

## 2 Conclusions

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## The reference

2.1. On 7 July 2003 the Secretary of State for Trade and Industry (Secretary of State) made a reference to us under the merger provisions of the Fair Trading Act 1973 (the Act) concerning the possible existence of a merger situation between Arla and Express. Our terms of reference (see Appendix 1.1) require us to consider whether the creation of that situation may be expected to operate against the public interest, limiting our consideration to the market for supply of fresh processed milk in the UK.

2.2. The proposed merger is a concentration with an EC dimension within the meaning of the EC Merger Regulation (ECMR) and was notified to the European Commission on 16 April 2003. By a decision<sup>1</sup> of 10 June 2003, in response to an application by the Office of Fair Trading (OFT), the European Commission referred the merger to the competent authorities of the UK under Article 9 of the ECMR as regards fresh processed milk and fresh non-bulk cream. By a decision<sup>2</sup> of the same date it cleared the merger in so far as it concerned aspects not referred to the UK authorities.

2.3. We are required to make our report within the period ending on 24 September 2003. The ECMR as read with Commission Regulation 447/98 requires our report to be published by 15 October 2003—accordingly there would be little scope for any extension of our timetable.

2.4. The expression ‘fresh processed milk’ in our terms of reference appears to us to exclude UHT, sterilized and flavoured milk. In our view, it is intended to have the same meaning in the terms of reference as it has in the two decisions of the European Commission mentioned in paragraph 2.2. It is clear from the decisions themselves that the expression is not intended to include UHT, sterilized or flavoured milk. We proceeded on the assumption that the expression, as used in our terms of reference, excludes those items but includes specially filtered milk. We use the expression in that sense in this report (see glossary for our full definition).

2.5. In recommending to the Secretary of State that the case should be referred to us, the OFT said that the merger gave rise to a significant prospect that it might lead to a substantial lessening of competition in relation to supply to the larger supermarkets. The OFT also noted that, although concerns in relation to the supply to schools did not appear sufficiently well founded to warrant reference by themselves, they might be worthy of further consideration as part of a wider merger investigation.

## The companies involved

### *Arla Foods amba*

2.6. Arla is a large Scandinavian dairy cooperative which was established in April 2000 as the result of a merger between the Danish cooperative MD Foods amba and the Swedish cooperative Arla EF. In addition to its UK subsidiary, Arla UK, Arla has production facilities in Denmark, Sweden, Saudi Arabia, Poland and Brazil and sales subsidiaries and joint ventures in a range of other countries.

2.7. Arla is owned by over 13,600 cooperative members (the farmers) in Denmark and Sweden. In the year to the end of September 2002, Arla reported turnover at around £3.3 billion, and operating profit of £119 million (see Table 4.9). More detailed financial information on Arla is in paragraphs 4.37 to 4.44.

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<sup>1</sup>European Commission Decision of 10/6/2003 relating to a partial referral of case no COMP/M.3130—Arla Foods/Express Dairies to the competent authorities of the United Kingdom pursuant to Article 9 of Regulation (EEC) No 4064/89.

<sup>2</sup>European Commission Decision of 10/6/2003 under Article 6(b) of Regulation (EEC) No 4064/89 relating to case No COMP/M.3130—Arla Foods/Express Dairies.

## *Arla UK*

2.8. Arla UK is currently the fourth largest supplier of fresh processed milk in the UK. It employs approximately 2,000 people in the UK. Its main business is the supply of fresh processed milk, cream, value-added and branded dairy products to major retailers. Arla UK also supplies these products to small retailers, wholesalers, and the food service sector. In the UK, Arla's Lurpak and Fonterra's Anchor butter brands are distributed by Arla UK.

2.9. Arla UK currently produces fresh processed milk at five dairies in England. In 2002, it announced plans to build a modern fresh processed milk dairy at Stourton (near Leeds). Construction began in February 2003 and it is expected that the dairy will be completed in October 2004, when the existing Leeds dairy will be closed.

2.10. Arla UK's turnover in the year ended September 2002 was £556 million, of which around [%] per cent related to the sale of fresh processed milk. Over the four years to the end of September 2002, its operating profit as a percentage of turnover was in the range 1.8 to 2.7 per cent, its return on capital employed was in the range 8 to 12 per cent, and its pre-tax weighted average cost of capital was around [%] per cent. Further information on Arla UK's financial performance is in paragraphs 4.52 to 4.57.

## ***Express Dairies plc***

2.11. Express was demerged from Northern Foods plc in 1998. It is one of the largest suppliers of fresh processed milk in the UK. Express employs more than 5,000 staff. It told us that its two core businesses were the supply of fresh processed milk and related products to supermarkets and its home delivery service. It produces fresh processed milk from seven dairies in Great Britain.

2.12. In recent years, Express's turnover has declined from a high point of £929 million in the year to 31 March 2000 to £715 million in the year to 31 March 2003. Over the three years to March 2003, Express's fresh processed milk sales [*Details omitted. See note on page iv.*] per cent of turnover), as shown in Table 4.7. It has sold businesses in recent years and reduced its level of debt which has fallen from around £200 million at March 2001 to some £100 million at March 2003 (see further paragraphs 4.2 and 4.3 and Table 4.1).

2.13. Over the four years to 31 March 2003, Express's operating profit as a percentage of turnover was in the range 1.3 to 3.5 per cent. Its return on capital employed was variable, ranging between 5 and 13 per cent; its pre-tax weighted average cost of capital was around [%] per cent. At March 2003, Express had a balance sheet gearing of around 70 per cent, which was higher than its competitors. [*Details omitted. See note on page iv.*]

2.14. Compared with its competitors, Express's fixed assets are more highly depreciated; in addition its capital expenditure has in recent years been significantly less than its annual depreciation charge, whereas its competitors have each invested in excess of their annual depreciation charge. Together, these indicators suggest that Express has fallen behind in investment, supporting the evidence we have heard from the merger parties. (See further Tables 4.3 and 4.4.)

2.15. Although demand for milk is fairly stable, the tendency of national multiples to move substantial amounts of business from one supplier to another injects significant variability to an individual company's performance. The business of Express is discussed in more detail in paragraphs 4.5 to 4.36.

## **The merger situation**

2.16. On 27 March 2003, Express, Arla Foods UK Holding Limited (a subsidiary of Arla) and Arla entered into a merger agreement. The agreement was conditional, among other things, on approval by the relevant regulatory authorities and of the Express shareholders. Under the agreement, Express would acquire all the shares in Arla UK from Arla Foods UK Holding Limited. Shares in Express representing 51 per cent of the enlarged issued share capital of the merged entity would be issued to Arla Foods UK Holding Limited. The result would be:

- Arla would have a controlling interest in the merged entity which would in turn hold the entire share capital of Arla UK; and
- the existing shareholders of Express at completion would thereafter hold 49 per cent of the issued share capital in the merged entity.

Express shareholders approved the proposals on 24 April 2003.

## ***Jurisdiction***

2.17. Under our terms of reference (see Appendix 1.1), we are required to investigate and report on whether arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation, as defined in section 64(8) of the Act, in that:

- (a) enterprises carried on by or under the control of Arla will cease to be distinct from enterprises carried on by or under the control of Express (one at least of which is carried on in the UK); and
- (b) the value of the assets to be taken over exceeds £70 million (the assets test); or the merger will create or enhance a share of at least one-quarter in the supply of goods or services of any description in the UK, or a substantial part of the UK (the share of supply test).

2.18. ‘Enterprise’ is defined in section 63 of the Act as, or part of, the activities of a business. One of the circumstances in which enterprises are to be regarded as ceasing to be distinct (set out in section 65) is where they come under common ownership or control. Where we find that either the assets test or the share of supply test is satisfied, we are required to exclude the other from our consideration.

2.19. If we find that such arrangements are in progress or contemplation, then we are required to consider whether the creation of the merger situation may be expected to operate or (if events so require) operates against the public interest. In this regard, we are limited to consideration of such elements in, or possible consequences of, the creation of that situation which relates to the market for supply of fresh processed milk in the UK.

2.20. It is clear from the merger agreement (see paragraph 2.16), and what the parties have told us, that arrangements are in progress that, if carried into effect, will result in enterprises currently controlled by Arla and Express coming under common control. It is also clear, from Express’s balance sheet (see Appendix 4.2), that the value of the assets to be taken over, calculated in accordance with section 67 of the Act, exceeds £70 million.

2.21. In view of the considerations set out in paragraph 2.20, we conclude that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation as described in our terms of reference. Accordingly, we have to consider whether the creation of that situation may be expected to operate against the public interest.

## Background

2.22. There are over 200 liquid milk processors (which produce fresh processed milk and cream) in Great Britain. The largest of these processors are Arla UK, Dairy Crest plc (Dairy Crest), Express and Robert Wiseman Dairies PLC (Wiseman). There appears to be significant overcapacity in the industry currently. We [*Details omitted. See note on page iv.*] expect there to be continuing overcapacity in the industry post-merger.

2.23. The Competition Commission (CC) replaced the Monopolies and Mergers Commission (MMC) on 1 April 1999. The CC and the MMC considered the milk industry on three occasions in the past ten years. In 2000, the CC concluded that the supply of fresh processed milk to middle ground retailers in Scotland operated against the public interest, but the Secretary of State was not able to impose remedies (see further paragraph 3.71).<sup>1</sup> This followed an earlier merger inquiry relating to Scotland—the MMC recommended in 1996 that the merger between Wiseman and Scottish Pride Holdings plc should be allowed with certain conditions.<sup>2</sup> In its report on raw milk in 1999,<sup>3</sup> the MMC recommended the break-up of Milk Marque Limited into a number of independent quota-holding bodies and Milk Marque subsequently broke itself up in line with these recommendations.

2.24. We are aware that other UK competition authorities are currently considering milk industry issues. The Competition Appeal Tribunal is considering an application by Claymore Dairies Limited and Express under the Competition Act 1998. In those proceedings the applicants are seeking to challenge the decision of the Director General of Fair Trading to close his file on an alleged abuse of a dominant position by Wiseman in relation to the supply of fresh processed milk to middle ground customers in Scotland.

2.25. The OFT is currently investigating two matters in the milk industry. The first relates to allegations of price fixing and market sharing in the market for supply of milk in northern England. The second relates to separate allegations of price fixing and market sharing in the market for the supply of milk in Scotland.

2.26. As part of the first of the OFT's investigations referred to in paragraph 2.25, the OFT visited certain of the premises of the main parties and others on 3 July 2003. We sought explanations from the parties and the OFT. Unsurprisingly at this early stage in the investigation they were unable to supply us with information that would enable us to reach firm conclusions. We also noted that the OFT's investigations would not be complete before we had to submit our report. We recognized that if we found that any anti-competitive practices did exist, it could—but would not necessarily—affect our conclusions. In light of these considerations, we had to consider how to proceed.

2.27. We thought it was very unlikely that we would be able to complete any inquiries we might ourselves make into these allegations within the time then available. Because the merger was referred to the UK under the ECMR, the final decision needed to be published by 15 October (see paragraph 2.3). Furthermore, the OFT told us that were we to pursue our own inquiries into this matter, it could compromise its investigations. In any case, we considered that it was possible to address the key question for us—ie whether the merger could be expected to result in an increased incidence of coordinated behaviour—by examining the characteristics of the relevant market(s) with and without the merger. After due consideration, we decided that it was neither necessary nor desirable to investigate these allegations ourselves.

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<sup>1</sup>*Scottish Milk: a report on the supply of fresh processed milk to middle ground retailers in Scotland*, The Stationery Office, Cm 5002, December 2000.

<sup>2</sup>*Robert Wiseman Dairies plc and Scottish Pride Holdings plc: a report on the proposed merger*, The Stationery Office, Cm 3504, December 1996.

<sup>3</sup>*Milk: a report on the supply in Great Britain of raw cows' milk*, The Stationery Office, Cm 4286, July 1999.

## **The markets affected**

2.28. Around 6,800 million litres of fresh processed milk are consumed in the UK each year. Doorstep sales continue to decline and just over half of all fresh processed milk consumed is now purchased through the national multiples. The national multiples have developed specific requirements in relation to the production of milk, and this has influenced the development of the milk processing sector.

2.29. The national multiples purchase more than 98 per cent of their fresh processed milk from the four largest processors. Although there is a trade-off between processing efficiencies arising from very large dairies and increased transport costs, there is a trend towards developing ‘super-dairies’ with modern equipment and large volumes to supply these customers.

### ***Market definition***

2.30. In order to assess the merger’s effect on competition, we need to consider how the market or markets related to the supply of fresh processed milk should be defined. We confine our analysis to Great Britain because neither party supplies fresh processed milk in Northern Ireland.

#### ***Fresh processed milk***

2.31. Nearly all fresh processed milk is sold as whole, semi-skimmed or skimmed milk. There is very little further product differentiation beyond standardized fat content, although we did consider whether any of the following could constitute separate product markets for the purpose of this inquiry:

- Regional milk.
- Specially filtered fresh milk (Cravendale PurFiltre is the only brand available in the UK).
- Organic milk.
- Fresh flavoured milk.
- Milk other than cows’ milk.
- Sterilized milk.
- UHT milk.

2.32. Given that each of regional, Cravendale PurFiltre, and organic milk represents a very small percentage of the overall sales of fresh processed milk in the UK and that there appears to be a degree of demand-side substitution between them and regular milk, we have included them as part of the relevant product market. However, we do not think that fresh flavoured milk, non-cows’ milk, sterilized milk or UHT milk are close substitutes for fresh processed milk. (See further paragraphs 5.2 to 5.9.)

2.33. We conclude that the relevant product for the purpose of our consideration of this merger is fresh pasteurized non-flavoured cows’ milk (ie ‘fresh processed milk’—see glossary). This incorporates organic, regional and specially filtered milk, but does not include non-cows’ milk, flavoured milk, sterilized milk or UHT milk.

## *Future of supply to various customers*

2.34. The CC has previously considered the range of different categories of customer for fresh processed milk, most recently in the inquiry into the supply of milk in Scotland.<sup>1</sup> That inquiry's terms of reference excluded supply to Asda, Marks & Spencer, Safeway, Sainsbury's, Somerfield and Tesco (ie the larger supermarkets in Scotland at that time), retailers whose sole business was the delivery of fresh processed milk (either with or without other goods) to households, and all non-retailers. However, the CC said that that might not have been the most effective way to define the market from an economic perspective.

2.35. Instead, the CC suggested that the market could be considered as having three segments:

- (a) *the larger supermarkets;*
- (b) *middle ground customers*—other supermarket groups, shops other than supermarkets, catering market customers and public sector bodies; and
- (c) *doorstep.*

2.36. In the present inquiry, the merger parties suggested that there were important competitive interactions between the middle ground and larger supermarket segments. First, the purchasing patterns of many larger middle ground retailers were becoming more like those of the larger supermarkets—approximately [X] per cent of Express's middle ground sales in 2002, and approximately [X] per cent of Arla's middle ground sales in the same year, were to customers that procured on a national/multi-regional basis.

2.37. Second, they said that the smaller dairies which were meeting the demands of sophisticated middle ground purchasers were also increasingly able to meet the requirements of the larger supermarkets—a number of the smaller dairies had started to supply some of the larger supermarkets and several were established suppliers to large middle ground customers such as Aldi Stores Ltd, E H Booth and Co Ltd and Lidl UK GmbH.

2.38. Third, they noted that the larger supermarkets paid the same wholesale price to processors for milk for all of their stores, which further extended their competitive influence in the middle ground since several multiples now had high-street and convenience formats.

2.39. The parties also suggested that there was no longer a compelling case for regarding doorstep customers as a distinct market segment. They also drew attention to the reduction in doorstep sales over the past ten years and the corresponding increase in sales of fresh milk by the national multiples.

2.40. Although we agree that the boundaries are becoming increasingly blurred, we think it appropriate to consider both the largest supermarkets and doorstep customers as separate segments. We think that all customers have a degree of flexibility in shaping their requirements, but the volumes, processing requirements and distribution associated with supply to national multiples and doorstep customers allow these reasonably homogeneous groups to be broken away reasonably cleanly.

2.41. We consider that there is value in distinguishing a group that has the most demanding requirements in terms of quality, traceability and assurance of supply. The merger parties have acknowledged that middle ground customers tend to set less exacting standards in relation to the quality of their milk than national supermarkets. In our view, these additional requirements—over and above the characteristics shared with middle ground customers (as

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<sup>1</sup>Op cit.

highlighted by the merger parties)—coupled with the observation that supply of significant volume to the national multiples is limited to the four largest processors, justify drawing a distinction.

2.42. We also consider that the particular distribution requirements (for example, small volumes to many customers) associated with supply to doorstep customers make it useful to consider this element of the market separately. It is appropriate to limit this segment to the supply to final doorstep customers—supply to bottled milk buyers (BMBs), many of whom supply doorstep customers, is not included. Although we accept the merger parties’ suggestion that there is significant switching from doorstep to other retailers, we do not think this undermines the utility of the segmentation from a supply-side viewpoint.

2.43. The remaining middle ground segment is a ‘catch-all’. We considered breaking down the categories of customers still further, but concluded that there were not sufficiently distinct middle ground customer subcategories (for example, BMBs, catering, public sector bodies, retailers other than the national multiples) to warrant separate consideration for the purposes of this inquiry. This is despite the fact that there are clear differences between many of the individual customers—the problem is that the characteristics adopted by individual customers will overlap with many characteristics shown by customers in other categories. We noted, for example, that not all schools arrange their procurement of milk in the same way—with some having more in common with catering customers and others appearing to be more like doorstep customers.

2.44. For these reasons, we are satisfied that it is useful to consider three customer segments—national multiples, middle ground customers and doorstep customers—when assessing the competitive effects of this merger. We describe these segments and consider their relevant geographic markets in turn.

- *National multiples*

2.45. We accept that the line we have drawn between national multiples and the next level of major retailers is somewhat arbitrary. However, the top eight can be distinguished because of the importance they attribute to their own brands (all regular milk sold by national multiples carries their own labels) and the volumes of milk that they buy wholesale. By the top eight, we mean Asda, Marks & Spencer, Morrisons, Sainsbury’s, Somerfield, Tesco and Waitrose (the national multiples).

2.46. In our view, the importance that the national multiples attribute to their own brand has driven them to demand very exacting standards (including on traceability of product) and performance from their suppliers. This may be coupled with their preference for strongly centralized purchasing and large suppliers with multi-regional scope. These policies limit their main supply options to the four major processors, ie Arla UK, Dairy Crest, Express and Wiseman.

2.47. Table 2.1 shows that the supply to national multiples in Great Britain is dominated by the four largest processors.

TABLE 2.1 Shares of supply of fresh processed milk to national multiples in Great Britain

	<i>per cent</i>			
	1999/2000	2000/01	2001/02	April 2003
Arla	22	22	20	22
Dairy Crest*	25	22	24	24
Express	31	30	30	24
Wiseman	20	24	25	29
Others	<u>2</u>	<u>2</u>	<u>1</u>	<u>2</u>
Total	100	100	100	100

Source: Merger parties (estimates—see Table 5.2 for further details).

\*Includes share of Unigate PLC for 1999/2000.

Note: Financial years.

2.48. As we have noted in paragraph 2.29, these customers represent such an important element of the businesses of the major processors that they are investing significant amounts in super-dairies with modern facilities and lower average costs at high volumes to compete for this business. At present, few national multiples consider smaller dairies to be credible supply options for their regular milk.

2.49. The national multiples demand at least daily deliveries, either direct to their stores or to their own regional distribution centres (RDCs). Processors employ one of two distribution models—either direct from dairy or via a distribution depot. Although most deliveries are within 160 km of the dairy, it is viable to transport milk over much longer distances; for example, Wiseman serviced the Manchester area from Glasgow before it built its dairy there.

2.50. In order to determine the geographic scope of the market, we considered the location of those dairies that supply the national multiples and their activities in various regions (see further paragraph 5.32 and Figure 5.1). In broad terms (as shown on the maps in Figure 5.1, rather than reflecting ACNielsen regions), the current geographic presence of the processors supplying fresh processed milk to the multiples is:

<i>Region</i>	<i>Suppliers</i>
London and south-east England	Arla UK, Dairy Crest and Express
South-west England and South Wales	Dairy Crest and Wiseman
Central England	Arla UK, Dairy Crest, Express and Wiseman
North Wales	Arla UK, Dairy Crest and Wiseman
North England	Arla UK, Dairy Crest (via national multiples' RDCs), Express and Wiseman
Scotland	Express and Wiseman

2.51. The parties made a number of points to support their view that the geographical scope of the market for the supply of fresh processed milk to national multiples covers at least Great Britain, including:

- Prices to major multiples are bargained on a national basis and do not vary between regions.
- Wiseman already supplies middle ground accounts in the South-East—the parties believe that Wiseman would be able to compete effectively to serve national multiples' stores across London and the South-East.
- Wiseman's Droitwich dairy is only some 160 km from London and Wiseman supplies milk over much greater distances to a wide range of national multiples' outlets throughout Wales, the South-West and the North-East.

- Dairy Crest supplies sites over 160 km north of its Severnside plant, as well as sites in Yorkshire, and could increase its presence in northern England.
- Wiseman and Dairy Crest could easily expand their operations by supplying via an appropriately located depot. They state that Wiseman could establish a depot in west London (to be supplied from Droitwich) that could then service the South-East. Similarly, Dairy Crest could establish a depot near Manchester (to be supplied from Severnside) to service central and north England.
- Both Dairy Crest and Wiseman planned to expand—the parties cited statements of intent in Dairy Crest’s and Wiseman’s annual reports for 2002.

2.52. We broadly agree with the parties; see further paragraphs 5.33 to 5.44.

2.53. Further, we note that both (a) the importance of delivering to customers fresh processed milk with adequate shelf life remaining, and (b) the high cost of transport relative to unit value, mean that the product is not easily imported from outside Great Britain.

2.54. Taking account of these considerations, we consider that the geographic scope of the market to supply the national multiples is no wider than Great Britain, and note that supply in Scotland may have some regional aspects due to the absence of current or likely future operations of Dairy Crest in the area. However, since there is no overlap between the parties in Scotland, we leave aside this issue for the purposes of assessing the proposed merger.

- *Middle ground customers*

2.55. Middle ground customers are not a homogeneous group—we are defining the segment as all customers who are neither national multiples nor doorstep customers. Within this definition, we have included BMBs which buy milk from dairies for onward distribution to doorstep customers.

2.56. Given that the middle ground segment is made up of a variety of different types of customers, with varying requirements, it is not possible to identify all the relevant markets. There are at least four factors that appear to have some bearing on which dairies are available to supply any particular customer—the size of dairy, its location, whether it has glass bottle and/or non-returnable container (NRC) filling capacity, and whether it can access the means for distribution. In respect of the geographic market for the middle ground sector, we note that the actual location of dairies can have a strong bearing on the nature of competition in any particular region.

2.57. The parties suggested that the geographic market for sales to middle ground customers was England and Wales because (a) an increasing number of larger middle ground customers procured supplies on a national/multi-regional basis, and (b) in respect of smaller customers, there was a chain of substitutability which linked each region (however defined) with its neighbouring regions throughout England and Wales. They noted that because of the lack of dairies in the far north of England, the chain of substitution did not extend to Scotland.

2.58. Although we agree that the geographic scope of the market may be quite broad for some customers (particularly those with centralized procurement), this is certainly not the case for all middle ground customers. The price data that the parties supplied for middle ground customers showed that prices ranged from less than [redacted] pence per litre (ppl) to more than [redacted] ppl. We accept that costs vary and different cost factors may determine some price differentials. However, Arla UK told us that the bargaining process and the buyer power of the customer also affected the price agreed, as did the extent to which processors were keen to secure marginal volumes.

2.59. We have rejected the merger parties' argument that there is a chain of substitution in respect of prices, as we note that that would require prices to be transparent in order to allow customers readily to identify the best deals. It is clear that price differentiation is the norm for this market.

2.60. Accordingly, it is our view that it is not appropriate to adopt a broad geographic market definition for middle ground customers on the basis of a chain of substitution. Instead, we conclude that there are a series of markets that overlap geographically, determined by groups of customers and, in some cases, by individual customers.

2.61. We have not sought to define these markets. For the purposes of our inquiry, it is sufficient to determine whether or not the merger will result in there being substantially less competition to supply middle ground customers in significant markets.

2.62. We approach this by considering what alternative supply options are available to customers in those parts of Great Britain where both parties currently hold a significant share of sales and where their combined sales will be substantial (see paragraph 2.84 onwards).

- *Doorstep customers*

2.63. There has been a dramatic shift from doorstep sales to supermarket sales over the past ten years. The parties told us that the decline in doorstep sales in recent years was from 1,449 million litres per annum (mlpa) in 1999/2000 to 1,110 mlpa in 2001/02, a 23.4 per cent decrease.

2.64. We agree with the parties that the geographic scope for supply to doorstep customers is local—each delivery round can be viewed as a 'local monopoly', at least in the short term, since customers generally have only one option for doorstep delivery of bottled milk. Thus, to the extent that the price of doorstep deliveries is constrained, it is not from roundsmen working contiguous regions but rather the possible loss of further doorstep sales to alternative sources of supply, namely retailers.

## **Situation in the absence of the merger**

2.65. In order to assess the effects of a merger, the CC generally takes a view on what would be likely to happen in the absence of the merger.

2.66. We consider that both Arla UK and Express are currently viable businesses. However, we would expect Express's position to weaken over the next 12 to 18 months if new investment capital could not be found. [

*Details omitted. See note on page iv.*

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2.67. The parties have told us that the merger is necessary to achieve better economies of scale to compete effectively and fund new investment. They said that they had not made the necessary investment over the years to be on a par with the two leading milk processors in terms of efficiency. They believed that the merger would narrow the gap by allowing inefficient capacity to be replaced with new, modern and more efficient capacity. The parties indicated that operating the new Stourton dairy at a throughput of [⌘] mlpa could reduce the merged entity's costs by up to [⌘]ppl—see further paragraphs 4.69 and 4.70.

2.68. The parties also told us that the merger was a good fit between their existing businesses. Express would benefit from Arla's branded imported products and Arla would benefit from the opportunity to market these products through the enlarged distribution network

of the merged entity. Express also noted that the problem of its pension scheme deficit could be difficult to overcome without the merger.

2.69. We considered alternative scenarios that could occur in the absence of the merger. One possibility is that Express could attract another investor—either from within or outside the industry (which would clearly have an impact on the competitive effects). However, we do not think this is likely; Dairy Crest and Wiseman have undertaken significant investments, mid-size processors are unlikely to have the funds necessary and there does not appear to have been any interest from farmers’ groups or anyone outside the industry.

2.70. A further possibility is that an independent Express would be forced to dispose of significant elements of its business, perhaps to a number of different buyers. In this scenario, an increasingly weakened Express would be some way behind the three major processors (Arla UK, Dairy Crest and Wiseman) and, although it would probably continue to supply middle ground customers, it would be unlikely to offer a credible supply alternative to national multiples.

2.71. We also considered whether Express or Arla UK would exit the market if the merger did not proceed. In the absence of the merger, we think that Arla UK and Express may lose customers in the short term—we have noted: (a) that the other major processors have developed super-dairies and successfully reduced their costs; (b) Express’s inability to invest; and (c) the fact that Arla UK’s fresh milk processing business is smaller than those of its major competitors. Nevertheless, we would not expect either to exit the market in the short term. It is our view that Arla UK’s customers would, for example, be reassured by the development of Stourton and that Express could refocus its business (perhaps on one or two segments of the market) in order to bolster its position, though quite possibly at a lower market share overall.

2.72. [

*Details omitted. See note on page iv.*

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## **The public interest**

2.73. Our terms of reference require us to consider whether the merger may be expected to operate against the public interest, limiting our consideration to the market for supply of fresh processed milk in the UK, and the Act requires us to take into account all matters which appear to us in the particular circumstances to be relevant and, among other things, to have regard to the desirability:

- (a) of maintaining and promoting effective competition between persons supplying goods and services in the UK;
- (b) of promoting the interests of consumers, purchasers and other users of goods and services in the UK in respect of the prices charged for them and in respect of their quality and the variety of goods and services supplied;
- (c) of promoting, through competition, the reduction of costs and the development and use of new techniques and new products, and of facilitating the entry of new competitors into existing markets;
- (d) of maintaining and promoting the balanced distribution of industry and employment in the UK; and
- (e) of maintaining and promoting competitive activity in markets outside the UK on the part of producers of goods, and of suppliers of goods and services, in the UK.

2.74. In this case, we sent letters to Arla UK and Express (the Issues Letter) in which we set out several issues which appeared to us to be relevant in assessing whether the merger could be expected to operate against the public interest. The main content of the letter was published as an Issues Statement (see Appendix 2.1), to elicit views on the impact of the merger in respect of: (a) competition in supply to national multiples; (b) national multiples' buyer power; (c) competition in supply to middle ground customers; (d) competition in supply to doorstep customers; (e) coordinated behaviour; (f) wider impacts including farm-gate prices and milk quality; and (g) efficiency improvements. We consider these issues in turn.

2.75. Clearly, if we concluded that an increase in coordinated behaviour would arise in consequence of the merger, this could affect our view of competition in supply to any of the three customer segments. However, we consider first the impact of the merger assuming that there is no increment in coordinated behaviour. We then turn to the question of coordinated behaviour in order to complete the assessment of competition.

### ***Competition in supply to national multiples***

2.76. It is clear that the merger will result in the supply to national multiples becoming even more concentrated than it is now, with only three processors supplying almost 100 per cent of this market segment. We expect that there would continue to be excess capacity 12 to 18 months post-merger. The parties estimate that overcapacity post-merger will be around 29 per cent (see further paragraphs 5.68 to 5.74). We consider this to be sufficient to give these large customers flexibility to switch their supply between the major processors.

2.77. The parties said that both Dairy Crest and Wiseman presently had the ability to compete to supply many national multiples' stores in the North and London/South-East respectively using their existing facilities. Dairy Crest and Wiseman told us that this would be possible by using milk depots serviced from existing dairies (see further paragraphs 5.36 to 5.40). Given that access to depots does not present a barrier to expansion (see paragraph 4.81), it is our view that each of the major processors will have the potential to expand their national coverage post-merger.

2.78. The parties also suggested that competition for supply to national multiples could come from existing middle ground suppliers or new entry, possibly from farmers. We consider that the likelihood of expansion or entry from these quarters is related to the requirements set by the national multiples—for example, these customers could reduce the volumes that they offer for individual tenders to make contracts more attractive to smaller processors and they have the option of sponsoring expansion or new entry by guaranteeing business. Whilst some national multiples told us that they would not pursue these options, nonetheless the fact that the option is available acts as a constraint.

2.79. Although the merger would reduce the number of suppliers to the national multiples from four to three, this may overstate the risk to competition which the merger would represent since, as noted in paragraph 2.72, absent the merger, we consider that one of the four will be weakened, potentially severely.

### ***National multiples' buyer power***

2.80. A number of factors indicate that the national multiples have a significant degree of buyer power in respect of their purchases of fresh processed milk, for example:

- All regular fresh processed milk sold by national multiples is under their own labels. Therefore, despite the fact that milk is a very important product for the national multiples to carry at a competitive price, there is no brand loyalty for regular milk.

- The share of each major processor’s sales to multiples as a proportion of its total sales continues to grow, and a high proportion of the sales of each of these processors is now concentrated in only three or four customers.

2.81. It appears to us therefore that, despite the Supermarket Code,<sup>1</sup> the national multiples are able to exert a substantial degree of buyer power in relation to the supply of fresh processed milk. This view is consistent with evidence of increasing gross margins on milk made by the national multiples in recent years (see paragraphs 5.98 and 5.99).

2.82. We expect the national multiples to continue to have a significant degree of buyer power post-merger, especially given the expected overcapacity in what is effectively a commodity market. If the national multiples became dissatisfied with the level of service or price available from the major milk processors, it is our view that they would be able to invite tenders from a wider pool of suppliers. (See further paragraph 5.104.)

2.83. In light of these considerations, we do not expect the merger to result in a substantial lessening of competition in respect of supply to national multiples.

### ***Competition in supply to middle ground customers***

2.84. The middle ground segment includes supply of milk in glass bottles and NRCs—we consider these separately. First, in relation to the supply of milk in glass bottles, we do not expect the merger to have a material effect on competition as there is overcapacity and shrinking demand. We accept the view put to us by one BMB that the parties could not afford to raise the price of bottled milk to BMBs, as this would be passed on to final consumers with the end-result of even greater losses of sales in this sector.

2.85. Second, we consider the competitive effect of the merger in respect of supply to middle ground customers in NRCs. As set out in paragraph 2.62, we need to consider those parts of England and Wales where the parties’ combined sales are substantial and the increment in the merged entity’s share is significant. The areas that warrant further consideration are the ACNielsen regions of Lancashire and London due to the substantial share of sales that the parties combined currently enjoy in both regions, the significant increment in Lancashire and the volume of sales in London (see Table 2.2 and, further, paragraphs 5.125 and 5.126 and Table 5.5).

**TABLE 2.2 Share of primary sales of fresh processed milk in NRCs to middle ground customers in England and Wales, by ACNielsen regions , February 2003**

	<i>per cent</i>							
	<i>London</i>	<i>Midlands</i>	<i>Lancashire</i>	<i>Yorkshire</i>	<i>Southern</i>	<i>Anglia</i>	<i>Tyne &amp; Tees</i>	
Arla	5	( )	25	( )	<i>Figures omitted. See note on page iv.</i>			( )
Express	28		31					
Combined	33		57					
Others	67		43					
Total	100		100					

Source: Merger parties.

2.86. London is served by a number of processors other than the parties, including Dairy Crest, Associated Co-operative Creameries Limited and Freshways Limited, who supply significant volumes of milk from within or outside the region. We also note that the presence of

<sup>1</sup>The OFT Code of Practice on Supermarkets’ Dealings with Suppliers.

several wholesalers, who often source their milk from smaller dairies outside the London ACNielsen region, may extend the scope of the geographic market. Given the apparent numerous sources of supply, we do not expect the merger to lessen competition for supply of fresh processed milk in NRCs to middle ground customers in London.

2.87. In Lancashire, there is a particular concentration of dairies that currently supply middle ground customers. Even the smallest dairies are potential suppliers to many middle ground customers.

2.88. Our investigations revealed that concerns expressed by customers were exceptions rather than the rule. In the ACNielsen regions of Lancashire and Yorkshire, there appear to be some cases where Arla UK and Express are the only processors that deliver to certain customers, particularly schools. However, we note that wholesalers are already delivering other fresh produce to these customers and it is our view that the potential of these wholesalers to supply fresh processed milk should exercise a competitive constraint on a sole processor-supplier.

2.89. In relation to supply to larger middle ground customers with high-volume drops, we note that whilst larger drop sizes may mean that some smaller local processors and wholesalers are not well equipped to supply these customers, the greater volume available on these accounts may attract larger suppliers from further afield. We do not therefore expect the merger to have an appreciable effect on competition to supply these customers.

2.90. In the light of these considerations, we do not expect the merger to result in a substantial lessening of competition in relation to supply to middle ground customers.

### ***Competition in supply to doorstep customers***

2.91. The merger parties said that there were only three ACNielsen regions where both parties operated franchised and/or managed doorstep rounds, and they put forward a number of arguments to support their view that the proposed merger would not raise any local competition concerns.

2.92. We received no representations that the merger would result in a substantial reduction in competition in the doorstep sector. We are persuaded by the merger parties' arguments that the merger would have little impact in this sector.

2.93. First, there is no actual competition between the merger parties' franchised or managed doorstep operations. Second, the degree to which the merger parties' doorstep businesses serve adjoining areas is very limited. It is our view that the major price constraint in the doorstep sector is that unjustified price rises would increase the rate at which customers switch to other forms of supply. We therefore conclude that the merger is not expected to result in a substantial lessening of competition with respect to the supply to doorstep customers.

### ***Coordinated behaviour***

2.94. The factors that facilitate coordinated behaviour largely relate to both tacit and explicit collusion. One consideration is that the reduction in the number of suppliers to certain customers following the merger would make either form of collusion easier as there are fewer businesses that would need to reach an agreement or observe each other's behaviour.

2.95. Whilst we are aware of allegations of anti-competitive behaviour in the industry, we are in no position to conclude that there has been explicit collusion to date. However, we acknowledge that this does not mean that it has not occurred or will not occur in future.

2.96. Although some of the factors conducive to coordinated behaviour (either explicit or tacit collusion) exist in this market, we have also observed other characteristics that are not conducive to coordinated behaviour. This is discussed in more detail in paragraphs 5.106 to 5.119 and paragraph 5.151.

2.97. For example, in supply to national multiples, prices are negotiated and opaque, and we consider that the national multiples have considerable opportunities to disrupt coordinated outcomes due to their buyer power and ability to encourage expansion or new entry. In the middle ground segment, there is less buyer power but we would expect little increment in the likelihood of coordination because of the greater number of supply options. And with respect to doorstep customers, we do not expect the merger to alter the market significantly and therefore believe that the likelihood of coordination would be unchanged.

2.98. Having regard to all the evidence before us, we do not have an expectation that coordinated behaviour (explicit or tacit) would occur in any of the three market segments as a consequence of the merger.

### ***Wider impacts***

2.99. We considered the impact of the proposed merger on farm-gate prices and on the quality of fresh processed milk. We found no evidence to suggest that this merger would impact detrimentally on either.

### ***Efficiency improvements***

2.100. The parties submitted that the merger would result in a number of efficiency improvements that could not be realized in the absence of the merger (see paragraphs 4.114 to 4.116). However, we have not sought to assess these benefits as we have not identified any adverse effects against which it would be necessary to weigh benefits.

### ***Conclusion***

2.101. We conclude that we do not expect the merger to operate against the public interest. In particular, we do not expect it to lead to a substantial lessening of competition in the supply of fresh processed milk.