use powdered eggs. But given that prices are negotiated, and the knowledge that is likely to be available to the merged company from its dealings with its customers, it would in our view be able to discriminate against the substantial proportion of its customers least able or willing to switch to imports or use of powdered eggs.

- 6.71 We also noted in paragraph 5.28 the apparent advantage of being a supplier of both shell and liquid eggs. We note in Appendix G [redacted]. The parties also told us that there is an element of counter-cyclical supply of shell and processed eggs: seconds are both the output of its shell egg activities and input into its processed eggs activities, hence when price and profitability of supplying shell eggs are relatively low, profitability of liquid eggs is relatively high. The merged company's share of total egg supply in the UK would therefore put it at some advantage in the sourcing of eggs compared with any new entrant, or smaller supplier seeking to expand its activities.
- 6.72 In our view, therefore, the merger may be expected to result in an SLC in the supply of liquid eggs to customers in the UK for whom the use of imported eggs provides a poor substitute. This conclusion applies to both cage and free range liquid eggs; the difficulty in importing or finding other sources of free-range liquid eggs may, however, be even greater than for cage eggs. The parties are therefore, as a result of the merger, in a position to increase prices to some customers for liquid eggs, by price discrimination in the supply of liquid eggs, in particular between those customers willing to source outside the UK or use powdered egg and those reluctant to do so and also to reduce the range, quality, innovation and service levels in the supply of liquid eggs to such users.
- 6.73 We are less concerned about the effects of the merger on the supply of hard-boiled eggs. These are not currently supplied by Stonegate. [redacted] Even if Stonegate had been in a position to enter the market, given the presence of other suppliers, we saw insufficient reason to expect that the merger could result in a material loss of potential competition from Stonegate.

Upstream effects

- 6.74 As noted in paragraph 4.5 and Appendix E on the Competitive Effects of the Merger, many farmers have raised concerns regarding the upstream bargaining power of the Deans and Stonegate merged entity. There was particular concern from some farmers in parts of the South West who regarded Noble as the only 'route to market' for farmers. Although Noble pointed out two other suppliers who acquired eggs from producers in that region, the scale of their activities is very small. It was feared that Noble's increased bargaining power vis-à-vis its contracted producers would result in lower prices paid to producers and/or reduction in the quantity of eggs produced.
- 6.75 There was also some concern about the ability of the merged company to use its share of egg supply to bundle the supply of feed, pullets and/or spent hen processing with its supply contracts with producers for shell eggs, weakening competition in those other markets. Responses to our questionnaire from farmers appeared to indicate that although they do source other products from Deans or Stonegate, generally they were not currently required to do so. One referred to a contractual requirement to do so: but said they could switch to an alternative contract if they wished. Production of some particular egg brands, however, requires a producer to use the supplier's specified feed or pullets.
- 6.76 The only upstream market where, on their figures, the parties have a market share above 25 per cent is spent hen processing ([~~25~~] per cent). Some third parties have noted that it would not be in the interests of Noble to make it difficult for farmers to dispose of hens as this could delay the laying down of new flocks.

Assessment

- 6.77 We are concerned about the monopsony buying power of the merged company. It would account for almost half the total shell egg supply in the UK, but with higher

shares of supply to retailers. From the figures in Table 4, showing the merged companies' supply in relation to UK production, it would also supply about [X] per cent of free range (including organic) eggs produced in the UK and [X] per cent of Lion brand free range (including organic) eggs produced in the UK (the bulk of which is produced for it under contract by other producers). In their relations with such a strong buyer of eggs, the large number of individual producers, particularly of free range eggs, are in a far less powerful position. Setting up production is both risky and expensive; producers need the security of contracts in order to invest; producers also benefit from the advice packers are able to give. In some parts of the country, particularly parts of the South West, there are few if any alternatives to the merged company in a similar position to acquire from producers.

6.78 The merged company's share of supply particularly of free range eggs puts it in a strong position in other ways. It is able to receive and analyse information on the costs and production volumes of many hundred separate producers, with its own production facilities also providing a benchmark to be used in negotiation with producers. It also has an overview of the industry that enables it to plan several years ahead that can influence its buying strategies.

6.79 As noted in paragraph 4.5, we did, however, receive a wide range of views from producers and their representative bodies. Some producers believed the merger would improve their position through the increased bargaining power of the merged company in relation to that of the multiple retailers, and from which they believed they would also benefit, and that it would reduce the cyclical fluctuation in the industry. Others, as noted in paragraph 6.74, were concerned about the merger; others were uncertain as to where the balance of the effects lay. The parties themselves, as noted in paragraph 4.6, stated that they believed producers would share in the benefits of the merger. But in our view on balance the interest of the

merged company given its powerful position both in procurement of eggs and their onward supply to retailers would be to restrict production, to reduce prices to producers and to increase those to retailers, even though this may not be its current stated intention.

6.80 The strong buying power of the merged company would therefore give it the ability as well as the incentive to buy from producers on less favourable terms in a number of ways: to cut back prices to producers; to fail to pass on any increases in price it may receive from retailers; or (as an alternative means of increasing its margins) to bundle its purchases with sales of inputs such as animal feed, pullets or spent hen facilities; to offer less favourable contracts to producers in non-price terms, such as payment terms, or provision for breakages; to threaten or dictate to producers; and/or to discriminate between producers in such policies.

6.81 Lower prices to producers of eggs could benefit consumers if passed on to them. But ultimately, deterioration in trading terms with producers would in our view reduce the volume of eggs produced in the UK, raising prices to retailers and to final consumers. The influence of the merged company could also be exerted to the detriment of producers, competitors, customers and consumers in other ways. By long term contracts with producers, the merged entity could jeopardize the position of other suppliers and/or limit the opportunities for entry thereby or in other ways, for example, by pricing policies, price discrimination or own branding of eggs. We also share the concern expressed to us by some parties that it could be in a position to influence wider industry developments through its strong position on trade associations, although it is more difficult to establish an expectation that this would occur as a result of the merger.

6.82 Hence, the merger may be expected to result in an SLC in the procurement of shell eggs from producers.

7. Provisional findings

7.1 We have therefore provisionally found that the merger may be expected to result in an SLC in:

- (a) supply of cage and barn, of free range and of organic shell eggs to retailers (paragraph 6.58);
- (b) supply of free range liquid eggs and of cage liquid eggs, to those customers in the UK for whom the use of imported eggs provides a poor substitute (paragraph 6.72); and
- (c) procurement of shell eggs from producers in the UK (paragraph 6.82);

We have found that the merger may not be expected to result in an SLC in supply of shell eggs to catering and wholesale customers (paragraph 6.60); nor supply of hard-boiled eggs (paragraph 6.73).

7.2 As a result of the SLCs provisionally identified, the merger may also be expected to have the following adverse effects:

- (a) the reduction in the number of suppliers and the absence of alternative suppliers of equivalent scale may be expected to lead to a loss of rivalry which allows the merged entity to increase prices to retail customers unilaterally for cage and barn, free range and organic shell eggs (paragraph 6.58);
- (b) 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 to retailers of cage and barn, free range or organic eggs, including to customers of different types (paragraph 6.58);
- (c) the merged entity would be in a position to refuse to supply certain retailers (paragraph 6.58);

- (d) the parties are also in a position to increase prices to some customers for liquid eggs, by price discrimination in the supply of liquid eggs, in particular between those customers willing to source outside the UK or use powdered eggs and those for whom imported eggs or powdered eggs provide a poor substitute, and reduce the range, quality, innovation or service levels in the supply of liquid eggs to such users (paragraph 6.72);
- (e) the merged entity could use its market power in the purchasing of eggs to buy from producers on less favourable terms, including, for example, reducing the prices paid to them, or making the purchase of other products (such as pullets, animal feed, spent hen processing) a condition of its supply contracts, reducing the number of eggs produced and raising prices to retailers (paragraphs 6.80 and 6.81); and
- (f) by long term contracts with producers, the merged entity could jeopardize the position of other suppliers and/or limit the opportunities for entry thereby or in other ways, for example, by pricing policies, price discrimination or own branding of eggs (paragraph 6.81).

The effect of the above would, in our view, be to increase final prices to consumers and to reduce the range, quality, innovation and service levels available to them.

7.3 In addition to the unilateral effects of the merger set out above—any increased prices by the merged company alone—we considered whether the merger could result in a multilateral increase in prices—ie increased prices not only by the merged company but also by other suppliers. Several factors suggest multilateral effects are likely to arise. Although prices are not transparent, but negotiated with both suppliers and customers, it is nonetheless easy for suppliers to identify the effects of each other's actions when an order is lost, if not necessarily during the process of negotiation. It is likely to be in the interests of other suppliers of shell, of free range and of organic eggs to retailers and of liquid eggs, particularly given their difficulty in acquiring eggs

in the short term, at least in part to follow a price increase by the merged company rather than maintain, or reduce, their prices to increase market share. In our view, therefore, the merger would be expected to have the effect of enabling other suppliers of shell, of free range and of organic eggs to retailers and of liquid eggs to attain higher prices than would otherwise be the case. The above outcome does not require any form of coordinated behaviour, but could emerge purely from the actions of the suppliers in the market responding to one another's prices.

7.4 This is, however, an industry characterised by a relatively small number of suppliers, with considerable knowledge of each other's operations, and which cooperate actively on a number of industry bodies such as the BEIC and the CEA, hence we considered whether the merger could give rise also to coordinated effects. But given our conclusion that the merger may be expected to result in an SLC through its unilateral and multi-lateral effects, we have not needed to reach a final view on whether, on balance, coordinated effects may also be expected.

7.5 We are therefore required to consider whether action should be taken for the purpose of remedying, mitigating or preventing the SLC or any adverse effects which may be expected to result from such an SLC, having regard to the effect of any action on any relevant customer benefits (as defined in the Act) in relation to the merger.