



# **Clifford Kent Holdings Limited and Deans Food Group Limited**

A report on the completed merger of Clifford Kent Holdings Limited, parent company of Stonegate Farmers Limited, and Deans Food Group Limited

20 April 2007

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The Competition Commission has excluded from this published version of the 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 ✂.

# Completed merger of Clifford Kent Holdings Limited and Deans Food Group Limited

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### Glossary

## Summary

1. On 13 September 2006,<sup>1</sup> the Competition Commission (CC) was asked to investigate the completed merger of Clifford Kent Holdings Limited (Clifford Kent), parent company of Stonegate Farmers Limited, and Deans Food Group Limited (Deans) through Noble Foods Limited (Noble), with both Stonegate<sup>2</sup> 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 pasteurized to supply to food manufacturers in liquid or powdered form; and small eggs which have been hard-boiled. The Office of Fair Trading (OFT) said that the merger had given Noble around 60 to 70 per cent of the supply of shell eggs to retailers and over half of the supply of liquid eggs, 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 2004/05, Deans had a turnover of £314 million and an operating profit of £7.2 million; turnover in Stonegate Farmers Limited 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.
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 (the merged business); 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 to sell their eggs after the merger, that Noble could reduce egg prices to producers, 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. Noble 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.

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

<sup>2</sup>In this report, we refer to the group consisting of Clifford Kent and its subsidiaries, the largest of which is Stonegate Farmers Limited, as Stonegate (except where we need to specify companies).

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, non-organic free range eggs, and 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.
9. 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. At the time of our provisional findings, we did not therefore regard the supply of liquid eggs as a market wider than the UK for those customers for whom imports provide a poor substitute. However, evidence that we received in response to our provisional findings suggested that the geographical market definition for liquid eggs was less clear-cut. Some customers are clearly prepared to acquire eggs produced and processed either in the UK or in Continental Europe. Others prefer to use liquid eggs that have been processed in the UK but are less concerned at least for some of their own requirements whether the eggs themselves are of UK origin. Others, responding to the demands of retail customers, only wish to use liquid eggs from eggs produced and processed in the UK. The extent to which the merger will reduce competition depends on particular customers choosing between all three alternatives and the ability of Noble to determine their willingness to do so: a combination of interrelated factors, which we find it more appropriate to consider together.
10. 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**

11. *Competitive effects: switching.* Following the merger of Deans and Stonegate, the OFT said, as noted above, that Noble accounts for over 60 per cent of sales of shell egg to retailers, consistent with the figures we have seen. 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, the main element of the switching by the major retailers that has occurred over the past five years has been 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.

12. 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 minimize 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).
13. *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. Increasing availability through entry or expansion of free range production is likely to be a lengthy process, given the need for planning permission, particularly with regard to free range facilities, 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.
14. *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.
15. *Bargaining power.* Multiple retailers account for the overwhelming majority of retail sales of shell eggs. The parties argue that the bargaining power of multiple 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.
16. In our 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

17. 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 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

18. *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 pasteurized 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, but, in our view this is not sufficient to establish demand substitutability given the strong preference of some customers not to use powdered eggs or imported shell eggs.
19. In our provisional findings, we took the view that 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: that 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; and that the merger might, therefore, 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. Subsequent to the provisional findings, however, and given new evidence received, we have reconsidered whether there are sufficient alternative sources of competition to offset the effects of the loss of competition between Deans and Stonegate. We still have concern that some customers may have difficulty in switching some of their requirements to other suppliers, but the extent to which this may be the case is uncertain—to ourselves and, to some degree, to Noble in negotiating prices. Although some loss of competition may result from the merger, the threat by customers in aggregate to switch some of their requirements to imported liquid eggs or to other UK suppliers in response to any attempted price increase seemed to us effective enough to conclude that the merger may not be expected to result in an SLC in supply of liquid eggs.
20. *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

21. 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 we believe it would ultimately result in the reduction in the quantity of eggs produced and so would raise prices to retailers and final consumers. Hence, in our view the merger may be expected to result in an SLC in the procurement of shell eggs from producers.

## Conclusion

22. We have therefore found that the merger may be expected to result in an SLC in the following markets:
- (a) the supply of cage and barn, of free range and of organic shell eggs to retailers; and
  - (b) the procurement of shell eggs from producers in the UK.
23. As a result of the SLCs identified, the merger may 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 would allow 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 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
  - (e) 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

24. In addition to the unilateral effects of the merger we considered whether it could also result in a multilateral increase in prices to retailers—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 the smaller suppliers of shell eggs to retailers, 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 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 to attain higher prices than would otherwise be the case. Given our conclusion that the merger may be expected to result in an SLC through its unilateral and multilateral effects, we have not needed to reach a final view on whether, on balance, coordinated effects may also be expected.

## Remedies

25. 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 Enterprise Act 2002) in relation to the merger.
26. We concluded that:
- (a) the divestiture of Stonegate is likely to be the most practicable and effective, comprehensive and proportionate remedy for dealing with the SLC and the resulting adverse effects of the merger;
  - (b) the behavioural remedy proposed by Noble and its subsequent revisions, which would allow some Noble producers to give a shorter notice period to be released from their contracts in order that they could supply other suppliers, is not as practicable and effective and comprehensive as divestiture in remedying the SLC;
  - (c) The process and scope for divestiture is set out in paragraph 8.50, including:
    - Noble being allowed [X] to sell Stonegate to a suitable purchaser (the initial period). The initial period may be extended by the CC by [X] (to make a maximum period of up to [X]) if the monitoring trustee satisfies the CC that good progress is being made in the sale process. If required by the buyer and the requirement is considered reasonable by the CC, [X];
    - If Stonegate is not sold within the initial period (including any extension referred to above) the CC would have the right to appoint an independent divestiture trustee with the mandate to dispose of Stonegate to a suitable purchaser at the best available price in the circumstances.
    - If the divestiture of Stonegate proves not to be possible a form of behavioural remedy, as described in paragraphs 8.77 and 8.78, should then be implemented.

# Findings

## 1. The reference

- 1.1 By a reference made by the OFT on 13 September 2006,<sup>3</sup> the CC was asked to investigate the completed merger of Clifford Kent, the parent company of Stonegate Farmers Limited, and Deans through 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 an SLC within any market or markets in the UK or parts of the UK. Following an extension to the original inquiry period ending on 27 February 2007, we are required to report by 24 April 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 or 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 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 company, Noble, which acquired the majority of the shares of Deans and Clifford Kent, which in turn holds the majority of shares in Stonegate Farmers Limited, the main subsidiary of Clifford Kent that deals in eggs. (In this report we refer to the group consisting of Clifford Kent and its subsidiaries, the largest of which is Stonegate Farmers Limited, as Stonegate, except where we need to specify companies.) 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.<sup>4</sup> 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 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.

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<sup>3</sup>The terms of reference were revised on 12 December 2006 in order to clarify the merging entities, in particular including a reference to Clifford Kent. Other minor typographical changes were also made.

<sup>4</sup>Initially incorporated as Goodmix Limited (Goodmix) (see paragraph 2.16).

- 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 14 September 2006. Revised undertakings that replaced these earlier undertakings were given to the CC on 20 November 2006 and published on our website ([www.competition-commission.org.uk/inquiries/ref2006/stonegate/index.htm](http://www.competition-commission.org.uk/inquiries/ref2006/stonegate/index.htm)).
- 1.8 We published our provisional findings (a non-confidential version of which is on our website) and a Notice of Possible Remedies on 5 January 2007 and received comments from main parties and third parties.

## 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.<sup>5</sup> 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 [§<].<sup>6</sup>
- 2.2 Production standards are set by EU egg market regulations<sup>7</sup> 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).<sup>8</sup> 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.<sup>9</sup>

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: Department for the Environment, Food and Rural Affairs (Defra).

Note: Figures in this and other tables may not sum due to rounding.

As shown in Table 1, in 2005, cage eggs accounted for approximately 63 per cent of the volume of UK production, barn 6 per cent and free range (including organic) 30 per cent. By producer<sup>10</sup> value, however, cage accounts for 48 per cent of production, barn 7 per cent and free range (including organic) 45 per cent.

<sup>5</sup>The 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.

<sup>6</sup>Defra statistics; the parties presentation to banks and Deans 2004–2007 Shell Egg Division Business Plan.

<sup>7</sup>The 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.

<sup>8</sup>Organic 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.

<sup>9</sup>Defra statistics; parties' presentation to banks.

<sup>10</sup>Producers are egg farmers who provide eggs to egg suppliers and other third parties.

- 2.3 We saw estimates from the parties and other sources<sup>11</sup> that over 50 per cent of available eggs are supplied to retailers,<sup>12</sup> the bulk of these sales being direct sales by suppliers<sup>13</sup> to retailers. However, [X] of the combined sales volumes of Deans and Stonegate, are supplied to retailers. The multiple retailers (operators of chains of supermarkets) account for over [X] of sales; and the four major retailers<sup>14</sup> alone for some [X] of such sales. The bulk of sales by retailers [X] 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, other parties suggested,<sup>15</sup> an investigation by Defra) into the possible mis-labelling of eggs by a smaller egg supplier,<sup>16</sup> 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.
- 2.5 Almost 25 per cent<sup>17</sup> of the total volume of eggs was estimated to be sold through wholesalers. It was stated in the parties' presentation to banks that the section of the wholesale market for eggs responsible for supplying independent retailers had undoubtedly shrunk in recent years with the increasing share of retailing accounted for by multiple retailers; hence 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 quality<sup>18</sup> and ungraded eggs have been broken and pasteurized 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: pasteurized 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.<sup>19</sup> Improvements in those

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<sup>11</sup>Parties' presentation to banks; Mintel *Eggs, Market Intelligence*, June 2006 also estimates UK retail sales of eggs of about 5 billion in 2005, compared with production of almost 9 billion in Table 1.

<sup>12</sup>Organizations providing food for domestic consumption, including supermarkets, symbol groups and independent grocery stores.

<sup>13</sup>Suppliers are firms who contract to supply eggs to retail and other commercial customers. But see paragraph 2.10.

<sup>14</sup>Tesco plc (Tesco), J Sainsbury plc (Sainsbury's), Asda Group Limited (Asda), Wm Morrison Supermarkets plc (Morrisons).

<sup>15</sup>For example, by one major retailer ([X]) and the CEA.

<sup>16</sup>We were aware of developments in the investigation by Defra during the course of the inquiry, and how it had affected the companies involved in our inquiry, but this has not affected our decision.

<sup>17</sup>BEIC estimated the food service industry to account for 23 per cent of the market.

<sup>18</sup>Second-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.

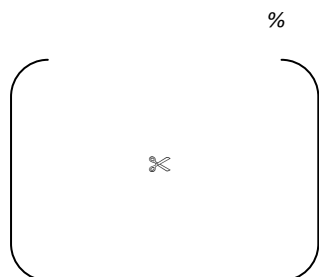
<sup>19</sup>We understand there are around 80 different sets of legislation covering poultry production and marketing, relating to: animal housing; town and country planning; animal welfare; animal health, including salmonella, avian influenza and Newcastle

standards, particularly a ban by 2012 on conventional cage egg production and the introduction of 'enriched cage' egg production (see Glossary) are estimated by the parties<sup>20</sup> to 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 mark, 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 heard<sup>21</sup> also referred to the Lion mark as having helped to protect the UK market from imports.

2.9 The BEIC is itself an organization 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 summarized in Table 2.

TABLE 2 Percentage of Lion-marked 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 mark and the 7 per cent 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;

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.

<sup>20</sup>[X]

<sup>21</sup>Including the British Free Range Egg Producers' Association (BFREPA), and the main parties in the parties' presentation to banks.

- (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 overlap in activities between the two companies, now combined as Noble, 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, 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 Farmers Limited 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 [X] of Deans' eggs are produced for it by independent producers. [X]
- 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. [X] per cent of the eggs supplied by Stonegate are produced for it by independent producers. [X] It also no longer has its own egg processing facilities, all of the processed eggs it supplies being processed for it by third parties (see paragraph 6.80). Geographically, Stonegate is limited outside its main areas of supply and it supplies shell eggs to only one retailer in [X] and one in [X].
- 2.16 Goodmix was incorporated for the purpose of effecting the merger between Deans and Stonegate. It changed its name to Noble soon after the merger.

## ***Parties' rationale for the merger***

- 2.17 As the parties told us in their submission (reproduced on our website) 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 realizing part of the value of his investment (the effect of this on the companies' financial situation is referred to in paragraph 2.21 and 8.25). [REDACTED] But also as part of its objective to be a least cost operator Deans believed that 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 [REDACTED] 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 [REDACTED]

### **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 summarized above, they were both profitable before the merger. Deans' recent Business Plans showed it had a clear strategy as an independent company. [REDACTED]
- 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 significant change in the structure of supply of shell eggs. We have therefore reached an expectation that, in the absence of the merger, the market structure prevailing before the merger would have been sustained at least as regards the supply of shell eggs (there is, however, somewhat more uncertainty about the supply of liquid eggs to which we refer in paragraph 6.90(a)).

## 4. Issues

- 4.1 In its press notice issued at the time of the reference, the OFT said that the merger had given Noble around 60 to 70 per cent of supply of shell eggs to UK retailers and over half of the supply of liquid eggs, 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), 12 responses to a questionnaire sent to larger liquid egg customers;<sup>22</sup> ten responses to questionnaires sent to smaller liquid egg customers; and slightly fewer than 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 (but [redacted] of the four major retailers) expressed concern about the effects of the merger, in particular, [redacted], [redacted], [redacted] and [redacted]; of those [redacted] expressed a concern that the merger would remove 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. Among 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 reluctant to import; and hence that there would be a loss of competition and adverse effects on prices and innovation.
- 4.4 Of ten 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, [redacted]. However, the majority (8 of 12) of 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 with 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 slightly fewer than 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.

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<sup>22</sup>These customers were among the 30 largest customers of Deans and equivalent size for Stonegate.

- 4.6 The parties argued that two main factors would ensure the merged company would not have market power in supplying retail customers. These were first, the bargaining power of their customers, and their ability to switch, or threaten to switch business to smaller competitors or to imports; and 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 market(s)

- 5.1 We discuss definition of the relevant market or markets affected by the merger in more detail in Appendix D. As stated in the CC's merger guidelines,<sup>23</sup> 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, first in the context of supply to retailers about which, as noted in paragraph 4.1, the OFT was primarily concerned; and second, 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 recognizing, 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.<sup>24</sup> 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 seven 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.

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<sup>23</sup> *Merger References: Competition Commission Guidelines, CC2*, June 2003, paragraph 2.4.

<sup>24</sup> As shown, for example, in *Mintel Eggs, Market Intelligence*, June 2006.

- 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 eggs—particularly for supply to retailers.
- 5.4 We consider 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 separate types of eggs. In particular, some consumers strongly prefer free range eggs, for which they are prepared to pay a higher price, given their concern for animal welfare; or organic eggs, with an even higher price 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 1, clear evidence that [redacted] in free range eggs have no impact on sales of cage eggs or vice versa.<sup>25</sup>
- 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)<sup>26</sup> 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.
- 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

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<sup>25</sup>However, we do not have any clear quantitative evidence in relation to the sale of barn eggs and have therefore not been able to draw any similar conclusion.

<sup>26</sup>A 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.

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

	<i>pence/dozen</i>			
	<i>Organic</i>	<i>Free range</i>	<i>Barn</i>	<i>Cage</i>
Feed				
Bird depreciation				
Mortality				
Wages			✂	
Direct expenses				
Capital depreciation				
Total p/dozen				

Source: Deans.

Notes:

1. Feed: [✂]. 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 6.49). 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. On the other hand, the figures in Table 3 suggest that, given the significantly different costs of cage and barn eggs (in addition to the costs of converting a facility), 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 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-marked 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, 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.<sup>27</sup> 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 In its comments on the provisional findings Noble argued that our finding of a separate wholesale market for shell eggs was based on 'conjecture not evidence'. We do not accept this. We noted in paragraph 2.5 that with the increasing share of retailing accounted for by multiple retailers, the section of the wholesale market responsible for supplying independent retailers had shrunk in recent years, and that the bulk of the wholesale sector is now accounted for by foodservice companies or companies serving restaurants or caterers. We saw nothing to suggest that multiple retailers would, for example, consider being supplied through wholesalers in the event of a SSNIP by any hypothetical monopoly supplier to retailers, given the different requirement of those customers. Among other evidence to suggest a separate retail market are the very different shares of supply to catering and wholesaler customers on the one hand and to retail customers on the other [REDACTED].<sup>28</sup> [REDACTED] There may be some enterprises supplying only catering and wholesale customers who would be in a position to supply some retail customers on a limited basis, or other suppliers who currently supply retail as well as catering and wholesale customers who could expand their sales to retailers to some extent. But they are

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<sup>27</sup>[REDACTED]

<sup>28</sup>Noble said that there was [REDACTED]. We do not regard these factors as inconsistent with there being separate wholesale and retail markets.

much smaller than the parties and their ability to supply retailers on any scale is likely to be limited.

- 5.15 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, non-organic free range eggs, and 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 as appropriate. In practice, moreover, the statistics available for the industry do not fully distinguish between these markets.<sup>29</sup>

### *Geographical markets for shell eggs*

#### *Supply to retailers*

- 5.16 For the reasons set out in Appendix D, it is unlikely that the relevant geographic market for any of the above three categories of supply 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 mark 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 multiple 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.
  - (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.

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<sup>29</sup>Mintel: *Eggs, Market Intelligence*, June 2006, 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.

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 6.60 et seq.

5.17 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,<sup>30</sup> 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.

(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’ marked eggs in Scotland and have also seen published estimates<sup>31</sup> of one of the other suppliers, Glenrath Farms Ltd (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 Great Britain, we understand few, if any, suppliers in Great Britain 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 Great Britain is clearly relevant in our consideration of competition.

5.18 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 [REDACTED], so whether either Northern Ireland or Scotland are separate markets does not materially affect our analysis.

### *Supply to catering and wholesale customers*

5.19 The factors set out in paragraph 5.16 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

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<sup>30</sup>The 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.

<sup>31</sup>Mintel: *Eggs, Market Intelligence*, June 2006.

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 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***

- 5.20 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.
- 5.21 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 being profitable for a hypothetical monopolist. They appear to concede that supply-side substitution from liquid to powder egg is not easy.
- 5.22 The parties provided us with details of customers using both powder and liquid eggs, but this does not necessarily mean such customers would switch to one from the other in response to a SSNIP and vice versa. Their evidence included internal memoranda referring to [REDACTED].
- 5.23 We sent a questionnaire to Deans' and Stonegate's liquid egg customers. (The respondents represented about [REDACTED] the value of the parties' liquid egg sales.) Their replies indicated that for many customers liquid and powdered eggs are not substitutable following a SSNIP by a hypothetical monopoly supplier. Only [REDACTED] per cent by value of Deans' and Stonegate's 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). Some respondents 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, but in their comments on the provisional findings, they argued they had rebutted the views of customers that powdered eggs were not a substitute for liquid eggs by pointing to a number of customers that had switched from one to the other or considered doing so, in some cases on cost grounds. We do not, however, believe the very strong perception of some customers can be dismissed: the standard approach to market definition is to start with a narrow market and see if there is sufficient substitutability to widen this definition, which would be determined in part by the perception and behaviour of customers.
- 5.24 The parties estimated that sales volumes would need to decrease by about [REDACTED] per cent to render a 5 per cent increase in price unprofitable. But on the basis of the above evidence, the value of sales that would be switched by customers to powdered eggs in response to a 5 per cent price increase would not be sufficient to prevent such a price increase being profitable, given that costs would be to some extent variable with the volume of liquid eggs supplied. The parties noted that only half of customers by value responded to the questionnaire. Although we acknowledge that there is uncertainty about whether the SSNIP test would be satisfied across Noble's customer base as a whole, we regard the responses to our questionnaire as

sufficient to establish that a significant proportion of liquid egg customers would not be prepared to switch to powder in response to a 5 per cent price rise.

- 5.25 Furthermore, 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 unprofitable, 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 switch and those who would not switch in response to a price increase. Noble argued that it had insufficient information as to which customers would switch to powdered eggs in response to a price rise and which would not, and said it could not therefore discriminate between them on that basis. But in our view, the process of negotiation is likely to reveal customers' propensity to switch to powdered eggs or, therefore, by inference those that are unlikely to do so. Given also the relatively limited number of customers, a reasonably competent salesperson would from negotiation of prices be in a position to know who currently uses powder, on what scale and for what purpose, the technology they use and the alternatives available to them, and to price discriminate on that basis.<sup>32</sup>
- 5.26 The parties also provided pricing data that showed that prices of liquid eggs and powdered eggs 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 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 eggs use shell eggs as their main input. The parties argued that if the observed correlation in prices of liquid eggs and powdered eggs 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 eggs since all powdered eggs are imported. 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.
- 5.27 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. 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, for 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 of liquid eggs to implement a SSNIP.
- 5.28 Information we received from the parties suggested that buyers of processed eggs had a lower requirement for free range eggs than the buyers of shell eggs for onward retail sale. Deans estimated that free range accounted in [%] for about [%] per cent of UK liquid egg sales, [%], but [%] multiple retailers now only stock free range egg products. [%]; 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 (although our conclusions on the effect of the merger on supply of liquid

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<sup>32</sup>This would not, however, necessarily apply to knowledge of the extent to which customers would switch to imported liquid eggs or other producers of UK or imported egg, which we discuss in paragraph 6.77 et seq.

eggs would not be affected even were we to regard this as a single market); but we are not aware of any significant barn or organic liquid egg products.

- 5.29 Noble argued that that there was complete supply-side substitutability, between cage and free range liquid egg products, ie that packers could readily switch between them. But as we discuss further in paragraph 6.89, [REDACTED]. Noble argued that these business plans were by now out of date; that previous shortages of free range eggs for processing arose from previous instances of avian flu; that ample imported free range eggs for processing were now available; and it was therefore perverse to argue that there was insufficient supply-side substitutability for cage and free range eggs to form part of the same market. This evidence suggests to us that supply-side substitutability can change significantly over time. The susceptibility of suppliers even to such temporary shortages of free range eggs suggest that supply-side substitutability cannot be regarded as sufficient for cage and free range liquid eggs to be regarded as the same market.
- 5.30 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.
- 5.31 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 6.88, 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*

- 5.32 We accept that the market for powdered eggs, little or none 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.
- 5.33 But the level of imports of liquid eggs is also low—about 9 per cent of the UK consumption of liquid eggs excluding liquid eggs made from powdered egg imports. We considered customer responses to our questionnaire. Some customers stated that they used a supplier from outside the UK. But somewhat [REDACTED] 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 [REDACTED] 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 types of liquid eggs, nine to 12 days being quoted to us for some types, limiting the amount that can be kept in stock.

- 5.34 The parties told us that transport costs for liquid eggs were low, amounting to an average of [REDACTED] of delivered price within the UK, and they estimated that transport costs from Germany to the UK would amount to around [REDACTED] of delivered prices. [REDACTED], a UK competitor, told us, for example, delivery costs to a nearby town would account for less than [REDACTED] per cent of the selling price. Delivery to most locations within the UK would increase delivery costs to below 5 per cent (between [REDACTED] and [REDACTED] per cent) of delivered prices and delivery to Continental Europe would result in delivery costs between 5 and 10 per cent (of around [REDACTED] per cent) of the delivered price. Given that as liquid egg products are relatively low-value products, [REDACTED] nonetheless regarded transport costs as accounting for a reasonably large proportion of profit, but its major current concern was competition from elsewhere in the EU.
- 5.35 Replies to the questionnaires that we sent to the parties liquid egg customers (see paragraph 5.23), suggest a significant proportion of them ([REDACTED]) would not be prepared to use imported liquid eggs in response to a 5 per cent price rise. However, it is uncertain whether or not sufficient customers would be prepared to do so for the SSNIP test to be satisfied across Noble's UK liquid egg customer base as a whole. But for the same reasons as set out in paragraph 5.27, given the negotiation of prices to users of liquid eggs and, [REDACTED], we took the view in our provisional findings that the parties would be in a position to [REDACTED] discriminate between customers on that basis. Our provisional view therefore was that it was also appropriate to regard the supply of liquid eggs as a UK market for those customers for whom imports provide a poor substitute.
- 5.36 Noble argued we had 'simply accepted the assertions of customers'. But these are very strong assertions, in a market in which share of imports—about 9 per cent—is low. Noble itself acknowledged that customers rarely store liquid eggs, but argued imported eggs did not have to be stored, and that most manufacturers would, as a matter of course, carry at least a couple of days stock, which was more than enough to cover the delivery time for continental supplies. But this is a further reason in our view why customers are likely to be reluctant to import, given also the greater inconvenience and risk of relying on imports. These factors would apply even if, as the parties argued, there was greater availability of free range eggs for processing from Continental Europe than some customers believed to be the case.<sup>33</sup>
- 5.37 However, in response to our provisional findings, Noble also presented some further evidence relevant to the geographic market definition of liquid eggs. It referred to one recent case of a customer [REDACTED]. It also noted that [REDACTED] although [REDACTED] told us such threats had to be carried out to be effective, without doing which [REDACTED] Noble would be in a position to price discriminate. But several of the other liquid egg customers concerned about the merger had told us that use of imported eggs could be investigated or considered ([REDACTED]);<sup>34</sup> another ([REDACTED]) said it may consider only supplying customers prepared to be supplied with imported liquid eggs.<sup>35</sup> (On the other hand, some who said they would not import ([REDACTED]) were unconcerned about the merger.) Further material we received from some other processors ([REDACTED]) suggested they had little difficulty in sourcing UK or imported eggs, and that there was little disadvantage from using imported eggs, although others took a different view ([REDACTED]).
- 5.38 The additional material we received following the provisional findings from Noble and a number of other parties suggests that the geographical market definition for liquid

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<sup>33</sup>Noble also argued that such import penetration would be sufficient to satisfy the Elzinga-Hogarty test based on the ratio of production minus imports to domestic consumption: if imports are sufficiently high, the test is passed. But this is a purely arbitrary test, the analysis is static, and there is no specified rule as to the relevant threshold.

<sup>34</sup>[REDACTED]

<sup>35</sup>[REDACTED]

eggs is less clear-cut than we had previously considered. As liquid eggs are pasteurized, the preference to use Lion eggs or UK rather than non-UK eggs for safety reasons is less widespread. Some customers are clearly prepared to acquire eggs produced and processed either in the UK or in Continental Europe. Others prefer liquid eggs that have been processed in the UK—for example to provide a shorter supply chain more responsive to variations in demand—but are less concerned at least for some of their requirements whether the eggs themselves are of UK origin. Others, responding to the demands of retail customers, only wish to use liquid eggs from eggs produced and processed in the UK. The extent to which the merger will reduce competition depends on particular customers choosing between those three alternatives and the ability of Noble to determine their willingness to do so: hence, although there may be some customers which Noble can identify as reluctant to import processed eggs, those customers would still have the option of switching, or threatening to switch to other UK processors as long as capacity is available. The effect of the merger depends therefore on a combination of interrelated factors, which we find it more appropriate to consider together in paragraph 6.77 et seq.

- 5.39 A number of parties told us that, as a result of transport costs, competition from imported liquid eggs was likely to be strongest for customers toward the south of the UK; but we saw no evidence to suggest that this was sufficient to result in regional markets for the supply of liquid eggs.

### ***Upstream markets***

- 5.40 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 6.50, 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 them 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.<sup>36</sup> 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.<sup>36</sup>
  - (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.<sup>36</sup>

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<sup>36</sup>*The 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.

(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.

5.41 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 6.53, 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 with other agricultural activities. But we note in paragraph 6.50 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.

5.42 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. Noble also referred to another packer/supplier competing to acquire eggs from the west of Wiltshire. We note, however, that this is still a considerable distance from Cornwall and Devon which was the source of most concerns expressed to us. The distances noted above between producer and packer would suggest a limited range over which eggs could be supplied particularly from Devon and Cornwall, 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. As noted in paragraph 3.2, we have reached an expectation that, in the absence of the merger, the market structure prevailing before the merger would 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. [✂]

6.3 Table 4 summarizes 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 eggs, 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						
Lion-marked shell eggs						
<i>By type of eggs</i>						
Free range eggs (including organic)						
Barn eggs*						
Cage eggs						
Lion-marked free range (including organic eggs)						
Lion-marked barn eggs						
Lion-marked cage eggs						
<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 powdered 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, 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 ([REDACTED] per cent, as shown in Table 4).<sup>37</sup> 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 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-marked 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,

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<sup>37</sup>We 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.

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

On the basis of information we received from the five largest multiple retailers (the four major retailers plus Somerfield), Deans and Stonegate would account for about 70 per cent of sales to them.

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 93 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 to prevent a price rise by Noble being profitable.
- 6.7 However, as we note in Appendix E, the parties' shares have been largely stable, only increasing to any significant extent as a result of acquisition of other companies. The parties initially stated this position,<sup>38</sup> but have argued there has been considerable churn—ie losses and gains—within the overall market share figures, with what they regarded as significant changes in their market share, of up to about [redacted] per cent, in particular years. Such changes in market share do not appear to us to be particularly significant. In our view, as we now discuss, 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's 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] But the information provided to us by the parties also showed that the switching in [redacted] included one major 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 some wholesaler and catering customers ([redacted]). For supply to retailers alone, [redacted] of Deans' business won or lost over the period was from or to Stonegate,<sup>39</sup> [redacted] in 2003, 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 major retailers.

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<sup>38</sup>RBB Economics, paper to OFT, Evidence of No SLC from Creation of Noble Foods.

<sup>39</sup>[redacted]

(c) On the parties' analysis, therefore, the main element of switching by the major retailers that has occurred has been between Deans and Stonegate, including the largest cases of switching.

6.9 Noble said it was wrong to exclude switches from wholesale and catering customers who were in the same market as retailers. In paragraph 5.13, however, we took the view that supply to wholesale and catering customers was a separate market: the scale of supply to some of the major retailers in particular is several times greater than to any individual wholesale or catering customer, hence the view of most of the largest multiple retailers that the bulk of their requirements can only be met by the largest suppliers.

6.10 Noble also argued it was incorrect to focus only on 2003 and 2004: however, we considered the period since 2001 as a whole. It also said it was not permissible to include post-merger switching which was irrelevant to the degree of pre-merger switching; but it acknowledged that negotiation of such switching would have started several months before the merger. It also said it was invalid to discount the switch to Freshlay, but the Freshlay business having been acquired by Deans, the relevance of its performance as a previous competitor is now limited.

6.11 Finally, Noble argued that insofar as we were relying on switching by [X] and [X]; that [X] had demonstrated it can and would switch significant volumes from [X] to discipline it; and that [X] would be 'betting' its [X], if it sought to raise prices above the competitive level. But in our view, the effect of the merger is to reduce or even remove the opportunity for those two retailers to switch between suppliers on a significant scale, for example as they did in [X]. Noble continued to dispute this, [X]<sup>40</sup> This proved, it argued, [X]: a point we discuss in paragraph 6.25.

6.12 But the circumstances of that [X] were unusual. [X]<sup>41</sup> We also noted that [X] was also unusual [X].

6.13 [X]

6.14 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 [X].<sup>42</sup> There is also evidence of smaller-scale switching between Deans and Stonegate for [X].

(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 only one clear example of a retail customer, a mid-range retailer, switching the majority of its requirements to a smaller supplier, when [X] switched approximately 2,000 cpw from Stonegate to Oaklands in December 2005. [X] The other figures of actual switching by major

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<sup>40</sup>The case per week (cpw) is a standard unit of quantity measurement in the egg packing industry. A case is 30 dozen eggs.

<sup>41</sup>Noble argued that we were confusing a methodology for market definition (a SSNIP) with the ability of customers to render a price rise by Noble unprofitable. But our concern in this paragraph is solely with a critical loss analysis of the ability of customers to render such a price rise unprofitable, for which we have adopted a 5 per cent price rise (as with the SSNIP test) purely for illustration. Moreover, although Noble argued that [X] had shown it was able to switch all of what Noble was supplying—hence showing that were other suppliers with available eggs that would have enabled it to inflict critical loss—one cannot infer that retailers in general would have been able to do so in response to a general price increase of 5 per cent: see paragraph 6.25. For this, it is the percentage of Noble's sales in total that can be switched that is relevant.

<sup>42</sup>[X] switched away from Stonegate to a combination of Deans and Glenrath. [X]

retailers to individual smaller suppliers are all [REDACTED] or below of the retailers' respective requirements.

- (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. This was particularly the case when attempting to switch large volumes between suppliers.<sup>43</sup>

6.15 Noble pointed out from its own analysis to which we refer in paragraph 6.8 that the majority of switching by retailers and wholesalers as a whole is to or from third parties. But this is not inconsistent with our view that switching by smaller retailers is no larger than would be expected broadly on the basis of their market shares. Deans has a share of supply to retail and to catering and wholesale customers combined of about [REDACTED] and Stonegate about [REDACTED]. Deans therefore accounts for [REDACTED] not supplied by Stonegate, and Stonegate for a somewhat lesser proportion [REDACTED] of eggs that are not supplied by Deans.<sup>44</sup> There is a large fringe of other suppliers, but it is fragmented, and with a smaller share of supply to larger retailers. Hence, as shown by the figures in the footnote to paragraph 6.5, Deans would account for the majority of eggs supplied to larger retailers that are not supplied by Stonegate, and Stonegate for about half of eggs supplied to larger retailers not supplied by Deans. Also, as shown in paragraph 6.8, the majority of switching by larger retailers has often been between Deans and Stonegate over the past five years as a whole.

6.16 Noble criticized our view that 'size of itself matters', arguing that what matters is availability of egg, which was not achieved by size or any potential economies that may give. We noted in paragraph 6.4 that market shares are but indicators, subject to consideration of other factors, and we accept that size is not necessarily important in itself but has to be considered in the context of a particular market. But we do not accept, as the parties argued, that size does not matter in this market and that what really matters is egg availability (see also paragraph 6.42). Size does in our view matter in a number of key respects. Potential economies of scale for larger suppliers are shown by the intended benefits of the merger, including the netting out of temporary egg surpluses allowing less downgrading<sup>45</sup> and the ability to rationalize packing. Other advantages of scale include the benefits to producers, giving them confidence in the suppliers' continuous ability to acquire the producers' eggs and supply them to retailers; greater flexibility from having a portfolio of producer and customer contracts and the infrastructure to deliver on the scale required by the largest retailers; the ability to offer category captain services (advising, and in some cases influencing or controlling, the supply arrangements for eggs, the ranges stocked and their marketing); and less risk in being the main supplier to the largest retailers than would be incurred by smaller companies who would become critically dependent on retaining the business of a particular larger retailer. Moreover, the larger the supplier, the greater the volume of sales loss necessary to inflict a critical loss (see also paragraph 6.21 et seq) should that supplier attempt to increase prices (see Annex 3 to Appendix E), and the greater the difficulty in a retailer being able to seek other sources of supply for that volume of sales. Our analyses of switching in

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<sup>43</sup>Some 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. Noble argued that our analysis only related to retailers' ability to switch their entire volumes. Our original questionnaire only asked about the ease of switching in general, we did not specify that customers needed to switch all of their requirements. Customers volunteered the information themselves. As discussed below under critical loss, looking at individual customers in isolation is misleading, the question is whether a 5 per cent increase in price would induce customers in aggregate to switch more than the critical loss away from Noble.

<sup>44</sup>[REDACTED]

<sup>45</sup>Selling an egg—at some cost—as a different, inferior production type and/or different size than purchased, for example, organic as free range or free range as cage.

paragraphs 6.8 and 6.14 above and in Annex 1 and Annex 2 of Appendix E also show that market shares are a reasonable guide to market power.

- 6.17 We do not therefore accept Noble's comment on the provisional findings that the sales data show that Stonegate and Deans have not been clear competitors. For the reasons given in paragraph 6.16, size is also important to retailers and producers; although as evident from the discussion above, there has been a limited degree of churn between the larger and smaller suppliers, as would be expected on the basis of market shares—the churn between Deans and Stonegate has been particularly important for the larger retailers. The effect of the merger has been the loss of the second-largest supplier, smaller than the first but much larger than the rest, leaving competition only from the fragmented fringe of far smaller suppliers.
- 6.18 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: '[X]'. 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.
- 6.19 The parties acknowledged that as a result of this merger the ability to switch material volumes between Deans and Stonegate had been lost: '[X]'. 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.
- 6.20 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 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.
- 6.21 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, of switching or threatening to switch to smaller suppliers 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; in their view the actual loss of business from switching to smaller suppliers in response to any price rises would exceed this figure.

- 6.22 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 (an average of [redacted] per cent for all egg types). The range of estimates depends on how the resulting surplus eggs following a loss of business were disposed of, the higher figures assuming they would be sold to wholesalers, the lower figures assuming more appropriately in this context that they would be used in processing (hence unavailable for other suppliers to retailers), the price of eggs being used for processing being lower. 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.
- 6.23 Noble argued there was no evidence that, had Deans raised its prices by 5 per cent prior to the merger to all its customers, customers would have been able to switch [redacted] per cent of all Deans' volumes to competitors (including Stonegate) at short notice as would have been necessary to impose a critical loss. It argued (see also paragraph 6.42) that, even while Stonegate was independent of Deans, Stonegate and other competitors would have had insufficient availability of eggs to allow such a switch in volumes from Deans. Hence there was no possibility of critical loss being imposed even before the merger and so the merger itself had not foreclosed the possibility of imposing critical loss. But the ability of competitors to impose a critical loss would have been the main constraint on the level of prices that Deans could have charged before the merger. Hence, it is implausible that competitors had previously not been in a position to impose a critical loss since, had that been the case, Deans' prices could profitably have been higher.
- 6.24 There is no reason to believe that the ability to impose critical loss on Deans before the merger, and the availability of eggs to do so, was confined to suppliers other than Stonegate; indeed we have noted in paragraph 6.8(c) that [redacted] of the switching by the major retailers has previously often been between Deans and Stonegate. Also relevant is Deans' previous ability to impose critical loss on Stonegate: [redacted]. Moreover, as noted in Annex 3 to Appendix E, the larger the output of a company and its market share, the greater the volume of sales necessary to impose a 'critical loss'; as we noted in paragraph 6.16, the effect of the merger is therefore to increase the volume of sales that would have to be lost for a critical loss to be incurred by Noble following any general price rise, while removing the main alternative supplier of such eggs. For these reasons, therefore, we cannot accept the parties' argument that the merger has made no difference to the ability of competitors to impose a critical loss.
- 6.25 We also noted in paragraph 6.11 Noble's argument that [redacted], subsequent to the provisional findings, [redacted]. But [redacted] (see also paragraphs 6.23 and 6.73(a)). [redacted], referred to in paragraph 6.14 and the footnotes to paragraph 6.73) [redacted].<sup>46</sup>

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<sup>46</sup>Noble argued that the relevant question was what percentage of Noble's current sales to a given retailer would Noble have to lose to make a 5 per cent price rise unprofitable. We do not accept this: in our view, while some individual retailers may be able

- 6.26 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 [redacted] per cent of the retail market as a whole; or more than about one-[redacted] of supplies to any major retailer.<sup>47</sup>
- 6.27 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 those alternative suppliers; or on being able to gain access to egg supplies from the incumbent supplier which we discuss in paragraph 6.32 et seq. (We discuss in paragraph 6.47 et seq, in the context of entry and expansion the extent to which current producers are contracted to existing suppliers, and the difficulty of attracting such producers to switch to a new supplier.)
- 6.28 Egg availability is discussed in Appendix E. Competitors who responded to us have all told us they are supply-constrained: two suppliers said they had some availability in cage eggs, but with limited volumes.
- 6.29 During our inquiry, there was a serious shortage of free range eggs for the Christmas 2006 peak. We noted in paragraph 2.4 that the shortage was variously attributed to growth in 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.
- 6.30 In contrast, there may potentially be more availability of cage eggs given the reduction in demand. However, we have noted above [redacted], although these were not fully implemented. We were also told that the requirements for use of enriched cages (see Glossary) with an associated increase in costs could further reduce the number of caged birds stocked, and that uncertainty over the precise nature of these and other regulatory requirements as well as the likely costs was currently deterring investment in new caged bird facilities.
- 6.31 [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.
- 6.32 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 minimize losses. The eggs would therefore become available however indirectly to the new supplier who would, consequently, have no capacity problems. [redacted] 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.

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to switch large proportions of business individually within the capacity headroom available, they could not all do so, for which the relevant question is the percentage of Noble's sales in total that can be switched.

<sup>47</sup>One 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 major retailers: but we do not see scope for other major retailers being able readily to adopt such patterns of supply.

- 6.33 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 discussed in more detail in Appendix E. As noted in that appendix, we do not believe that Noble's analyses show that Noble would be likely to make any such surplus eggs available to the market given the revenue loss of withholding eggs from the wholesale market.
- 6.34 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.
- 6.35 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.
- 6.36 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.
- 6.37 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.
- 6.38 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] per cent 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 [redacted]-month period, between [redacted] per cent of the cage and free range flocks of the contracted producers would become due for replacement, as would between [redacted] per cent of its own cage flock (although substantially less of their free

range flock).<sup>48</sup> 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. [REDACTED]; 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 increasing the production of eggs more slowly than the expected growth of demand or even 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.

- 6.39 In commenting on our provisional findings, Noble argued it would not be in a position to reduce capacity. But the ability of a supplier to reduce capacity is shown in the reduction of Deans' former surplus of cage eggs. [REDACTED] As shown in Table 4, Noble supplies more than [REDACTED] of eggs produced in the UK. It directly controls its own level of production: as implied in paragraphs 2.14 and 2.15 about [REDACTED] of Deans' and [REDACTED] of Stonegate's cage eggs are produced by the companies themselves, compared with a much smaller proportion, about [REDACTED] of Deans' and [REDACTED] of Stonegate's, free range eggs. Noble is therefore able directly to reduce a large part of its cage egg production. We accept that Noble is not in a position to compel its contracted producers to reduce production, therefore having little direct control over free range egg production,<sup>49</sup> but it is in a strong position to influence them to do so, through its own activities as a purchaser of eggs, but also if other suppliers followed any price reduction to producers, further reducing the overall level of production.
- 6.40 The parties also argued that it was pure speculation that critical loss would be higher in this scenario. But the scale of critical loss depends on the extent to which a reduction in sales following a price increase results in an offsetting reduction in profitability: the greater the extent to which costs are fixed, the greater the offsetting reduction in profitability for a particular loss of sales, and the smaller the loss of sales necessary for a critical loss to be inflicted. The current critical loss figures reflect an assumption that the level of production at farm level is left unchanged—ie if the volume of sales is reduced, production costs are unchanged, but the eggs are sold at a lower price to the wholesale market. If production costs were reduced, the reduction in sales following a price increase would result in a smaller reduction in profitability, and the critical loss of business, at or beyond which a price rise would be unprofitable, would be expected to be higher.
- 6.41 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 expected to reduce

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<sup>48</sup>In the case of Stonegate, its internal free range eggs are produced [REDACTED]. 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 six months in advance of hatching the egg.

<sup>49</sup>Noble argued that evidence to the contrary was shown by the identification in the Shell Eggs Business Plan of the risk of not being able to reduce contracted production even from cage eggs. But we have noted above that, although the Plan was not implemented in full, Deans did nonetheless largely reduce its previous surplus of eggs, despite any such risk.

significantly the ability of retailers to switch to alternative suppliers of all three categories of shell eggs—cage plus barn eggs, free range eggs, and organic eggs—unless new suppliers could enter the market, or existing suppliers expanded the scale of their operation, which we discuss in the next section.

- 6.42 The parties also argued that we should take account of their own recent limited egg availability in establishing the counterfactual, ie the extent of competition that would have occurred between them had the merger not occurred. In their view, we should take as the ‘real counterfactual’ that Stonegate and Deans had no greater egg availability for competing for new customers than their smaller competitors; in particular, Stonegate did not have significant surpluses of eggs in the months leading up to the merger—hence the merger would make no difference. But we do not accept that the ‘real counterfactual’ can be described by reference to a lack of egg availability for the two companies immediately preceding the merger (when the merger was under consideration, and when egg availability may also have been affected by temporary factors such as disease among chicken flocks). We were told that suppliers normally have some surplus, in order to have sufficient eggs to meet peak demands particularly before Christmas; as we have noted in paragraph 6.31 the merger has itself reduced the scale of surpluses needed by the two companies and therefore of egg availability in the market as a whole.
- 6.43 But more relevant to the definition of the counterfactual is that the two largest suppliers have now become one, removing a major source of competition and rivalry from the market. We noted in paragraph 6.2 their confirmation that before the merger the parties were effective competitors to each other, and that in the absence of the merger they would have continued to compete. We noted above the benefits of scale, including the ability of larger suppliers to reallocate sales between their portfolio of contracts. The importance of size, when the availability of eggs is limited, is also shown by [redacted].<sup>50</sup> We noted in paragraph 6.5 that the merged company is at least [redacted] than any of its competitors, and with a correspondingly greater availability of eggs. A number of customers have also suggested that it would be much more difficult to switch to another supplier after the merger. The counterfactual therefore is the continuation of competition between Deans and Stonegate at the level at which it was sustained before the merger, not only for the business of individual retailers, but also in seeking new producers and in all the other elements of their business strategies.

### *Prospects for entry and expansion*

- 6.44 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 which 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.
- 6.45 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.<sup>51</sup> 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,

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<sup>50</sup>[redacted]

<sup>51</sup>Although they also listed six exits as a result of acquisition, directly or indirectly by themselves in that period.

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.

6.46 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.

6.47 As noted in 5.40(a), the parties estimated that some [REDACTED] per cent of the free range flock was not under exclusive contract to particular packers/suppliers. As discussed in Appendix F, 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] per cent (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, ie the proportion of producers gained as well as lost, was significantly higher than this: as noted in Appendix F, gains of producers average between [REDACTED] and [REDACTED] per cent for Stonegate and [REDACTED] 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 paragraphs 6.16 and 6.48).

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

6.48 The parties drew our attention to the efforts being made by other suppliers to recruit new producers, including existing Deans' and Stonegate's producers. But they could only point to a few instances, [REDACTED], of producers being approached; only three examples of producers actually switching, one specifically in response to an offer of better terms which could themselves be regarded as disadvantaging the competing supplier who could only acquire eggs from such producers at higher cost than incurred by Noble; and only [REDACTED] of producers considering switching. (There were also some examples of producers ceasing to produce for other reasons or selling

locally.) These examples did not therefore call into question the other evidence we saw that existing producers are likely to be wary of switching to a new packer/supplier;<sup>52</sup> producers would need confidence in a new supplier's ability not only to continue to acquire the producers' eggs, but also to supply those eggs to retailers given the risks to them of being unpaid or left with eggs they could not sell if the packer was unable to do so. Producers are also likely to be more confident about the growth prospects of the larger suppliers/packers, given their higher share of supply to the multiple retailers, who have been the fastest-growing outlets for shell eggs. It is therefore not surprising that the producer base remains relatively immobile; and additional payments of 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. Evidence was also given to us of other suppliers losing producers to Deans or Stonegate since the merger. Glenrath, as noted in its evidence on our website, told us it had lost a number of producers in Scotland to Deans since the merger.

- 6.49 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. [REDACTED]
- 6.50 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, 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 particularly for free range facilities, 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.
- 6.51 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 six to 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

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<sup>52</sup>BFREPA, for example, told us that for a new packer to enter the market, it would have to have guaranteed business from a major retailer before it could encourage producers to switch their products. Another large producer ([REDACTED]) also told us that it would not wish to switch to an alternative supplier buying at higher prices but selling at lower prices than its current packer since, if that was not sustainable, it could be left without a market for its eggs.

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. The balance of the evidence suggests that planning constraints do not always arise, but can be a barrier to entry or expansion depending on the location and the nature of the development.

- 6.52 As well as the significant up-front costs of investment referred to in 6.49, 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.<sup>53</sup>
- 6.53 Production of free range eggs has nonetheless increased by over 10 per cent a year<sup>54</sup> 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. The parties argued they were at no advantage to their competitors and their larger scale was irrelevant, but this we do not accept: we noted in 6.48 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.
- 6.54 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 caged birds, in particular many of the current cages becoming illegal, is a significant factor deterring entry.
- 6.55 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 paragraphs 6.16 and 6.43), in their competing on any scale for the business of multiple retailers. [✂]<sup>55</sup>

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<sup>53</sup>See also footnote to paragraph 6.48.

<sup>54</sup>Defra statistics.

<sup>55</sup>The parties pointed out that this document was now a year old, and these other suppliers had subsequently competed for, and won, business from them.

- 6.56 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].<sup>56</sup> 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, in our view, become increasingly effective in reinforcing the position of the merged company and in disadvantaging smaller competitors and new entrants.
- 6.57 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 92 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 94 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.
- 6.58 The parties objected that we had focused on an excessively narrow definition of sponsoring new entry, which in their view was what major retailers, in particular Tesco, had recently done. We do not accept this: we saw nothing to suggest that major retailers were prepared to enter into formal contractual commitments to develop and support new entrants for a period of time, (except in a few cases to develop specialist types of branded egg from dedicated flocks). Although there have, as we have acknowledged, been many instances of major retailers awarding contracts to supply all or part of an individual depot to other suppliers, the scale on which they have done so remains limited, and it would take several years before any such competitor was able to develop to the former size of Stonegate.
- 6.59 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*

- 6.60 Although the parties, as noted in paragraph 5.16, 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. In support of this, they drew our attention to the concerns of some producers that recent shortages of UK free range eggs and the sale by retailers of imported eggs, produced to lower standards on Continent, could have seriously weakened the value of the Lion mark and the position of UK producers in the longer-term. But the parties themselves described current circumstances as exceptional. We do not believe that any more general inferences on the inhibition of retailers to import eggs can be drawn with any certainty from the response to such extreme, and probably temporary, conditions in the UK market. Indeed we noted that some supermarkets when selling imported eggs were displaying notices saying they hoped soon to be restocking with British eggs, and some soon ceased to sell imported eggs.

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<sup>56</sup>[redacted]

- 6.61 We noted in paragraph 2.1 that about 7 per cent of shell eggs were imported. We were told<sup>57</sup> 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,<sup>58</sup> although processing accounts for only one-quarter of egg demand; the percentage of retail sales accounted for by imports would therefore be less than 7 per cent.
- 6.62 As noted in paragraph 5.16, 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.
- 6.63 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.

#### *Bargaining power of customers*

- 6.64 We noted in paragraph 2.3 that multiple retailers account for about [X] per cent of retail sales of shell eggs. The four major 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.
- 6.65 As noted in our merger guidelines, the fact that the market is characterized 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

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<sup>57</sup>For example, by the parties, and Northern Foods plc (Northern Foods).

<sup>58</sup>The main parties said there was no independent data to support this.

(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

- 6.66 The parties referred to recent CC inquiries which examined the issue of the buying power of multiple retailers, on the basis of which they said our starting point must be that the four largest multiple retailers exercised market power against the parties. Among the inquiries to which they referred was the Supermarkets inquiry in 2000<sup>59</sup> and the recent Cott/Macaw case.<sup>60</sup> We have considered the arguments raised by the parties, but we have in our view adopted a similar approach to that adopted in previous inquiries. We note that our conclusions in each case are based on the particular facts of the particular case including different structures of the various markets concerned. Hence, the current case differs from earlier cases, so the analysis used in those previous cases cannot be directly applied to the current case. The conclusion of Cott/Macaw, for example, referred to the spare capacity of other suppliers, the prospect for expansion, modest entry barriers and also a certain amount of volatility in switching. Moreover, while Cott/Macaw involved a merger of the two largest suppliers, the third-largest supplier was a substantial food company with a 24 per cent share of the market being investigated. In contrast, the current merger is of the two largest suppliers by some margin, with the estimated market share of the third-largest supplier being below [redacted] for each type of egg, and the remaining competition being from more local, family-owned suppliers. We consider that the markets in the current merger have less spare capacity, less prospects for expansion, greater barriers to entry and less volatility in switching than in the Cott/Macaw case. There are also a number of vertical issues in the current case.<sup>61</sup>
- 6.67 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 the requirements of larger retailers. Hence, we regarded that evidence as not persuasive compared with the evidence of actual switching to which we referred in paragraphs 6.8 to 6.15.
- 6.68 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. We carefully considered all the evidence that Noble produced. We do not consider that the pre-merger evidence is relevant to a situation likely to exist after the merger for the reasons set out in paragraph 6.67. Equally we consider a period in which the merger has been under consideration by the OFT and ourselves as

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<sup>59</sup> *Supermarkets: a report on the supply of groceries from multiple stores in the UK*, CC, October 2000, Cm 4842.

<sup>60</sup> *Cott Beverages Ltd and Macaw (Holdings) Ltd: a report on the acquisition by Cott Beverages Limited of Macaw (Holdings) Limited*, CC, April 2006.

<sup>61</sup> The earlier Arla/Express report (*Arla Foods amba and Express Dairies plc: a report on the proposed merger*, CC, October 2003, Cm 5983) relating to the supply of milk to multiple retailers referred to the weakening of Express in the absence of the merger, and the overcapacity in the industry; there would also in that case have remained two competitors each with 25 per cent of the market, the effect of the merger being a reduction from four to three suppliers. These factors are also different from the current case.

insufficient and too limited to draw conclusions about what may be expected to happen in the longer term.

- 6.69 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-maximizing 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 to see whether there was evidence that larger customers were less profitable to the supplier than other customer groups. Such evidence would be consistent with a customer's bargaining power being in some way determined by its size but not conclusive of this. In the event, our analysis found no clear evidence [REDACTED]. Such an analysis suggests that the bargaining power of larger retailers may be no greater than that of smaller retailers, [REDACTED]. The analysis cannot be taken to imply that larger retailers have no bargaining power: the issue we have to consider is whether if the merger weakens any countervailing bargaining power the merger may then affect competition.
- 6.70 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 6.57 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.
- 6.71 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. [REDACTED]
- 6.72 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. This assessment was not accepted by Noble on the grounds that the merger had no effect on the availability of eggs for competitors to supply to retailers, an argument we did not accept for the reasons set out in paragraph 6.42. In our view, the options available to such retailers—given the 'must stock' nature of the product, the difficulty in switching supplier, the limited prospects for entry and expansion we have noted above and the reluctance to import—are likely to be much reduced by the merger. As we note in paragraphs 104 to 105 of Appendix E, the second-best option for any customer of Deans before the merger 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.
- 6.73 We referred in paragraph 6.65 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 6.43 and 6.72.<sup>62</sup>
- (b) those retailers are unlikely credibly to threaten to set up their own supply arrangements given their reluctance to sponsor new suppliers (paragraphs 6.57 and 6.70);
- (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;<sup>63</sup> 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.

### *Overall assessment on supply of shell eggs to retailers*

6.74 We have therefore concluded that:

- (a) the merger is likely significantly to reduce 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 6.41);
- (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 6.59);
- (c) actual or potential competition from imports is also unlikely to offset such a reduction in competition (paragraph 6.63); and
- (d) the bargaining power of retailers is also insufficient to offset any such reduction in competition (paragraph 6.73).

In our view, the merger may therefore be expected to result in an SLC in the 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. As a result of that loss of rivalry, the merged entity

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<sup>62</sup>The 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. We also discussed in paragraphs 6.12 and 6.25 why we did not regard the example, following the provisional findings, of [redacted] switching the majority of its requirements from Noble as calling this conclusion into question.

<sup>63</sup>The 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.

would be in a position to act in a way that would 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 6.71).

### ***Supply of shell eggs to catering and wholesale customers***

6.75 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 5.19, 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—almost 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 catering and wholesale 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 supplier 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 (McDonald's), purchase mainly cage eggs.<sup>64</sup>
- (f) We do not therefore expect that the merger may result in the significant reduction of opportunities for such customers to switch to other suppliers, smaller suppliers clearly having a larger share of supply to that sector.

6.76 In our 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***

6.77 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 [redacted] per cent) of UK liquid egg sales. The overlap between the parties is only in pasteurized liquid 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.

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<sup>64</sup>In this context, it is interesting to note that McDonald's indicated that switching supplier would be relatively difficult.

- 6.78 [REDACTED] We accept, as the parties argued, that the combined companies' [REDACTED] per cent market share of liquid eggs [REDACTED] may not have allowed for the subsequent weakening of Stonegate's position (although one customer to whom we spoke did not accept that any subsequent weakening had occurred). Nonetheless, as apparent in Table 4, the parties still estimated that Noble had a [REDACTED] per cent share of liquid egg sales (excluding powder) at the time of the merger, [REDACTED]. Moreover, these estimates, which include imports, would underestimate the share of supply to those customers reluctant to import.
- 6.79 As noted in paragraph 4.4 and in the provisional findings, a number of liquid egg customers expressed concerns to us about the effects of the merger on competition. The main points made to us were:
- (a) The merger combined the UK's two leading egg processors which met the standards required by retailers into one business with a much higher share of supply than that of any of the remaining egg processors, and thereby reduced competition.
  - (b) Several of the customers from whom we heard were also reluctant to import liquid eggs and, in some cases, UK eggs had to be used for customers. This merger, it was argued, therefore gave Noble a controlling interest in this market. Other disadvantages from the 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 a shortage of Continental supplies of free range eggs, which were required by users of liquid eggs much 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.
  - (c) Some customers also expressed doubts as to the prospects of new entry, or of expansion by smaller producers of liquid eggs (concerns some customers reiterated to us in commenting on the possibility of our revising our findings on 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 where they met current standards for quality, reliability and security of supply, and enjoyed sufficient economies of scale for them to compete on all fronts. Any plan to shift volume to smaller processors (or suppliers 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; another said that, as a result of the merger it now had a choice of two key suppliers rather than three, of which Noble was far the largest. As with the supply of shell eggs to retailers, availability of eggs was also thought to be a likely constraint.
- 6.80 Some third parties from whom we heard also noted that Stonegate contracted its production of liquid eggs to [REDACTED], which, on the parties' figures, is the [REDACTED] supplier after the merger of liquid eggs with a market share of almost [REDACTED] per cent, and also to [REDACTED]. The parties initially acknowledged that [REDACTED] 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. [REDACTED] own production is, however, primarily of value-added products, which are not supplied by Stonegate. The parties later told us that [REDACTED] had given notice to

terminate its contract with Stonegate.<sup>65</sup> We do not therefore see the arrangement with [X] as further exacerbating the effects of the merger.

- 6.81 The parties argued that there was relatively little switching, and therefore evidence of competition, 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 at any point argue that Stonegate and Deans' products (aside from those mentioned in paragraph 6.77) were in different markets, but rather that they were in the same market, but one which was European in character. As such, and as evident in the [X] to which we referred in paragraph 6.78, 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 any prospect of switching between the previous two largest suppliers, which, in our provisional view, had been potentially a significant competitive constraint. In commenting on the provisional findings, Noble claimed it was impossible to find any logical nexus between switching being low and the potential to switch to another sizeable supplier still having a significant competitive constraint: but we do not necessarily accept this. Potential competition to be the main or sole supplier, retained for a number of years if performance is satisfactory, can also be an important source of effective competition, in addition to the ability frequently to switch between suppliers.
- 6.82 Noble argued that the main competition it faced was from imports of powdered eggs, imports of liquid eggs and other liquid eggs from other UK suppliers. It quoted a number of examples of customers recently switching to smaller suppliers or to imports although the overall scale of such switching was limited: about [X] of the UK market.
- 6.83 In our provisional findings we took the view that:
- (a) It was appropriate to distinguish a UK market for liquid eggs for those customers unable or unwilling to use powdered eggs or to import given Noble's ability to distinguish and price discriminate against such customers.
  - (b) The merger would appear likely to have reduced significantly the opportunities to switch supplier for those liquid egg customers unable or unwilling to use powdered or imported liquid eggs.
  - (c) The bargaining power of such customers was likely to be reduced by the merger given the limited number of other suppliers and their limited scale.
  - (d) The parties were 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 eggs 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.

After publication of the provisional findings, however, we received further evidence. We considered this carefully and reconsidered whether there are sufficient alternative sources of competition to offset the effects of the loss of competition between Deans and Stonegate.

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<sup>65</sup>Following which, subsequent to the provisional findings, the CC gave consent for Deans to manufacture liquid eggs for Stonegate.

- 6.84 As to competition from powdered eggs, as we concluded in paragraph 5.27, we remain of the view that liquid eggs are a separate economic market from powdered eggs. Powdered eggs were said by some customers from whom we heard to make little economic sense, and were not an ingredient that retailers wanted. For some manufacturers it was not an option 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 and do switch between liquid and powdered eggs: indeed the parties gave us internal memoranda carefully documenting when [redacted] of their 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. 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. We accept that, in some cases, liquid and powdered eggs may be genuinely substitutable, but from the evidence we received from customers, to which we referred in paragraph 5.23, such cases may be limited.
- 6.85 However, as to competition from imports, as we noted in paragraph 5.38, the new evidence suggested that the geographical market for liquid eggs is less clear-cut. We noted in paragraph 5.38 that because liquid eggs are pasteurized, the preference to use Lion eggs or UK eggs rather than non-UK eggs for safety reasons is less widespread. Hence, there are three categories of customer: those that are prepared to use eggs produced and processed in the UK or elsewhere; those willing to use eggs produced in the UK or elsewhere but who prefer them to be processed in the UK; and those who wish to use eggs both purchased and processed in the UK. But the further information we saw suggested that, even in this last category, some customers were prepared to consider non-UK suppliers, and to threaten to purchase at least some, and in some cases all, of their requirements from them.
- 6.86 The scale of demand for liquid eggs produced and processed in the UK and for which customers would be unable or unwilling to substitute imported liquid eggs is uncertain, as is the extent to which the parties would be in a position to distinguish between customers according to their willingness or ability to use imported liquid eggs. Even to the extent some customers are unable or unwilling to switch to imported liquid eggs, or liquid eggs processed in the UK from imported eggs, and could be identified by Noble, those customers would still be in a position to threaten to switch to other UK suppliers, subject to those suppliers having adequate capacity and availability of eggs for processing (which we discuss further below). Noble's ability to raise prices to those customers unable or unwilling to use imported liquid eggs would again depend on the ability of other UK processors to supply sufficient alternative UK liquid eggs to inflict a 'critical loss' of business on Noble—ie a loss of business following any price rise sufficient to ensure that such a price rise would be unprofitable for Noble. The ability of other UK processors to inflict such a critical loss would depend in part on the extent of their spare capacity and their having sufficient availability of UK eggs for processing. The smaller the volume of demand from UK-loyal customers (who will only take eggs that are both produced and processed in the UK), the smaller would be the critical loss in volume terms should Noble attempt selectively to increase prices to those customers and the more effective would be a given volume of competitor spare capacity and egg availability as a discipline on price rises.
- 6.87 As to competition from other UK processors, the parties' internal documents showed that their own 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 UK processors to allow them effectively to compete. We noted

in the provisional findings that of the ten other suppliers of liquid eggs listed by the parties, three are overseas producers, currently with limited market shares and with some UK customers reluctant to import liquid eggs, but given the additional evidence noted above, we do not now believe we can discount these other suppliers as effective competitors for this reason.

- 6.88 We referred in paragraph 6.79(c) to concerns by some customers that availability of eggs limited the ability of smaller processors to compete. [REDACTED] We noted in paragraph 5.31 the apparent advantage of being a supplier of both shell and liquid eggs. We also note in Appendix G [REDACTED]. The parties also told us that there is an element of counter-cyclical in supplying both shell and processed eggs: seconds are a by-product of the shell egg activities and an input into its processed eggs activities, hence when the price and profitability of supplying shell eggs are relatively low, the profitability of liquid eggs is relatively high. In our provisional findings, we took the view that 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 with any smaller supplier seeking to expand its activities.
- 6.89 However, Noble argued that the problems of egg availability for processing mentioned in those documents were as a result of avian flu at that time, and were no longer the case. [REDACTED]
- 6.90 Other information we received after publication of the provisional findings suggested:
- (a) [REDACTED]
  - (b) That several UK processors ([REDACTED]) have little difficulty in acquiring eggs, as well as the capacity to process them, although others ([REDACTED]) claim egg availability is a more serious problem and one which could be exacerbated by the merger.
  - (c) That many of those suppliers do not feel disadvantaged by transport costs or otherwise, in using, if necessary, imported eggs.
  - (d) That several UK processors regard the UK market for liquid eggs as highly competitive, including competition from imported liquid eggs.
- 6.91 Having reconsidered our provisional findings, we still have concern that some customers may have difficulty in switching some of their requirements to other suppliers, but the extent to which this may be the case is uncertain to ourselves and, to some degree, to Noble in negotiating prices. (Discrimination between customers on this basis would therefore be more complex than on the basis of the willingness to use powdered egg, to which we referred in paragraph 5.25.) Although some loss of competition may result from the merger, the threat customers in aggregate to switch even substantial proportions of their requirements to imported liquid eggs or to other UK suppliers in response to any attempted price increase by Noble seemed to us effective enough for us not to expect that the merger may result in an SLC in the supply of liquid eggs.
- 6.92 As in our provisional findings, we are not 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***

- 6.93 As noted in paragraph 4.5 and Appendix E, 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.
- 6.94 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 from farmers to our questionnaire 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. [redacted] Production of some particular egg brands, however, requires a producer to use the supplier's specified feed or pullets.
- 6.95 The only upstream market where, on their figures, the parties have a market share above 25 per cent is spent hen processing ([redacted] 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. Although we received little concern about previous 'bundling' of supplies with purchases of eggs, this remains a potential effect of the merger given Noble's share of egg purchases from producers.

## ***Assessment***

- 6.96 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 [redacted] per cent of free range (including organic) eggs produced in the UK and [redacted] per cent of Lion-marked 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.
- 6.97 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.
- 6.98 As noted in paragraph 4.5, we received 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. The National Farmers' Union (NFU), for example, in commenting on the provisional findings said that the merger was the direct result of cost pressure exerted on egg producers by multiple retailers leading to an attempt to reduce overheads by the leading egg suppliers, and that we had not paid due regard to the proportion of the retail price retained by the retailers relative to egg producers and suppliers, a supply chain issue that discouraged investment by producers. Many others, as noted in 6.93, 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.

- 6.99 In our view, the strong position of Noble as a result of the merger, as we have set out in paragraph 6.96, would give it the ability and the incentive to promote its own interests, not only in the supply to retailers as we have concluded in paragraph 6.74, to the detriment of consumers, but also in the procurement of eggs from producers. A loss of horizontal competition in the purchasing of shell eggs from producers, relative to the counterfactual of Deans and Stonegate competing or potentially competing against each other for producers, may be expected to result in reduced producer prices. We would expect lower producer prices in turn and, in the longer term, to induce the exit of marginal producers and reduce incentives to invest for the others. On balance, therefore, 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 buy from producers on less favourable terms and to increase prices to retailers, even though this may not be its current stated intention.
- 6.100 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 terms to producers; and/or to discriminate between producers in such policies. Noble argued that producers were quite able to decline any onerous terms and contract with a competing supplier: although it would be open to them to do so, the limited extent of switching (see paragraph 6.47) suggests they would be reluctant to do so but could instead leave the market.
- 6.101 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. The merged entity could jeopardize the position of other suppliers and/or limit the opportunities for entry by long term contracts with producers, 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.
- 6.102 Hence, the merger may be expected to result in an SLC in the procurement of shell eggs from producers.

## 7. Conclusion

7.1 We have therefore 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 6.74); and

(b) procurement of shell eggs from producers in the UK (paragraph 6.102).

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 6.76) or supply of hard-boiled eggs (paragraph 6.92). Further we have found that the merger may not be expected to result in an SLC in the supply of free range liquid eggs and cage liquid eggs (paragraph 6.91).

7.2 As a result of the SLCs 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 would allow the merged entity to increase prices to retail customers unilaterally for cage and barn, free range and organic shell eggs (paragraph 6.74);

(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 6.74);

(c) the merged entity would be in a position to refuse to supply certain retailers (paragraph 6.74);

(d) 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 6.100 and 6.101); and

(e) the merged entity could jeopardize the position of other suppliers and/or limit the opportunities for entry by long term contracts with producers, or in other ways, for example, by pricing policies, price discrimination or own-branding of eggs (paragraph 6.101).

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 to retailers—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, 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 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 an industry characterized 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 coordinated effects may also be expected.

## **8. Remedies**

- 8.1 Our having concluded in paragraph 7.1 that the merger situation may be expected to result in an SLC, with the adverse effects specified in paragraphs 7.2 and 7.3, we have, under section 35 of the Act, to decide on three questions concerning remedial action, namely:

- (a) whether action should be taken by the CC for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has resulted or may be expected to result from the SLC;
- (b) whether the CC should recommend the taking of action by others (eg regulators, government departments) to remedy, mitigate or prevent the SLC concerned;
- (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.

- 8.2 In considering these questions the CC 'shall, in particular, have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the substantial lessening of competition and any adverse effects resulting from it' (section 35(4)).

- 8.3 In deciding the questions mentioned above the CC 'shall, in particular have regard to the effect of any action on any relevant customer benefits in relation to the creation of the relevant merger situation concerned' (section 35(5)).

- 8.4 The CC's guidance<sup>66</sup> states:

4.8 The remedial action that the Commission will decide should be taken will always depend on the facts and circumstances of the case. When deciding what is an appropriate remedy, the Commission will consider the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality.

4.9 The Commission must have regard to the reasonableness of any remedy and this will include consideration of the costs of any action it may decide is appropriate. The Commission will aim to

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<sup>66</sup>*Merger References: Competition Commission Guidelines, CC2, June 2003, paragraphs 4.8 to 4.10.*

ensure that no remedy is disproportionate in relation to the SLC or other adverse effect. If the Commission is choosing between two remedies which it considers would be equally effective, it will choose the remedy that imposes the least cost or that is least restrictive.

4.10 The Commission will generally include in its consideration of costs the costs of implementing a remedy. However, for completed mergers the Commission will not normally consider the costs of divestment to the parties as it is open to the parties to make merger proposals conditional on competition authorities' approval. It is for the parties concerned to assess whether there is a risk that a completed merger would be prohibited subsequently and the Commission will normally expect this risk to be reflected already in the acquisition price. Since the cost of divestment was, in essence, avoidable, the Commission will not, in the absence of exceptional circumstances, accept that the cost of divestment should be considered in the setting of remedies.

8.5 Having identified the least cost, least intrusive effective remedy or package of remedies, the CC may decide to modify that remedy in order to take account of any relevant customer benefits.

8.6 Section 30 of the Act describes relevant customer benefits as benefits to relevant customers in the form of lower prices, higher quality, greater choice or greater innovation in relation to goods or services in any market in the UK. A benefit is only a relevant customer benefit if it accrues (within a reasonable time period) as a result of the creation of the merger and if it was unlikely to accrue without the merger or a similar lessening of competition.<sup>67</sup> Relevant customers are customers at any point in the chain of production and distribution and are not limited to final consumers<sup>68</sup>. It can also include future customers.

8.7 It is open to the CC to reach an expectation that an SLC would result from a merger, but not to put in place a remedy. This might be the case if an inquiry group believed that the only effective remedy would entail relevant costs that are disproportionate to the scale of the SLC, but is only expected to occur in exceptional circumstances<sup>69</sup>.

### **Remedy options**

8.8 The purpose of remedies is to address an SLC and any adverse effects resulting, or expected to result, from it as required by section 35 of the Act. In general, this may be achievable in several different ways. It is possible to distinguish two broad categories of merger remedies:

(a) Structural remedies—which seek to address the competition problem through a direct (usually) one-off change in market structure, eg by reversing the transaction through divestiture;

(b) Behavioural remedies that facilitate competition or control outcomes—which seek to change the behaviour of a firm or firms in the market so as to improve the

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<sup>67</sup> *Merger References: Competition Commission Guidelines*, CC2, June 2003, paragraph 4.38.

<sup>68</sup> See also *Merger References: Competition Commission Guidelines*, CC2, June 2003, paragraph 4.39.

<sup>69</sup> See also *Merger References: Competition Commission Guidelines*, CC2, June 2003, paragraph 4.6. The guidance states that it is unlikely that the CC will decide that there is no case for remedies where it has decided that a merger results or may be expected to result in an SLC.

process of competition, eg by lowering barriers to entry or reducing switching costs or which seek to address the adverse effects expected to result from the lessening of competition by directly controlling outcomes, eg by controlling prices, product range, and/or product quality.

8.9 In its guidance, the CC has said that:

Structural remedies, such as divestiture or prohibition, are likely to be preferable to behavioural remedies, which seek to regulate the behaviour of firms, as structural remedies address the effects of a merger more directly and will usually require less monitoring or enforcement of compliance. However, behavioural remedies may be considered more suitable in some circumstances, for example, where the SLC is expected to be of limited duration or where the relevant customer benefits expected from a merger are substantial and behavioural remedies are likely to be more effective in preserving these than structural remedies. In certain circumstances, it may also be necessary to add behavioural remedies to a structural remedy in order to provide an effective and comprehensive solution.<sup>70</sup>

8.10 The remedies notice, published on 5 January 2007, sought comments on the divestiture of Deans or Stonegate, behavioural remedies and customers benefits. As expressed in this notice we considered that behavioural remedies are unlikely to be effective in addressing the SLC and its resulting adverse effects and in particular are likely to be difficult to monitor and enforce. Therefore we considered that structural remedies are likely to be preferable. Against this background we therefore need to consider (a) structural remedies and (b) possible behavioural remedies.

### **Structural remedy (divestiture)**

8.11 The main issues in considering the possibility of a divestiture remedy in this case are:

- (a) What should be divested that would, in principle, be effective in addressing the SLCs we have identified?
- (b) What are the risks that may prevent effective implementation of such a divestiture?

8.12 In assessing these issues, the CC's divestiture guidance<sup>71</sup> points to a number of risks that may impair the effectiveness of divestiture remedies:

- (a) Composition risks—these are risks that the scope of the divestiture package may be too constrained or not appropriately configured to attract a suitable purchaser or may not allow a purchaser to operate effectively and viably in the market.
- (b) Purchaser risks—these are risks that a suitable purchaser is not available or that the merger parties will dispose to a weak or otherwise inappropriate purchaser.
- (c) Asset risks—these are risks that the competitive capability of a divestiture package will deteriorate prior to completion of divestiture, for example through loss of customers or key members of staff.

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<sup>70</sup>Application of divestiture remedies in merger inquiries: Competition Commission Guidelines, CC8, December 2004, paragraph 1.8.

<sup>71</sup>Application of divestiture remedies in merger inquiries: Competition Commission Guidelines, CC8, December 2004, paragraph 2.3.

## **What should be divested?**

8.13 Our divestiture guidance states that:

In defining a divestiture package that will satisfactorily address the anticipated SLC, the CC will normally seek to identify the smallest operating unit of a business (eg a subsidiary or a division) that contains all the relevant operations pertinent to the area of competitive overlap and that can compete successfully on a stand-alone basis.<sup>72</sup>

The guidance also notes that:

The CC will generally prefer divestiture of an existing business that can compete effectively on a stand-alone basis independently of the merger parties, to divestiture of part of an operating unit or a collection of assets. This is because divestiture of such a business is less likely to be subject to purchaser and composition risk.<sup>73</sup>

8.14 In our remedies notice we noted that we were of the view that the divestiture of the Deans' business or the Stonegate business, providing that constitutes a business capable of competing on a stand alone basis, should be sufficient to address the SLC by restoring the pre-merger situation. The parties believed that divestiture of either Deans or Stonegate would be disproportionate since they believed a behavioural remedy that they proposed would be more effective, less costly and less uncertain in addressing the SLC.<sup>74</sup> However the parties also believed that the divestiture of Deans would be particularly disproportionate since the SLC (if it existed) could be equally addressed by the divestiture of Stonegate.

8.15 A number of retailers<sup>75</sup> agreed that the divestiture of Deans or Stonegate would address the SLC equally well however some parties<sup>76</sup> suggested that Deans would be the better company to divest because Stonegate would not be as competitive as prior to the merger and, because there were more opportunities to add value at Deans, it would be a more attractive sales package.

## **What are the risks?**

### *Composition risks*

8.16 In considering divestiture, a key consideration is whether the divested entity would be viable on a stand-alone basis.

8.17 [redacted]<sup>77</sup> [redacted]<sup>78</sup> [redacted]<sup>79</sup> [redacted]<sup>80</sup> [redacted]

8.18 [redacted]<sup>81</sup>

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<sup>72</sup>Application of divestiture remedies in merger inquiries: Competition Commission Guidelines, CC8, December 2004, paragraph 3.1.

<sup>73</sup>Application of divestiture remedies in merger inquiries: Competition Commission Guidelines, CC8, December 2004, paragraph 3.3.

<sup>74</sup>Note the parties also argued there was no SLC.

<sup>75</sup>[redacted], [redacted], [redacted], [redacted]

<sup>76</sup>[redacted], [redacted]

<sup>77</sup>Noble remedies hearing 31 January 2007.

<sup>78</sup>[redacted]

<sup>79</sup>[redacted], [redacted], [redacted], [redacted]

<sup>80</sup>[redacted]

<sup>81</sup>[redacted]

- 8.19 [REDACTED]
- 8.20 We are also aware of producers owned by one of the parties that supply the other and this will need to be dealt with on an individual basis to ensure that any divestiture creates a viable and independent competitor.
- 8.21 Noble<sup>82</sup> has suggested that [REDACTED]<sup>83</sup> [REDACTED]. Producers may be prepared to consent to their contracts being assigned if retailers move. We deal with the [REDACTED] issues below.
- 8.22 We may also require some additional protections for the divestiture which will include the arrangements set out in paragraphs 8.41 to 8.44.

### *Financial issues*

- 8.23 The parties have raised concerns [REDACTED]:
- (a) [REDACTED]
- (b) [REDACTED]
- (c) [REDACTED]
- 8.24 [REDACTED]<sup>84</sup>[REDACTED]<sup>85</sup>[REDACTED]
- 8.25 We note that both Deans and Stonegate were profitable before the merger. [REDACTED]<sup>86</sup> [REDACTED]<sup>87</sup> The financial viability of Stonegate and Deans following divestiture is dealt with in paragraphs 8.32 to 8.33.
- 8.26 [REDACTED]<sup>88</sup>:
- (a) [REDACTED]
- (b) [REDACTED]
- (c) [REDACTED]
- 8.27 [REDACTED]<sup>89</sup>[REDACTED]
- 8.28 [REDACTED]
- 8.29 [REDACTED]<sup>90</sup> [REDACTED]<sup>91</sup>
- 8.30 We have taken all these factors into account. We consider that [REDACTED] and Noble could renegotiate [REDACTED] if this was necessary to facilitate divestiture of Stonegate. [REDACTED]
- 8.31 [REDACTED]<sup>92</sup> [REDACTED] Complicated financing arrangements that are put in place at the time of, or following, a merger are not a reason in itself to prevent the CC from remedying an

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<sup>82</sup>Response to remedies working paper of 23 February 2007.

<sup>83</sup>[REDACTED]

<sup>84</sup>[REDACTED]

<sup>85</sup>[REDACTED]

<sup>86</sup>[REDACTED] presentation to the CC dated 10 April 2007.

<sup>87</sup>[REDACTED]

<sup>88</sup>[REDACTED]

<sup>89</sup>[REDACTED]

<sup>90</sup>Letter to the CC dated 2 March 2007.

<sup>91</sup>Remedies hearing with Stonegate 31 January 2007.

SLC finding through divestment. To do so would allow parties to a merger to frustrate the remedy options and powers available to the CC in completed mergers. [REDACTED] We are satisfied that if we were to use powers under the Act to order a divestment, the effect such an order would have on [REDACTED] would be proportionate.

- 8.32 With regard to the financial viability of a divested Stonegate and the residual Noble/Deans, we have examined the financial forecasts and projections provided by the parties and undertaken our own analysis which indicates a more positive outcome. The parties' auditors, [REDACTED], also presented on behalf of the parties its views on the financial projections and the CC's exercise. The analysis, together with [REDACTED] views and our consideration of those views, is described in more detail in Appendix H.
- 8.33 We have considered very carefully the arguments and projections put forward by the parties and [REDACTED]. We recognize that any financial projections are, by their nature, speculative. Nevertheless, we have not encountered compelling evidence that would divert us from our judgement that the companies concerned were financially viable before the merger and that the constituent companies are likely to be financially viable post divestiture.
- 8.34 We would therefore require that the financing of Deans and Stonegate should be separated and that Stonegate is sold with an appropriate level of debt to ensure that the business is viable and competitive. We consider that the appropriate level of debt [REDACTED].
- 8.35 As a general point, we note the approach set out in CC guidance in relation to the cost of remedies<sup>93</sup> (see paragraph 8.4). In particular, we note that, since the merger was a completed merger, the parties have exposed themselves to the risk of the CC finding that the merger has resulted in an SLC and therefore, in the absence of exceptional circumstances, we would not normally consider the costs of divestiture in setting remedies. In principle, therefore, we do not consider that the structure of financing arrangements, and the cost to parties of restructuring in the event of a divestiture, is an appropriate reason for not divesting a business. In this particular case, we have considered carefully the reasons advanced by the parties for not divesting one of the businesses, but for the reasons we have set out, we do not consider that these reasons are sufficient to change our view that the divestiture of one of the businesses is an effective way to remedy the SLC.

### **Purchaser risks**

- 8.36 The parties suggest that [REDACTED].<sup>94</sup> [REDACTED]
- 8.37 [REDACTED]<sup>95</sup> [REDACTED]<sup>96</sup> [REDACTED]<sup>97</sup> [REDACTED]<sup>98</sup> [REDACTED] and a number of parties<sup>99</sup> have suggested that there would be buyers at the right price. [REDACTED]<sup>100</sup>[REDACTED] Other parties,<sup>101</sup> however, have suggested that a sale may face obstacles. [REDACTED]<sup>102</sup> [REDACTED]<sup>103</sup> [REDACTED]

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<sup>92</sup>We note that correspondence and notes of conversations in [REDACTED] between [REDACTED], acting for Deans, and [REDACTED], acting for Stonegate, emphasised the importance of holding discussions with the bank regarding the bank's ability to provide funding regardless of a possible CC investigation.

<sup>93</sup>*Merger References: Competition Commission Guidelines, CC2, June 2003, paragraph 4.10.*

<sup>94</sup>[REDACTED]

<sup>95</sup>[REDACTED]

<sup>96</sup>[REDACTED]

<sup>97</sup>[REDACTED]

<sup>98</sup>[REDACTED]

<sup>99</sup>[REDACTED], [REDACTED], [REDACTED], [REDACTED], [REDACTED]

<sup>100</sup>[REDACTED]

<sup>101</sup>[REDACTED], [REDACTED], [REDACTED]

8.38 The parties have also suggested that their main competitors such [REDACTED]. A party<sup>104</sup> has suggested to us that it may be interested in purchasing a smaller set of assets but we note that:

(a) Fragmentation of operations through disposal to a number of operators is unlikely to be effective in restoring the degree of rivalry that would have been present between Deans and Stonegate in the absence of the merger. In particular, there would not be a strong second competitor in the market.

(b) Achieving a satisfactory set of partial sales of the Deans or Stonegate business is highly uncertain.

8.39 We therefore consider that the divestiture of Stonegate would be more effective as a remedy than a partial divestiture and/or divestiture of assets and contracts.

8.40 It will be important to a purchaser to retain key staff, customers and suppliers to maintain the competitive capability of the business which has been divested. In this context, we note the following issues:

(a) [REDACTED]<sup>105</sup> [REDACTED]

(b) [REDACTED]<sup>106</sup> [REDACTED]

(c) [REDACTED]

8.41 As a general principle, any sale of a business may involve the vendor giving non-compete and non-solicitation covenants provided these are reasonable in terms of scope and duration in relation to the nature of the business sold. [REDACTED]:

(a) [REDACTED]

(b) [REDACTED]<sup>107</sup> [REDACTED]<sup>108</sup> [REDACTED]

(c) [REDACTED]

8.42 [REDACTED]

8.43 [REDACTED]<sup>109</sup> [REDACTED]<sup>110</sup>

8.44 We would also expect that in order to ensure the attractiveness of Stonegate to potential purchasers, the parties would provide undertakings that they will use all reasonable endeavours to ensure that Stonegate will be divested with its [REDACTED].

8.45 Taking account of the above factors we believe that it is likely that a suitable purchaser would be found given a suitable sale process and a degree of flexibility in the sale price.

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<sup>102</sup>[REDACTED]

<sup>103</sup>[REDACTED], [REDACTED],[REDACTED],[REDACTED],[REDACTED]

<sup>104</sup>[REDACTED]

<sup>105</sup>Remedies hearing with Noble.

<sup>106</sup>[REDACTED]

<sup>107</sup>[REDACTED], [REDACTED],[REDACTED],[REDACTED]

<sup>108</sup>[REDACTED], [REDACTED]

<sup>109</sup>For example, [REDACTED]

<sup>110</sup>[REDACTED]

## Asset risks

8.46 The CC's guidance on divestiture remedies<sup>111</sup> states:

5.2 The parties to a merger may have significant incentives to run down or neglect the business or assets of a divestiture package in order to reduce future competitive impact. The resulting asset risk may also be influenced by such factors as the length and complexity of the divestiture process and the pace at which customer goodwill and employee relations may erode.

5.4 Where hold-separate undertakings are in place, the CC will usually require the appointment of an independent monitoring trustee to oversee the performance of the hold-separate manager and the parties' compliance with the undertakings. The need for a trustee may be avoided if the CC can be satisfied that the hold-separate management will be appropriately independent. The trustee will have an overall duty to act in the best interests of the divestiture package. The trustee will oversee the ongoing management of the divestiture package and will have the right to propose and direct measures necessary to ensure compliance with the hold-separate undertakings. The trustee will report to the CC at regular intervals.

8.47 A number of parties<sup>112</sup> have suggested that the divestiture of Stonegate would not be viable and the resulting turmoil in the industry would cause damage to producers. However we believe that [redacted], the sale of a viable entity is likely.

8.48 We have interim undertakings in place which operate to hold separate the Deans and Stonegate businesses and to prevent any action being taken with respect to those businesses which might prejudice our scope to impose remedies. We have also appointed a monitoring trustee (see paragraph 8.42). We anticipate maintaining, and in some respects enhancing, the protection provided by these interim undertakings when final undertakings are accepted, [redacted].

8.49 We would also propose that the role of the monitoring trustee is expanded to include monitoring the divestiture process. The trustee would oversee the ongoing management of the divestiture package and would have the right to propose and direct measures necessary to ensure compliance with the hold-separate undertakings. The trustee would continue to report to the CC at regular intervals.

## Divestiture process

8.50 CC guidelines suggest a maximum of six months for the initial divestiture period, in which the parties should complete the disposal of a divestiture package.<sup>113</sup> Noble told us [redacted]. Others<sup>114</sup> agreed that the process should be as quick as possible, although one<sup>115</sup> party commented that [redacted] should be allowed. We consider that in this case an initial period of [redacted] would be a reasonable length of time for the initial divestiture period, subject to provisions to ensure the assets are protected during this time. This

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<sup>111</sup>Application of divestiture remedies in merger inquiries: Competition Commission Guidelines, CC8, December 2004,

<sup>112</sup>[redacted], [redacted], [redacted], [redacted]

<sup>113</sup>Application of divestiture remedies in merger inquiries: Competition Commission Guidelines, CC 8, December 2004, paragraph 5.5.

<sup>114</sup>[redacted], [redacted]

<sup>115</sup>[redacted]

initial period could be extended if a transaction was already underway. We therefore propose the following process:

- (a) Noble should be allowed [X] to sell Stonegate to a suitable purchaser (the initial period). The initial period may be extended by the CC by [X] to facilitate a transaction underway if the monitoring trustee satisfies the CC that good progress is being made in the sale process. If required by the buyer and the requirement is considered reasonable by the CC, [X].
- (b) If Stonegate is not sold within the initial period (including any extension referred to above) the CC would have the right to appoint an independent divestiture trustee with the mandate to dispose of Stonegate to a suitable purchaser at the best-available price in the circumstances. [X]
- (c) If a suitable purchaser is not forthcoming in the [X] months following the initial period, we will implement the alternative remedy described in paragraphs 8.77 and 8.78.
- (d) Any transactions will be subject to prior approval by the CC of the purchaser and the divestiture arrangements.

8.51 The CC will wish to ensure, before providing its approval at the end of the divestiture process, that the divestiture agreement and relevant supporting documentation convey all the assets required to be divested and contain no provisions that are inconsistent with the objectives of the divestiture to remedy the SLC identified.

### ***Behavioural remedies***

8.52 We have also considered whether behavioural remedies are more suitable than divestiture in the circumstances of this case. Our guidance<sup>116</sup> suggests that behavioural remedies may be considered more suitable in some circumstances, for example, where the SLC is expected to be of limited duration or where the relevant customer benefits expected from a merger are substantial and behavioural remedies are likely to be more effective in preserving these than structural remedies. However, in this case, these examples of specific circumstances do not appear to apply since the SLC is not expected to be of limited duration and the relevant customer benefits expected from the merger are not substantial (see paragraphs 8.81 to 8.86).

8.53 Our guidance also suggests that it may be necessary to add behavioural remedies to the divestiture remedy in order to provide an effective and comprehensive solution.

### ***The Noble behavioural remedies proposal***

8.54 Noble has submitted three behavioural remedy proposals which it suggests would address directly the concerns identified about switching and barriers to expansion as a result of the perceived limited availability of eggs, in particular free range eggs, and also the concerns about barriers to switching by producers. We considered Noble's proposals carefully, discussed them with Noble, and consulted on them.

8.55 In its first behavioural remedies proposal, Noble was willing to commit to release any current Stonegate producer from its contract with Stonegate on providing three months' notice so as to permit it to supply another packer/processor. This would

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<sup>116</sup>Application of divestiture remedies in merger inquiries: Competition Commission Guidelines, CC8, December 2004, paragraph 1.8.

involve Stonegate amending its contracts with its producers. This would be up to the volumes which a retailer currently supplied by the parties had notified it intended to switch. Noble suggests that this would make it easier for other packers to supply retailers at short notice and, more generally, would allow any retailer concerned about the size/significance of the merged firm as a supplier of eggs to reallocate a substantial proportion of its business to other packers within a short period of time. Noble considered that if retailers were concerned about the behaviour of the merged firm, they would rapidly be able to switch to and orchestrate the expansion of a smaller player(s) (Noble believes potentially to the size of Stonegate plus the smaller player) and the consequent reduction in share of the merged firm, in principle to the level represented by Deans prior to the merger.

8.56 Noble believed that this remedy (a) provides assurance that retailers and/or processed egg customers can rapidly and effectively discipline the merged firm by switching business to other packers/processors and (b) avoids the uncertainties and risks associated with divestiture.

8.57 Noble envisaged that the remedy would operate as follows:

(a) it would apply to all producers which supplied Stonegate at the date of the undertaking;

(b) Any of these producers could switch all or part of their business with Stonegate to another packer or processor on written notice. The aggregate switched would not exceed the amount which the retailer concerned has notified it intends to switch.

(c) The notice period should be three months, to tie in with the three months' notice which the major supermarkets are required to give to their suppliers under the Supermarkets Code of Practice<sup>117</sup> (in fact the requirement under the Code of Practice is to give a reasonable period of notice, rather than three months and this has also been noted by a retailer<sup>118</sup>).

(d) When giving written notice, the producers should provide confirmation from the packer or processor to whom they are switching that the eggs are required to supply a particular retailer and/or processed egg customer and documentary evidence from the customer in question should be included specifying the egg types and volumes required. This is to ensure that the business is switching to end customers and that other packers/processors are not simply poaching Stonegate's producers to supply the wholesale market or simply to undermine the merged firm. The packer would forward this data to the parties to enable them to verify that the aggregate volume does not exceed the amount the retailer has notified it intends to switch.

(e) The parties believed that it is unlikely that disputes will arise as there will be a straightforward check to be made of the aggregate volumes set out in the producer notices and the volume notified by the retailer. Should there be disputes, however, the parties would undertake to submit them to binding and

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<sup>117</sup>Clause 2 of the Code states: 'Reasonable Notice of variation of a Supermarket's terms of business shall be given to the affected Supplier(s).'

Clause 16 of the Code states: 'A Supermarket shall not directly or indirectly require a Supplier to change the specification (including the quantity of products required) of any agreed order *unless* that Supermarket either:

(a) gives Reasonable Notice of such change to that Supplier in writing; or

(b) fully compensates that Supplier for any net resulting costs incurred as a direct result of the failure to give Reasonable Notice.'

<sup>118</sup>[redacted]

speedy arbitration (eg by the current Monitoring Trustee or other independent third party approved by the CC).

- (f) The parties envisaged that this undertaking would remain in place until varied or lifted by the CC.

8.58 Noble also submitted a worked example to illustrate the process, which is shown in Appendix I.

8.59 Noble says that the remedy would provide the following benefits:

#### *Customers*

- (a) Customers are assured that they can rapidly switch large volumes to alternative suppliers, whereas that guarantee is not provided by a divestiture unless the divested entity has spare eggs.
- (b) The mere threat of switching large volumes will become much stronger.
- (c) The shorter notice period for producers may act as a stimulus to more frequent switching.

#### *Producers*

- (d) Stonegate producers can take advantage of the remedy to ensure that they obtain prices which provide a fair return on their investment, by offering to supply competitors at short notice.
- (e) They retain the assurance of a secure outlet for production because current notice periods for Noble would remain unchanged.
- (f) Deans' producers will know that the second-largest producer base in the UK, Stonegate's, has to be paid competitive rates by Noble and that they in turn will have to be paid competitive rates.

#### *Competitors*

- (g) All competitors would have the opportunity to expand their business by as much as Stonegate's volumes.
- (h) They acquire much easier and faster access to additional supplies of eggs, particularly free range, which enhances their credibility with customers in competing for new business.
- (i) They are able to plan substantial switches of business with customers and producers in advance.

#### *Other benefits claimed by Noble*

(j) [REDACTED]

(k) This remedy allows all the merger-specific efficiencies (which have resulted in customer benefits) to be retained rather than seeing the majority ([REDACTED] a year) lost.

(l) This remedy could probably be implemented much faster than a divestiture, in as little as two weeks.

(m) The need for monitoring is likely to be very limited and simple. The remedy is not likely to 'degrade' over time, but may well result in structural changes which obviate the need for its continuance.

8.60 Most retailers that commented to us<sup>119</sup> (representing a significant proportion of the retail egg market) did not feel that Noble's proposal would be effective in addressing the SLC since it would not restore the competitive situation to that which existed before the merger with a large second competitor.

8.61 Of the egg suppliers to the parties, two<sup>120</sup> small producers felt the merger should proceed and did not need remedying, emphasizing the value of stability and continuity. Another<sup>121</sup> believed that the proposed mechanism would be attractive to producers (but also suggested that only a low amount of volume would transfer in practice). A number<sup>122</sup> expressed concern that the proposed remedy only applied to Stonegate's producers, of which most felt that if the remedy included Deans' suppliers, it would be more effective in addressing the SLC. One<sup>123</sup> believed that the mechanism would not restore the pre-merger situation by giving producers all over the country the same access to the choice of market that they had before and another<sup>124</sup> expressed doubt that retailers would wish to deal with a large number of smaller competitors (and suggested that smaller competitors would not be able to grow rapidly because of a lack of Lion-quality packing capacity).

8.62 Two competitors<sup>125</sup> also felt the remedy as proposed would not remedy the SLC but, if extended to Deans' production, would be more effective. One other party<sup>126</sup> felt the behavioural remedy proposal 'would help'.

8.63 We have noted that not all of those third parties who responded to the consultation on Noble's behavioural remedy were critical of the proposal (see paragraphs 8.60-8.62). We note that it does not rely on finding a buyer for the Stonegate business. However, as a result of our own analysis and our assessment of the consultation responses as a whole, we consider that, although it may create the potential for some producer switching, there are a number of significant concerns about whether the proposal is practicable and effective in addressing the SLC:

(a) The mechanism would only apply to Stonegate's external producers, not its own in-house production. In total, [REDACTED]<sup>127</sup>. Therefore, even if all Stonegate's suppliers switched, the pre-merger situation would not be recreated<sup>128</sup> and the SLC would not be remedied. The producer volume is split between [REDACTED],<sup>129</sup> which two parties<sup>130</sup> suggested leaves only a small amount of the Stonegate free range volume available to compete for (one said this was only 15 per cent).

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<sup>119</sup>[REDACTED], [REDACTED],[REDACTED],[REDACTED] ([REDACTED] had no comment). [REDACTED] who felt the behavioural remedy offered a simpler and faster solution to moving business, and would be even better if Stonegate producers could just give three months' notice, without the requirement to match producer notices with volumes switched. [REDACTED] said that while it was otherwise happy with Noble's proposed remedy, it did not have any comments on a divestiture remedy.

<sup>120</sup>[REDACTED] (who said 'I believe that producers are a loyal bunch who prefer stability and continuity compared with the promise of an unknown alternative where any perceived benefit could be whittled away in any manner of hidden overheads') and [REDACTED].

<sup>121</sup>[REDACTED]

<sup>122</sup>[REDACTED], [REDACTED],[REDACTED]

<sup>123</sup>[REDACTED], [REDACTED]

<sup>124</sup>[REDACTED]

<sup>125</sup>[REDACTED], [REDACTED],[REDACTED] did not specifically comment on the parties' remedies proposal but, in their remedies hearing, suggested that freeing up producer contracts would be beneficial.

<sup>126</sup>[REDACTED]

<sup>127</sup>Note production of organic eggs in fact is slightly higher than sales but some are downgraded.

<sup>128</sup>[REDACTED]

<sup>129</sup>[REDACTED]

<sup>130</sup>[REDACTED]

- (b) A party<sup>131</sup> thought that the restriction to Stonegate's external producers would result in a competitor experiencing difficulty in sourcing sufficient intensive egg<sup>132</sup> to enable retail customers to switch any large volumes to the competitor [X].
- (c) Even if a significant amount of Stonegate's suppliers were dispersed around the other competitors, then the pre-merger situation would still not exist (ie a second large player to provide a strong alternative supplier for retailers' business).<sup>133</sup> There would be one large player and a number of fringe competitors slightly larger than now.<sup>134</sup> Some competition may be created, but this does not effectively restore the situation of rivalry that was present prior to the merger. Retailer comments (see paragraph 8.60) emphasized this point.
- (d) The mechanism, as set out in Noble's worked example, is complex.<sup>135</sup> This, and its lack of transparency to retailers, producers and competitors would allow Noble significant ability to frustrate the mechanism to prevent either retailers or producers switching:
- (i) For example, although Noble did not include it in the worked example for consultation, Noble would have had the right to persuade a producer to stay. Noble could selectively improve producer or retailer terms to prevent the transfer occurring. This could impact on a competitor's credibility. Noble, however, claims it would have limited ability to change a producer's terms because of the impact on its agreements with other producers.
  - (ii) One producer<sup>136</sup> was concerned that the restrictions contained in the remedy, which impose on producers an obligation to disclose to Noble what competitor they are moving to, and which contract between the competitor and retailer the notice relates to, look extremely onerous. The producer suggested that there are few examples in business where a company can demand information about contracts held between a former supplier or customer and a competitor.
- (e) Given the possibility of a failed transfer, producers may not wish to be associated with a proposed transfer for fear of reprisals from Noble.<sup>137</sup> A competitor to Noble would find it difficult to be sure that enough producers could be assembled at a suitable price to allow the transfer, and retailers would be wary of dealing with competitors to Noble when it was unclear that the competitor may not be able to amass the eggs.
- (f) One party<sup>138</sup> has suggested that Noble may be tempted to improve terms to Stonegate's producers to prevent switching and fund this by maintaining captive Deans' producers on less attractive terms.
- (g) Due to producers exiting the industry from time to time, the available supply base to which the remedy applies will gradually decline over time because new producers, including new producers within [X], would be outside the arrangement, and over time some attrition of the supply base may occur as some producers swap between Stonegate and other competitors.

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<sup>131</sup> [X], [X]

<sup>132</sup> We assumed this meant cage egg.

<sup>133</sup> The parties suggest that retailers would be likely to favour one player who would grow at the expense of the other competitors, however since each competitor is regionally based we consider this to be unlikely.

<sup>134</sup> [X]

<sup>135</sup> [X]

<sup>136</sup> [X]

<sup>137</sup> [X]

<sup>138</sup> [X]

- (h) There may be potential, given the market information that could be transmitted between parties in the mechanism proposed by the parties, for some coordinated effects to result.<sup>139</sup>
- (i) The highly concentrated nature of Stonegate's producer base for free range eggs ([REDACTED]) means that switching supplies for a retailer would require those producers to agree to part switch their volume to a competitor, with the balance remaining with Stonegate. It is unclear that a producer would agree to do this, since it would complicate its operation, and could make the mechanism unattractive for a large proportion of Stonegate's producer base. [REDACTED] It is unclear how the mechanism would work for those producers to be transferred.
- (j) Noble has an incentive to allow their least attractive producers to transfer, either because of location, quality of eggs or other factors. These would be less economic to Noble's competitors and it may be that the competitor is unable to attract a retailer with those producers.
- (k) Once a producer had switched, it would be unlikely that the new packer would agree to shorten that producer's notice period because of the impact on its own producer contracts. Therefore, there would be limited benefits for ultimate producer mobility from this mechanism compared with a divestiture.
- (l) The proposal, therefore, provided for what we consider to be a complex, opaque and bureaucratic exercise in managing the production base which we do not consequently regard as a practicable remedy.

8.64 In light of the issues and concerns set out above, we did not consider that Noble's behavioural remedy proposal is practicable nor will it address the SLC effectively.

8.65 In response to the CC's concerns, Noble put forward two further behavioural remedy proposals. In the next proposal, Noble suggested that they would agree to all of Stonegate's third-party producers being able to give three months' notice to switch. Although this addressed some of the concerns we had (specifically (d), (e) and (h) in paragraph 8.63) our other concerns remained such that we still did not consider it practicable or effective to address the SLC.

8.66 We queried with Noble whether it would consider including Deans in the proposal. Noble said this would be disproportionate and unnecessarily destabilizing and onerous.<sup>140</sup>

(a) it would throw into jeopardy Noble's ability to service the requirements of its major retail customers [REDACTED]; and

(b) [REDACTED].

8.67 [REDACTED]

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<sup>139</sup>We note that similar undertakings covering Deans' as well as Stonegate's egg suppliers were offered to the OFT in 2006 and were not felt by the OFT to be acceptable. The OFT, in its decision document, said: 'In this case, the proposed remedies raise the following serious questions: first, whether a rival could actually negotiate terms with the merged firm so as to represent an effective alternative source of supply; second, the possibility that such negotiations may facilitate supplier coordination; third, there is a requirement on the potential competitor to bid to supply eggs prior to having an assured source of supply; fourth, the parties propose that the remedy be in force for a limited period of two years.'

<sup>140</sup>20 March 2007 letter from Slaughter and May.

- 8.68 Noble proposed a third behavioural remedy that would also include Deans' third-party eggs that 'would mitigate to some degree the major commercial risks' it had raised as set out in paragraph 8.66:
- (a) a mechanism would be needed to ensure producer switching was in response to genuine retailer switching. Noble proposed that it should be able to apply to the OFT for a derogation to prevent switching where the eggs are not required to cover volume that a retailer wishes to switch from Noble; and
  - (b) there should be a cap on total aggregate customer switching equivalent to Stonegate's pre-merger third-party purchases.
- 8.69 The parties suggested that, even with the cap, it would still allow any two competitors to grow to the size of Stonegate.
- 8.70 We have considered the third proposal carefully, but do not consider that it addresses our concerns. Much of the bureaucracy of the first proposal is present in the third proposal since Noble has reintroduced a form of the mechanism where producers only transfer if a retailer transfers (although this time Noble has to apply for a derogation to prevent the switch).
- 8.71 In terms of Noble's claim that two competitors could become the size of Stonegate, mathematically, if there was large-scale customer and producer switching, and if two of the largest three fringe competitors were able to gain between them the equivalent of all of Stonegate's third-party production, they would roughly double in size. They would still be significantly smaller than Stonegate, however. This also assumes that the eggs would go to only two competitors. It is more likely that, if significant producer and customer switching did occur, the switched volume would be dispersed across all competitors. In this event, the gain in market share of the largest fringe competitors would be significantly lower. Also, the total volume cap under the third behavioural remedy is less than the total volume of all Stonegate's supply (ie in house production and third party purchases).
- 8.72 It is not clear how any of the behavioural remedies proposed by Noble would address problems associated with the size of Noble and its remaining competitors. The benefits of size and scale<sup>141</sup> and the reduced size of competitors will have implications both upstream and downstream.
- 8.73 Downstream, as outlined in Annex 3 of Appendix E, retailers will have to switch larger volumes to discipline a larger Noble, and the competitors to whom they will have to switch that volume are considerably smaller.
- 8.74 Similarly, upstream producers will be faced with a larger Noble and will no longer have the option to switch between two large packers, and will have experienced a reduction in competition for the purchasing of their eggs as a result of the merger. It is not clear how the reduction in their notice periods will address this loss of competition, as although they can now switch faster, the loss of a significant switching option is not addressed directly by the remedy.

### ***Behavioural remedy as final option after divestiture process***

- 8.75 We initially suggested to the parties (on 23 February 2007) that partial divestiture may be an appropriate remedy if divestiture of Stonegate by a divestiture trustee

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<sup>141</sup>Paragraph 6.12 of draft report put back to Noble on 20 February 2007.

proved unsuccessful. Following further consideration, we do not consider that this would be an appropriate remedy. We consider there is a risk that such a piecemeal divestiture may not itself prove successful and, even if it were to be achieved, we consider the piecemeal disposals may be unlikely to be sufficiently comprehensive in addressing the SLC.

- 8.76 A behavioural remedy would not be as comprehensive a solution as divestiture of Stonegate in remedying the SLC for the reasons set out in paragraphs 8.63 to 8.74. We consider that divestiture of Stonegate provides a more comprehensive solution to the SLC (than any behavioural remedy) because it directly addresses the SLC by creating a strong second competitor which we do not believe a behavioural remedy could achieve. We nevertheless consider that, in the event that the divestiture of Stonegate does not prove to be possible (this would be the case if no suitable buyer is found following attempts to sell by both Noble and a divestment trustee), a behavioural remedy could to some extent effectively address the SLC.
- 8.77 Therefore, if it does not prove possible to divest Stonegate, we will implement a behavioural remedy which would enable producers to switch more easily. This would also impose a pricing restraint by the threat of producers switching. It would require Noble to allow all of its third-party producers (both existing and new producers)<sup>142</sup> to give six weeks notice to terminate their contract with Noble. We consider that this remedy would function without any need to change the current contractual provisions (which typically specify a 12-month notice period). Instead, we would expect Noble to give an undertaking to the CC that it would waive this notice period to a maximum of six weeks should a third-party producer give notice to terminate.<sup>143</sup>
- 8.78 We consider that this behavioural remedy does no more than is necessary to create the opportunity for producers to switch to an alternative packer and is proportionate. As discussed above the underlying supply base of producers is currently relatively immobile (see paragraph 6.47). We believe the following features of the remedy are necessary for it to be a practicable remedy and one which could to some extent effectively address the SLC:
- (a) It would apply to all of Noble's third-party producers (both existing and new). This is to ensure that Noble cannot place Deans' producers on worse terms than Stonegate's producers, or apply price increases to its retail customers knowing the volume that could transfer would be less than a critical loss volume.
  - (b) We do not consider that a time limit should be placed on the remedy. We note, however, that under the Act, Noble could apply to the OFT for the undertakings to be varied or released when there was a change in circumstance. It would therefore be open to Noble to argue that the market was operating in such a way that the SLC we have identified no longer exists.
  - (c) The notice period for a producer to terminate its contract with Noble would be waived to a maximum of six weeks. We consider that a short time frame of six weeks is necessary to sufficiently increase the threat of and enable switching by producers in a relatively short time period. A longer period of notice would be less effective because there would be a greater risk of transfers failing and the level of churn in supply contracts remaining low as discussed above in paragraph 6.47.
- 8.79 We consider that this behavioural remedy should be the third step in the remedy process and would only apply after Noble has attempted to sell Stonegate and, if that

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<sup>142</sup>New producers would be those that enter in a contract with Noble after the signing of undertakings or the issuing of an order.

<sup>143</sup>The waiver would apply to existing and new contracts.

proves to be unsuccessful, after the period allowed for the divestiture trustee to sell Stonegate.

### **Measures supporting a divestiture**

8.80 It will be important to ensure that the divestiture package is viable such that a divested Stonegate may operate in such a way as to remedy the SLC identified. We will therefore require various undertakings to be given by the parties in relation to ensuring the maintenance and continuation of Stonegate's existing producer and customer base. The nature and scope of the undertakings are set out in paragraphs 8.41 to 8.44.

### **Relevant customer benefits**

8.81 Our guidance states in paragraph 4.34<sup>144</sup> that the CC may, in deciding the question of remedies have regard to the effects of any action on any relevant customer benefits in relation to the creation of the relevant merger situation concerned.

8.82 Relevant customer benefits are defined in section 35(5) of the Act.<sup>145</sup> Paragraph 4.37 of our guidance explains relevant customer benefits are benefits that arise from a merger and are:

... limited to benefits to relevant customers in the form of:

(a) lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom (whether or not the market or markets in which the substantial lessening of competition has, or may have occurred or (as the case may be) may occur); or

(b) greater innovation in relation to such goods or services.

8.83 The parties state that some, though by no means all, of the cost savings from the merger would be lost as a result of a divestiture of Stonegate from Deans:

(a) [REDACTED]

(b) [REDACTED]

(c) [REDACTED]

(d) [REDACTED].

8.84 However, we consider that it is unlikely that the savings arising from the merger that are discussed by the parties will result in significant relevant customer benefits. The benefits listed would only be relevant if they resulted in lower prices, better quality, etc to customers, [REDACTED].<sup>146</sup> From our analysis of the SLC, it appears likely that the merged entity will have sufficient market power to ensure that it retains most of the efficiencies resulting from the merger without passing them on to customers. We also note these savings [REDACTED].

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<sup>144</sup> *Merger References: Competition Commission Guidelines, CC2, June 2003.*

<sup>145</sup> Section 35(5) of the Enterprise Act (2002), which limits relevant customer benefits to lower prices, higher quality, greater choice and greater innovation.

<sup>146</sup> [REDACTED]

- 8.85 Retailer comments<sup>147</sup> suggest that they do not believe that any merger benefits have been passed on to customers to date. [REDACTED]<sup>148</sup>
- 8.86 We do not consider that the likely scale of relevant customer benefits is sufficient to modify our choice of remedy.

### **Proportionality**

- 8.87 As noted in paragraph 8.4, the CC's guidance<sup>149</sup> states that in deciding what is an appropriate remedy, the CC will have regard to the principle of proportionality as well as considering the effectiveness of different remedies and their associated costs. The guidelines state in paragraph 4.10:

The Commission will aim to ensure that no remedy is disproportionate in relation to the SLC or other adverse effect. If the Commission is choosing between two remedies which it considers would be equally effective, it will choose the remedy that imposes the least cost or that is least restrictive.<sup>150</sup>

- 8.88 As noted in paragraph 8.14, the parties have suggested that the behavioural remedy they proposed would address the SLC. However, as we set out in detail above (see paragraphs 8.63 to 8.74), we do not believe that Noble's proposed behavioural remedies would on their own effectively address the SLC.
- 8.89 We consider that in order effectively to address the SLC and its adverse effects in this case, a divestiture of one of the businesses of Noble would be required in order to restore as far as possible the pre-merger situation. This could mean the divestiture of either Stonegate or Deans, or a package based on either Stonegate or Deans. In line with our guidance, in choosing between two remedies which would be equally effective, the CC has generally chosen the remedy which imposes the lower cost or is the least restrictive. We consider that the divestiture of Stonegate, being the smaller of the two companies, is the least intrusive, least costly and therefore most proportionate remedy. We have taken account of the parties' arguments on proportionality and in particular, their view that divesting Deans would be disproportionate when it would be possible to divest Stonegate.
- 8.90 The CC's guidelines note that the CC will generally include in its consideration of costs the costs to the parties of implementing the remedy. However in relation to completed mergers the guidelines go on to say that the CC:

... will not normally consider the costs of divestment to the parties as it is open to the parties to make merger proposals conditional on competition authorities' approval. It is for the parties concerned to assess whether there is a risk that a completed merger would be prohibited subsequently and the Commission will normally expect this risk to be reflected already in the acquisition price. Since the cost of divestment was, in essence, avoidable, the Commission will not, in the absence of exceptional circumstances, accept that the cost of divestment should be considered in the setting of remedies.

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<sup>147</sup> [REDACTED], [REDACTED], [REDACTED]

<sup>148</sup> [REDACTED]

<sup>149</sup> Merger References: Competition Commission Guidelines, CC2, June 2003, paragraphs 4.6 to 4.10.

<sup>150</sup> Merger References: Competition Commission Guidelines, CC2, June 2003, paragraph 4.9.

8.91 We have considered carefully the issue relating to costs and in particular the points raised by the parties in this respect. We do not believe that the costs associated with divesting Stonegate changes our view that the divestiture of Stonegate is the most effective and proportionate remedy.

### ***Conclusions on remedies***

8.92 Our key conclusions are therefore:

- (a) the divestiture of Stonegate is likely to be the most practicable and effective, comprehensive and proportionate remedy for dealing with the SLC and the resulting adverse effects of the merger;
- (b) the behavioural remedy proposed by Noble and its subsequent revisions is not as practicable and effective and comprehensive as divestiture in remedying the SLC;
- (c) the process and scope for divestiture should be as set out in paragraph 8.50; and
- (d) we also consider that, if a buyer is not found for Stonegate, we will impose a remedy as set out in paragraphs 8.77 and 8.78.