

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 seven 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.