

Completed acquisition by Long Clawson Dairy Limited of the Millway business of Dairy Crest Group plc

The OFT's decision on reference under section 22(1) given on 8 October 2008. Full text of decision published 28 October 2008.

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**Please note that square brackets indicate figures or text which have been deleted or replaced at the request of the parties for reasons of commercial confidentiality.**

## **PARTIES**

1. **Long Clawson Dairy Limited** (Long Clawson) is a UK cheese-producing dairy with a portfolio of more than 30 products including Stilton, Shropshire Blue, and several types of blended cheese. In the financial year to 31 December 2007, Long Clawson's total turnover was £35.7 million. It currently operates three sites in the UK: Long Clawson (Head Office; production and packing of Stilton and other blue cheeses; distribution); Harby (maturation of Stilton and other blue cheeses); and Bottesford (production and packing of speciality blended products).
2. **Dairy Crest Group plc** (Dairy Crest) is a major UK chilled dairy foods company. Its portfolio of branded products includes Country Life Butter, Cathedral City, Davidstow, and Yoplait, among others. Dairy Crest operates a Stilton and speciality cheese business within its wholly owned subsidiary Millway Dairy Crest (Millway) at Hartington (Derbyshire). Millway, which is the object of the present transaction, produces Stilton (both blue and white varieties), other blue cheeses (Shropshire Blue and Dovedale), and blended cheeses. Millway's turnover for the financial year ending 31 March 2008 was £[ ] million.

## **JURISDICTION**

3. As a result of the transaction described below, Long Clawson and Millway

have ceased to be distinct for the purpose of Section 23 of the Enterprise Act 2002 (the Act). The transaction qualifies as a relevant merger situation on the share of supply test under Section 23 (3) of the Act as the parties' combined share of supply in the UK for Stilton cheese exceeds the 25 per cent threshold. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

## **TRANSACTION AND RATIONALE**

4. On 31 July 2008, Long Clawson acquired Millway for a total consideration of £[ ]. In addition, Long Clawson is also to acquire approximately £[ ]. The transaction was notified to the OFT by way of a satisfactory submission on 14 August 2008. The OFT accepted initial undertakings from Long Clawson on 29 August 2008. The administrative deadline expires on 8 October 2008 and the statutory deadline expires on 30 November 2008.
5. Stilton is traditionally produced using open vats of variable sizes. By contrast, Dairy Crest, following its acquisition of Millway in 2000, invested in costly equipment (an automated coagulator) as an alternative to the traditional vats. The automated coagulator was intended to significantly increase the production capacity of Blue Stilton produced, at a consistently higher quality level and on a continuous basis. The equipment has failed to provide the expected results and since then, Millway has suffered severe quality and operational problems in the manufacture of its Blue Stilton product. As a consequence, Millway's Blue Stilton business has kept declining over the past seven years [ ].
6. On the basis of the above, the parties submit that Millway is no longer a viable standalone business and, absent the merger, Dairy Crest [ ]. The OFT understands that [ ].
7. A claim that one party will exit absent the merger is to suggest that the OFT should not benchmark its post-merger competitive effects analysis against pre-merger conditions. In order to decide whether the duty to refer applies, the OFT must consider the merger's impact relative to the future situation that would prevail absent the merger (that is, the counterfactual).
8. The OFT's general approach is that it relies on pre-merger conditions as the appropriate proxy for the counterfactual and will 'test' the competitive

impact of any transaction against such a standard before proceeding to consider whether another counterfactual should be substituted. In general, where the merger raises no concerns relative to pre-merger conditions, nothing will turn on the OFT's adoption of its default counterfactual of pre-merger conditions and there will be no need to consider the detailed factual questions that arise under substitute counterfactuals that, for example, the failing firm defence or other exiting firm scenarios engage. Accordingly, in this case, the OFT first considered whether the merger raises concerns relative to the pre-merger conditions before considering whether a substitute counterfactual would be more appropriate.

## BACKGROUND

9. The parties' overlap in the manufacture of Blue and White Stilton, the supply to retailers of Blue Stilton, the supply of White Stilton to cheese blenders and the supply of blended cheese to retailers.
10. UK consumers spend around £65 million per year on Stilton, a typical English cheese, with large spike in sales at Christmas time. Both varieties of Stilton, blue and white, can be made using the same production facilities.
  - **Blue Stilton** contains typical blue veins as a result of the *penicillium roqueforti fungus* being introduced in the mold at an early stage of the manufacturing process. Blue Stilton is an end-product sold to consumers.
  - **White Stilton** has no fungus introduced in it. It is used mostly as a base to produce blended cheese, and is rarely consumed in its 'pure' form.
11. Both varieties of Stilton have been granted 'Protected Designation of Origin' (PDO) status by the European Commission and can only be produced, with a proper licence in the three East Midlands counties of Derbyshire, Leicestershire, and Nottinghamshire. The production of Stilton is subject to a strict code, using milk sourced only from the three counties listed above or from ten other adjacent counties. There are currently eight dairies licensed to produce Stilton, and each is subject to regular audits by an independent inspection agency.

12. Conversely, blended cheese is made with various types of cheese as base (for example Stilton, Cheddar, Wensleydale and Double Gloucester), which are then typically mixed with dried fruit or herbs.
13. Although Blue Stilton and White Stilton are essentially the same product from a supply-side perspective, the only difference being the lack of characteristic *fungus* in White Stilton, the OFT notes that, from a demand-side perspective, the two varieties are mainly sold through different channels and to different types of customers: as mentioned above, Blue Stilton is sold to retailers as an 'end-product', White Stilton is mainly sold as a base to blended cheese manufacturers.
14. Furthermore, the OFT's investigation suggests that Stilton manufacturers' profit margins on Blue Stilton are generally far higher than they are on White Stilton. In that context, Stilton manufacturers tend to use spare capacity to make White Stilton. Consequently, a small but significant and non-transitory increase in the price (SSNIP) of Blue Stilton may encourage supply-side substitution from White Stilton to Blue Stilton but the converse appears unlikely. Such an asymmetric constraint on the supply-side from Blue Stilton to White Stilton appears insufficient to make supply-side substitution broaden the Blue Stilton market to include White Stilton, although it may be the case that the market for White Stilton includes Blue Stilton.
15. For the above reasons, and because the OFT has competition concerns in relation to the merger's impact on the supply of Blue Stilton, but not in relation to White Stilton, the OFT's following discussion of market definition and competitive assessment addresses Blue Stilton and White Stilton separately.

## **BLUE STILTON**

16. The parties argue that Blue Stilton (and White Stilton) form part of a wider blue cheese market, including popular Continental blue cheeses such as Gorgonzola and Dolcelatte (Italy), Roquefort, Saint Agur (France), Danish Blue, and Cambozola (Germany) among others.

## **MARKET DEFINITION**

### **Demand-side substitution to other blue cheeses**

17. To substantiate this claim, the parties submitted a range of evidence—much of it regarding the preferences of final consumers—which they argue points towards the relevant product market being wider than Blue Stilton.
18. The OFT notes that the preferences of consumers at the retail level for buying and consuming various blue cheeses and the preferences of retailers at the wholesale level for stocking various blue cheeses, although obviously related, need not be synonymous. For example, a supermarket may consider two products to be relatively close substitutes for, say, shelf space even if consumers do not consider them strong substitutes; conversely, a supermarket may consider two products to be largely complementary – for example, its shelves must stock a reasonable volume of both products – even if many marginal consumers would switch between those products.
19. Nonetheless, the OFT is satisfied, on the basis of the weigh of evidence in this case ,that consumers' and retailers' preferences are aligned closely enough for the parties' evidence to be probative.<sup>1</sup> (The same applies to evidence considered below on supermarkets' preferences with respect to producers of blended cheese.)

### **Retail price correlations**

20. The parties note that retail prices of Blue Stilton and Danish Blue at the four largest supermarkets (ASDA, Sainsbury's, Tesco and Morrison's) have been closely aligned during the last 18 months which, they claim, indicates that Blue Stilton forms part of the same market as other blue cheeses.
21. The OFT's price correlation analysis based on data supplied by the parties reveals the following:

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<sup>1</sup> In summary, this is because of (a) linear pricing – wholesale Stilton pricing to supermarkets is on a similar £/kg basis to the retail pricing structure to consumers (£/kg); (b) evidence of full supply-chain pass-on of input costs for Stilton (fresh milk price increases) to end-consumers; and (c) various items of qualitative evidence from market participants.

- Negative or between Blue Stilton and Roquefort, Saint Agur, and Gorgonzola.
- Negligible correlation between Blue Stilton and Dolcelatte.
- Positive and high correlation between Blue Stilton and both Danish Blue and Cambozola.

While this data is consistent with a market that could include Danish Blue and possibly Cambozola in addition to Blue Stilton, it is wholly inconsistent with a market for all blue cheeses. That said, during the Christmas period, the sales of Blue Stilton reach their maximum and particularly at this time, are unlikely to be constrained by sales of any other blue cheese, not even Danish Blue.

#### **Absolute retail price differentials**

22. The parties also argue that retail prices for Blue Stilton are similar to prices for other blue cheeses. Such evidence is generally weaker evidence than price correlation evidence, however, because it is less probative of the likely behaviour of marginal customers – consumers might readily switch between higher and lower priced products if prices shifted, or not switch between similarly-priced products.
23. In any event, the OFT notes that price differences between Blue Stilton and other blue cheeses range from four to 148 per cent, with Danish Blue and Blue Stilton being the cheaper ones. This finding tends to support the conclusion of the price correlation evidence, and appears inconsistent with Blue Stilton being in a wider 'all blue cheese' market. To counter this, the parties argue that while standard Blue Stilton is priced at the lower end of the range, mature and premium Blue Stiltons are priced much more closely in line with Gorgonzola, St Agur, Dolcelatte, etc. However, production and sale figures provided by third parties indicate that mature and premium Stilton account for a very limited amount of sales in comparison to standard Blue Stilton. Taking this evidence together, the OFT therefore considers that the price of these specific varieties of Blue Stilton are not relevant to the overall price of Blue Stilton, the vast majority of which is non-premium volume.

### **Retail sales volume shifts**

24. The parties also submit that changes in total sales between 2006 and 2008 for Blue Stilton and other blue cheeses at seven of the eight largest multiple retailers show an inverse correlation between Blue Stilton and other blue cheese sales: when sales of Blue Stilton increase at a particular retailer, sales of other blue cheeses correspondingly decrease and *vice versa*.
25. In principle, this kind of evidence can be very powerful. However, on the facts of this case, the OFT notes that the changes in sales of Blue Stilton and other blue cheeses, although inversely related, show significant differences in the magnitude of sales changes for five of the seven supermarkets. That is, when sales of Blue Stilton go down or up, sales of other blue cheeses go up or down by very different quantities (sometimes by more than twice as much). Given that Blue Stilton and other blue cheeses appear to be consumed in similar quantities, the OFT is not satisfied that customer substitution from Blue Stilton to other blue cheeses (and vice versa) is the prime explanation for this, nor that it conclusively demonstrates that if all Stilton prices rose by a small but significant amount, sufficient consumers would migrate their purchases to other blue cheese to make that price increase unprofitable.

### **Monitoring by Stilton suppliers**

26. Finally, the parties claim to closely monitor sales and promotions of other blue cheeses, and to [ ]. Long Clawson in particular monitors the retail prices of Stilton and other blue cheeses regularly, which the OFT historically has treated as evidence of competitive interaction. However, substantially more probative weight will be given to monitoring activity of a postulated direct substitute product, when it is combined with concrete example of competitive responses – such as changes to price, marketing or promotional strategy, or other variables – to the other products being monitored. In this case, the OFT has not been made aware by the parties or other market participants of any concrete example of commercial action taken by the parties in response to any such monitoring, which casts some doubt on the constraint being imposed by these other producers.

## Supply side substitution

27. The parties submit that any blue cheese manufacturer would have the requisite knowledge to manufacture Blue Stilton.
28. While some third party respondents consider Blue Stilton and other blue cheeses to be in the same market from a supply-side perspective, the majority of them note that Blue Stilton is a long established traditional British cheese enjoying PDO status, which sets it apart from other imported blue cheeses. In particular, these third parties indicate that: (i) applying for a licence to produce Stilton can take up to a year and compliance with the PDO standards is not straightforward – evidence put to the OFT shows that one cheese producer was recently refused a licence to produce Blue Stilton cheese by the Stilton Cheese Makers Association, (ii) restrictions are imposed on Stilton producers, in relation to the location of production and to the origin of the milk as a result of its PDO status, and finally, (iii) it is technically difficult to produce good-quality Stilton in a consistent way, as evidenced by Millway's recent experiences, confirmed by some responses by other market participants.
29. Furthermore, the relevant issue for the OFT in considering whether supply-side substitution may broaden the Blue Stilton market to include other (or all) blue cheeses is not simply whether it is **feasible** for other blue cheese makers to manufacture Blue Stilton but whether it would be **profitable** for them to do so in response to a SSNIP for Blue Stilton.
30. In this regard, the OFT understands that manufacturers' profit margins on other blue cheeses are far higher than they are for Blue Stilton and, consequently, that they would be unlikely to switch to producing Blue Stilton (even if it were feasible for them to do so) in response to a SSNIP.
31. On the basis of the above, the OFT is of the view that scope for supply-side substitution is too limited to widen the market. Supply-side responses to a price rise in Blue Stilton are therefore considered under expansion and entry.

## Conclusion

32. In light of the above, the OFT considers that the relevant product market may be slightly wider than Blue Stilton, including possibly Danish Blue and Cambozola, but not so wide as to include other blue cheeses. As the volumes of Cambozola are very small, the more significant issue of the two is the constraint imposed by Danish Blue – supplied by Arla Foods (Arla), who is not an existing Stilton player – on the supply of Blue Stilton. The references to Danish Blue below, therefore, can also be read to include Cambozola.
33. The following assessment therefore considers market concentration and merger increment data both with respect to the supply of Blue Stilton alone, and the supply of Blue Stilton and Danish Blue combined. The ultimate conclusion is that while the inclusion of Danish blue reduces the merged firm combined share and increment, and adds another significant player to the market, it does not remove the OFT's competition concerns and the consequent duty to refer.
34. In these circumstances, it is not prudent to reach a binary conclusion on a finely balanced question of product market definition. It appears that exclusion of Danish Blue will understate its constraint, supplied by Arla as the third party monopoly supplier of Danish Blue in the UK [Endnote 1], and suggest the potential adverse competition effects are of greater magnitude (e.g. a higher predicted price rise) than would a more calibrated and accurate analysis.
35. At the same time, however, inclusion of Danish Blue supply on a 1:1 basis with Stilton supply, will overstate its constraint on Long Clawson post-merger, because the overall weight of evidence suggests that Arla will be a less effective substitute supplier to supermarkets to a given Stilton supplier than each Stilton supplier is to each other. Accordingly, Arla's Danish Blue is given proportionate weight in the assessment as a more distant constraint on Long Clawson, Millway and other Stilton rivals, and its 'market share' on a combined Blue Stilton/Danish Blue candidate market should be given discounted weight accordingly. This is discussed further below.

## UNILATERAL EFFECTS

### Shares of supply of Blue Stilton

36. Based on 2007 data, the parties' combined share in the manufacture of Blue Stilton, amounts to [55 - 65] per cent with an increment of [15 - 25] per cent.
37. Prior to the transaction, Millway has lost a large proportion of its Blue Stilton business, [ ]. The parties submit that this should be taken into account and Millway's market share should be reduced in line with current sales.
38. As reflected in the table below, the OFT notes that due to the recent loss [ ] encountered by Millway, its forecast annualised production of Blue Stilton for 2008 is expected to fall from [2 - 3,000] to [1 - 2,000] tonnes. Even on that basis, however, the transaction results in the merged entity holding a share of [45 - 55] per cent, with an increment of [5 - 15] per cent.

**Table 1: UK supply of Blue Stilton**

Supplier	Production (tonnes) (000s)		Market shares (%)	
	2007	2008	2007	2008
Long Clawson	[3 - 4]	[3 - 4]	[25 - 35]	[35 - 45]
Millway	[2 - 3]	[1 - 2]	[15 - 25]	[5 - 15]
<b>Combined</b>	[5 - 6]	[4 - 5]	[55 - 65]	[45 - 55]
Tuxford & Tebbutt	[1-2]	[2-3]	[15 - 25]	[25 - 35]
Cropwell Bishop	[1-2]	[1-2]	[15 - 25]	[15 - 25]
Subtotal others	[0-1]	[0-1]	[5 - 15]	[5 - 15]
Total	9,604	9,796	100	100

*Source: OFT compilation of market data from suppliers*

39. Further, the OFT notes from other evidence gathered that the six largest supermarket chains, which together sell the vast majority of Blue Stilton in

the UK, award their mainstream large-scale contracts for standard and mature Blue Stilton to only three of the above: Long Clawson, Millway and Tuxford & Tebbutt (T&T, a part of The Cheese Company). Evidence put to the OFT indicates that Cropwell Bishop is a niche player for premium supply, a family run business with significantly smaller capacity than its rivals.

40. While a cursory review of the concentration data above suggests that the transaction appears to be a so-called 4 to 3 reduction in the number of significant competitors, in relation to the main supermarkets responsible for [85 - 95] per cent of Stilton sold in the UK, the transaction is better viewed as a 3 to 2, combining two of the only three mainstream suppliers responsible for the vast majority of Blue Stilton sold.
41. Even allowing for adjustment to Millway's market share (that is, based on its annualised sales for 2008 which take into account [ ]), the transaction still results in Long Clawson significantly enhancing (by [5 - 15] per cent) its position as market leader with over [45 - 55] per cent of total UK sales of Blue Stilton post-merger, and acquiring a competitor that – while obviously having lost contracts and struggling with profitability, is currently the supplier to several of the UK's largest supermarkets: [ ], among other customers.

#### **Shares of supply of Blue Stilton and Danish Blue, combined**

42. Even if a wider market is considered which includes Danish Blue (and Cambozola) as well as Blue Stilton, the OFT's prima facie concerns are diluted to a degree, but fundamentally remain unchanged, as the transaction will still result in Long Clawson significantly enhancing its position as market leader, accounting for [35 - 45] per cent of the market with an increment of [5 - 15] per cent, almost [ ] of its nearest competitor, T&T.

**Table 2: UK combined supply of Blue Stilton and Danish Blue**

Supplier	Production (tonnes) (000s)		Market shares (%)	
	2007	2008	2007	2008
Long Clawson	[3 – 4]	[3 – 4]	[25 -35]	[25 - 35]
Millway	[2 - 3]	[1 – 2]	[15 - 25]	[5 – 15]
<b>Combined</b>	[5 – 6]	[4 – 5]	[45 - 55]	[35 – 45]
T&T	[1-2]	[2-3]	[15 - 25]	[15 – 25]
Cropwell Bishop	[1-2]	[1-2]	[5 - 15]	[5 – 15]
Others Stilton	[0-1]	[0-1]	[5 - 15]	[5 – 15]
All Stilton suppliers	[9–10]	[9–10]	[75 - 85]	[75 - 85]
Arla (Danish Blue)	[1-2]	[1-2]	[15 - 25]	[15 - 25]
Grand total	11,404	11,632	100	100

*Source: OFT compilation of market data from suppliers*

43. Moreover, as noted, the OFT considers that these market shares potentially underestimate the closeness of competition between the merging parties in the supply of Blue Stilton, and conversely potentially overestimate the competitive constraint of [ ] (the monopoly producer of Danish Blue in the UK [Endnote 1]) on the parties given that it does not currently produce and supply Blue Stilton.
44. Put simply, the overall weight of evidence suggests that the bargaining threat that a supermarket had to switch its entire large-volume Stilton contract from one of Long Clawson, Millway or T&T to another of these three is a significantly stronger price constraint on these Stilton suppliers than the threat to switch a small part – but by no means the majority or all – of its purchasing volume to [ ] and to stock Danish Blue instead. The finding is borne out by analysis of bidding data and other evidence, discussed next.

## **Bidding history and customer evidence**

45. Bidding data relating to the supply of Blue Stilton to various national supermarket chains over the past three years show that only the merging parties, together with T&T are listed among the incumbent suppliers or contract winners.
46. The parties argue that, according to an in-store survey of Stilton products sold by national multiples, the fringe of smaller producers such as Cropwell Bishop, Quenby Hall, Colston Bassett and Webster's do supply some national multiples with Blue Stilton. In this respect however, third party comments – retailers as well as Stilton producers, indicate that the smaller producers only account for a limited proportion of the quantity of Blue Stilton sold to the major retailers.
47. Indeed, concerns raised by several national multiples corroborate the proposition that, for the major retailers, only three producers of Blue Stilton are effectively competing with each other to provide their required volumes of cheese. These multiples indicate further that the loss of one of the three main Blue Stilton producers in their opinion will result in less choice and possibly make it more difficult to change supplier. The OFT considers that this loss of commercial leverage by customers in negotiations with the parties could give the parties the incentive to raise price or equivalently worsen non-price factors such as quality post-merger.
48. One customer in particular indicates that it has looked at alternative supply options following quality issues at Millway's Hartington facility but was not able to move due to limited options and limited capability of alternative suppliers. In particular, it notes that there are some smaller makers of Blue Stilton but they are unable to meet its volume requirements.
49. Another market participant explains that the bulk of sales lost by Millway as a result of the quality issue arisen at the Hartington facility will inevitably drift towards Long Clawson and T&T given the limited spare capacity encountered by other producers. In that respect, [ ]. In this regard, the OFT notes that - the fact that post-merger, the parties and one other player are the only Blue Stilton producers with spare capacity (at least for the national multiples' volumes that are most likely to switch) - exacerbates any unilateral

concerns arising as a result of the transaction as Long Clawson will effectively be a duopolist over the residual demand.

50. Finally, the parties submit that national grocery multiples generally split supplies of Stilton between different manufacturers. Thus, according to the parties, there is no need for one manufacturer to have the capacity to supply an entire retailer's requirements. Despite the possibility of splitting part of their orders, the OFT notes that retailers still view the parties and T&T as their only reliable suppliers for a significant proportion of their Blue Stilton requirements. For example, while retailers may split their orders for certain aspects of their requirements (for example, premium Blue Stilton), it appears to be the case that they will typically only use the parties and T&T for their standard Blue Stilton requirements. This view is corroborated by third parties, including one example where a customer tried to switch away from Millway to Long Clawson and T&T but was unable to do so, on account of the two suppliers being capacity constrained. Having failed to switch, the customer decided to stay with Millway and did not consider dividing-up its needs among the remaining fringe players.

#### **Preliminary competitive effects conclusion**

51. Overall, while the OFT does not rule out that Danish Blue and Cambozola suppliers may exert some competitive constraint on the parties, the OFT does not consider that any such constraint, assuming it does exist, would be great enough to prevent Long Clawson from raising the price of Blue Stilton, or possibly other variables of supply, as a result of unilateral effects arising from the merger of two of the only three winning bidders for large supermarket contracts, where those customers account for [85 - 95] per cent of Stilton sold in the UK.
52. This conclusion is supported by the market share data presented above which shows that, even if Danish Blue and Cambozola are given equal weighting in a putative Blue Stilton, Danish Blue and Cambozola market (which the OFT considers would potentially underestimate the loss of competition between the merging parties), the merger still results in Long Clawson having a very significant market share and increment, such that it is [ ] its nearest competitor, T&T.

53. The merger is therefore best understood as eliminating competition between two of the three main suppliers of Blue Stilton. Thus the question becomes whether customers, to protect themselves from adverse effects, could rely upon other potential supply sources -- with or without encouragement or sponsorship by them - to expand or enter and restore the bargaining dynamic of three credible volume supply options that existed pre-merger. For the following reasons, the OFT considers countervailing demand- and supply-side responses insufficient to resolve its concerns at this juncture.

#### **COUNTERVAILING CONSTRAINTS: BUYER POWER, EXPANSION, ENTRY**

54. The parties contend that their customers are large multiple retailers or wholesalers and as such have strong countervailing buyer power. Having considered that the presence of Arla as the Danish Blue supplier is insufficient as such to resolve concerns, the OFT considered that perhaps the prime option for supermarkets facing a post-merger price increase from Long Clawson (and potentially, in turn, T&T) would be to encourage or sponsor expansion by smaller dairies already licensed to produce Stilton.

#### **Expansion by existing suppliers is unlikely**

55. The parties submit that they are not aware of any material capacity constraints in the overall blue cheese market, and that increasing capacity for their rivals is likely to be straightforward.

56. However, production and capacity figures provided by the parties for Stilton producers show that a majority of them are working at already 80 per cent of their capacity utilisation rate (two of the smaller producers have some spare capacity, although in absolute terms it is not significant and at present one of these suppliers only manufactures White Stilton) which in the OFT's view indicates that there is little spare capacity in the industry, particularly when viewed in the context of providing alternative sources of supply for the national grocery multiples (which have very significant requirements).

57. The majority of third party comments confirm this general shortage of capacity – for example, as mentioned above, one customer informed the OFT that it had been unable to switch away from Millway due to other suppliers' being capacity constrained.

58. The parties claim that retailers could effectively sponsor expansion with a suitable advance order. According to the parties, the cost of a traditional vat capable of producing 160 additional tonnes per annum plus its installation amount to some £[5,000 – 10,000]. However, figures provided by another Stilton manufacturer suggest that additional equipment that is required is significantly more costly.
59. Even if the OFT were to accept that capital expenditure is not a material barrier to expansion (which it appears may be the case), the OFT does not consider that expansion by one of the existing smaller suppliers of Blue Stilton would be likely or sufficient to off-set its concerns for several reasons.
60. First, the OFT has seen little evidence of actual expansion having taken place in the market in recent years, notwithstanding the obvious decline of the Hartington plant over the last seven years: Cropwell Bishop appears to have grown its capacity recently although this has been on a relatively small scale.
61. Second, other than Long Clawson and T&T, there is just one other significant producer, Cropwell Bishop, with two national supermarket contracts for premium supply. However, the OFT considers it unsafe to rely on Cropwell Bishop to address its concerns given that this would require wholesale changes to Cropwell Bishop's current business model, in particular changing its family-run premium-end business model and expanding into a mass supplier, and potentially undermining margins on existing business. The OFT does not consider such fundamental changes to be likely simply in response to a three to five per cent price rise for non-premium Blue Stilton. This was confirmed by Cropwell Bishop who indicated to the OFT that it had no intention of undergoing such changes in the short to medium term, even in the event of such a price rise.
62. Third, competition for the national multiple's regular Blue Stilton contracts is unlikely to be affected by the other four licensed Stilton dairies, all of whom are much smaller businesses focussing on smaller volumes. None of these businesses have shown any capacity to expand into a mass supplier in the short to medium term in the event of a price rise of three to five per cent for non-premium Blue Stilton.

63. Fourth, while T&T indicated that it might be interested in expanding capacity, even if such expansion were timely and sufficient, the OFT does not consider that this would off-set its concerns given that the merger would still be considered a reduction in the number of main suppliers of Blue Stilton from three to two.

**Entry will not be timely, likely and sufficient**

64. The OFT also considered whether *de novo* entry, perhaps sponsored by the supermarkets, would be timely, likely and sufficient to address its concerns.
65. Competitors and customers agreed that the production of Stilton is characterised by technical difficulties, and that as a consequence, suppliers necessarily start production on a small scale basis. The OFT has been provided with little evidence of recent successful entry in the production of Blue Stilton. [ ] is the only example of entry, although this was on a very small scale. The OFT is also aware of another producer having unsuccessfully applied for a Blue Stilton license.
66. Finally, the OFT has seen no evidence of other blue cheese producers who would consider entering the Blue Stilton market. In the abstract, Arla appears in at least several relevant ways to be a good candidate entrant given its presence in the relevant geographic area for producing Stilton and its status as a major dairy supplier, including Danish Blue supplier, to UK supermarkets. It is also conceivable that while Arla has not historically or currently evidenced any intention to supply Stilton, this does not rule out that Arla would consider doing so, if encouraged by supermarkets in response to a price increase by the main Stilton suppliers.
67. On balance, however, the OFT is in no position in this case to consider that Arla is the player whose entry into Blue Stilton supply would be timely, likely and sufficient to defeat or deter a price rise by Long Clawson over the period of the next 2-3 years post-merger. Arla itself indicates that it does not have any current intention of entering into the production and supply of Blue Stilton. Furthermore, it may be relevant to note that, while entry into Stilton by acquisition may make more sense than organic start-up entry, because of direct acquisition of relevant know-how among other assets, Arla was not approached, or did not approach Dairy Crest, prior to the Millway sale. Meanwhile, the evidence indicates that producing consistent quality Blue

Stilton, in the East Midlands, requires careful know-how and handling. Even if Arla were to consider Stilton a profitable entry opportunity, the time by which it could establish production volumes of the calibre to replicate the large-volume supply of at least Millway – around [5 - 15] per cent of all Blue Stilton supply – representing the increment of the merger may be beyond the standard two-year horizon for timely entry under the OFT's Substantive Assessment Guidance.

68. This conclusion on countervailing constraints is corroborated by evidence received from customers in relation to buyer power. While one retailer indicates that it would be in a position to resist a price increase, several others expressed a different view. They note that the number of manufacturers currently capable of supplying their required volumes is limited to three (the parties and T&T), and that the merger further reduces their choice. Customers do not report having any thought that existing suppliers would be capable of expanding capacity, or that they would be able to sponsor new entry.
69. Accordingly, the OFT considers that new entry is no more likely (and arguably less likely) than expansion by existing suppliers to occur, not least with the speed (timeliness) and scale (sufficiency) needed to defeat price rises for large-volume Blue Stilton supply contracts in the foreseeable future.

#### **Overall conclusion on unilateral effects**

70. The OFT therefore provisionally believes there is a realistic prospect that the merger will substantially lessen competition by virtue of unilateral effects in the supply of Blue Stilton by Long Clawson. This conclusion, based on pre-merger conditions as a benchmark, is then tested in light of the OFT's conclusion as to whether it is appropriate to substitute an exiting/failing firm counterfactual, below.

#### **COORDINATED EFFECTS**

71. During the course of its investigation, the OFT has also considered the increased likelihood of coordination between the parties and T&T arising as a result of the transaction, notably in relation to possible price increases and market sharing.

72. For a merger to give rise to or strengthen tacit coordination, the OFT considers that the following necessary conditions must be satisfied. First, it must be possible for all firms in a market to reach terms of coordination without any express agreement: there must therefore be a focal point for coordination and sufficient transparency that all firms can identify it. Second, coordinating firms in a market must be able to monitor deviations from the coordinated outcome: again, this requires that there be sufficient transparency to detect 'cheating'. Third, there must be a credible threat of retaliation to discipline firms deviating from the terms of coordination, such that fear of retaliation drives firms to coordinate in spite of providing incentives to deviate. Fourth, there must be insufficient constraints outside the coordination to defeat it (for example, fringe expansion and/or entry must be unlikely and/or buyer power absent). Lastly, the merger must make coordination more likely (or existing coordination more effective, durable or widespread).

#### **Ability to reach terms of coordination**

73. In terms of their ability to align their behaviour in the market, the parties argue that Blue Stilton is not sufficiently homogeneous given the various types of Blue Stilton and the wide variety of packaging formats which producers currently supply. They argue a complete lack of transparency as to wholesale Stilton prices paid by retailers [ ]. In addition, they indicate that input prices, for example the price of milk, are also a matter of negotiation, specific to each producer. The parties acknowledge a certain degree of transparency as to which producer currently supplies which retailer given that switching supply requires a degree of coordination between the incumbent supplier and the new supplier.

74. Nevertheless, the OFT believes that the market for Blue Stilton is mature and stable with predictable spikes in demand before Christmas, and that standard Blue Stilton – which represents 80 per cent of the Blue Stilton sales, is relatively homogenous. In addition, the OFT notes a certain degree of transparency regarding both (i) the price of the main input, milk, as at least the average price of raw milk is published, and (ii) supplier-customer relationships. Finally, the parties are members of the Stilton Cheese Makers' Association which, in the OFT's view, could increase transparency and contact between suppliers.

75. In light of the above and considering also the history of collusive behaviour in the dairy industry,<sup>2</sup> the OFT is of the view that the merged entity and T&T might realistically have the ability to align their behaviour in the market. Furthermore, in reducing the number of main players in this market from three to two, the merger allows for even better transparency and ability to detect cheating in the sector, and therefore strengthens the ability of the remaining players to align their behaviour.

#### **Incentives to maintain coordination**

76. In terms of their incentive to coordinate, the parties argue that the existence of several producers in the market, each of various sizes and with different incentives, would make cheating difficult to identify. In addition, the parties argue the absence of any credible means of retaliation: they claim that [ ].

77. Despite the parties' arguments, the OFT finds that cheating could be easily observable in this market given (i) the limited number of main suppliers (the merging parties and T&T), (ii) the fact that entry in recent years has been limited and on a small scale, (iii) the merging parties and T&T are the main suppliers of the national grocery multiples, and finally (iv) producers seem to be informed of the identity of each respective grocery multiple's supplier and of their switches, when they arise. However, the OFT finds that T&T (as well as other third party producers) currently have limited spare capacity (as discussed further below), which may limit their ability to coordinate. The OFT also notes that the majority of third parties (producers and retailers) confirm [ ] that the Millway Hartington plant no longer represents a credible source of supply of Blue Stilton and is likely to stop producing it in the near future.

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<sup>2</sup> As a result of an investigation carried out by the OFT – a number of supermarkets (that is Asda, Safeway, and Sainsbury) and dairy processors (that is Dairy Crest, The Cheese Company (formerly Glanbia Foods Ltd and Wiseman) admitted their involvement in certain collusive practices aimed at increasing the retail prices of one (or more) of liquid milk, value butter and UK produced cheese in 2002 and/or 2003. In particular, both Dairy Crest and The Cheese Company (parent companies of Millway and Tuxford & Tebbutt, respectively) admitted that they facilitated the exchange of commercially sensitive information between certain retailers in respect of the retail price of UK produced cheese in 2002 - See the OFT's press release of 7 December 2007, at: [www.of.gov.uk/news/press/2007/170-07](http://www.of.gov.uk/news/press/2007/170-07).

## **Sustainability of coordination in light of external constraints**

78. In terms of sustainability, the parties submit that any coordination could be challenged by new players (Quenby and Shirevale) or by the possible expansion of any smaller player in the market. Finally, they submit that the tendering process—including which parties are invited to tender—lies entirely within the control of customers, who could therefore easily disrupt any attempt at coordination.
79. However, production of Stilton constitutes a mature market (the annual growth rate is around two per cent, according to information provided by the parties), with predictable spikes in demand around Christmas. Against the parties' arguments, smaller competitors currently work at capacity and lack the scale to expand output sufficient to challenge the parties and T&T in their supply of Blue Stilton to national grocery multiples. The OFT has already concluded that entry, expansion and buyer power would not be sufficient to resolve its unilateral effects concerns. By the same logic, under a coordination theory, the same evidence would suggest that coordination might not be disrupted by buyer power, expansion or entry, and might therefore be sustainable.

## **Conclusion**

80. Overall, the OFT is of the view that the merger removes the second largest player in terms of capacity (see next section), and results in a 3 to 2 in the number of Stilton manufacturers supplying the national grocery multiples. It is therefore plausible that this reduction in the number of players increases the likelihood of coordinated effects in this market. However, the OFT also notes that the current lack of spare capacity in the Blue Stilton production renders a retaliation mechanism less practicable.
81. The OFT previously expressed the view that the anti-competitive horizontal effects of a merger are normally either unilateral or coordinated effects and are not likely to occur at the same time in respect of the same dimensions of competition. However, it is possible that both effects occur at different times – for example, short-run unilateral effects and medium-term coordinated effects. Beyond the likely unilateral effects, the OFT considers that if coordinated effects were indeed likely following the merger, they would arise

sequentially following (and not, as noted, in parallel with) the unilateral effects.<sup>3</sup>

82. Given the OFT's ultimate conclusion to refer the transaction based on unilateral effects concerns in any event, and given further that the OFTs' coordinated effects concerns are, at a minimum, more than fanciful, the OFT considers it appropriate to refer the transaction also on the basis of coordinated effects concerns.

## **COUNTERFACTUAL**

83. Given that the merger raises competition concerns relative to pre-merger conditions, the OFT has considered whether, in line with its general approach to the counterfactual (as referred to earlier), another counterfactual should be substituted.
84. While Long Clawson has not sought to argue a failing firm defence, it argues that, absent the merger, [ ].
85. The OFT considers further below (i) the failing firm defence, and (ii) the impact that Millway's current financial position should have on the counterfactual.

### **Failing firm defence**

86. The OFT considers that the information and evidence provided by the parties do not satisfy the required evidentiary standard for the purpose of the failing firm defence. As addressed below, none of the conditions required to meet the failing firm defence are met in the present case. These conditions are:
- inevitability of market exit of the firm in question absent the merger
  - with no serious prospect of re-organisation, and
  - with no less anti-competitive alternative to the merger (that is no realistic acquisition by a less anti-competitive purchaser and no substantially better competitive outcome following failure of the firm in question).

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<sup>3</sup> See also the OFT's decision in *BOC/Ineos*, paragraph 68.

87. Where the merger does raise concerns relative to the pre-merger situation, the OFT is slow to clear a transaction based on the 'inevitability' of exit of the target business and will only do so when it has sufficient compelling evidence.

### **Inevitability of exit**

88. The parties submit that [ ]. They provided the OFT with financial accounts data showing that Millway has been loss-making for the last seven years.

89. The parties indicate that [ ].

### **No prospect of reorganisation**

90. The parties submit that the viability of Millway's business is dependent on the financial and commercial backing of the wider Dairy Crest Group. In particular all the commercial relationships were handled by the Dairy Crest commercial team. [ ]. In that context, Dairy Crest has taken the decision to [ ]. Dairy Crest having established ongoing relationships with all of the major retailers, the parties submit that a key requirement for it has been to ensure continuity of supply for its major customers and that Long Clawson has been seen as the best way of achieving this. It follows that absent the merger, [ ]. In that respect, Dairy Crest provided a note by [ ].

91. Having carefully examined Millway's financial statements, the OFT acknowledges that it continues making [ ]: in 2007/08 Millway has lost £[ ] million on a turnover of £[ ] million. Following its recent loss of business, this turnover has now [ ].

92. However, the OFT notes that although the reduction in turnover is significant, Millway still has a large portfolio of contracts including national multiples such as [ ]. The OFT also notes that [ ], having failed to transfer its Blue Stilton contracts from Millway to Long Clawson and T&T, decided to continue its commercial relationship with Millway instead of for example, sponsoring expansion by another player in the market.

93. Finally, the OFT is of the view that the standard of evidence to be provided in order to demonstrate the inevitability of exit and the absence of any possible restructuration is not met in the present case. The OFT has not seen

compelling evidence such as internal correspondence, board meeting minutes or business plan expressly stating [ ]. Additionally, the OFT is not persuaded, given the remaining contracts referred to above, that absent the merger, Millway's business could not be restructured and turned into a profitable business [ ].

94. Therefore, the OFT does not believe that Millway [ ] that, absent the merger, it will inevitably exit the market and that this will happen in the near future.

#### **No less anticompetitive alternative to the merger**

95. The OFT finds that the parties also fail to provide compelling evidence that there was no less anticompetitive purchaser for the Millway's business than Long Clawson. Given Long Clawson's high market share in the manufacture of Blue Stilton, it is obvious that an alternative buyer would result in lower combined shares. However in the present case, the parties indicate that Dairy Crest, in looking to preserve its established commercial relationships, only considered Long Clawson as a suitable buyer. They submit that although Dairy Crest might have attempted to sell the business as a going concern to another cheese manufacturer, it considers that this was unlikely given the current level of losses being incurred (due inter alia the recent significant loss of business) and the absence of synergies for most other manufacturers. Therefore, no less anti-competitive purchaser was approached in the present case.
96. In situations where a firm that is genuinely failing is being sold to that firm's closest competitor in the market, the OFT will require particularly strong evidence that there was no less anti-competitive purchaser available to whom the assets might have been sold. In seeking evidence on this point, the OFT will normally expect to see evidence of the sellers' efforts to realize a sale to a number of alternative purchasers and evidence that such less anti-competitive purchasers were genuinely not interested in acquiring the business regardless of selling price. That compelling evidence standard is not met in this case.
97. In these circumstances, the OFT is under a duty to refer the transaction because it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition relative to the realistic less anti-competitive alternatives identified above.

## WHITE STILTON

### HORIZONTAL ISSUES

98. The parties submit that all types of cheeses used as a base to produce blended cheese (Cheddar, Stilton, Double Gloucester, etc.) are substitutable with one another.
99. Apart from one blended cheese manufacturer who considers that White Stilton is a 'must-have' for specific types of blended cheeses and may not be equivalently replaced by any other variety of cheese, other third party comments corroborate the parties' submission on White Stilton. In addition, the parties have provided examples of retailers replacing their orders of White Stilton blended cheeses with other types of blended cheeses. Finally, the OFT notes that supermarket labels on blended cheeses are typically focussed on the blended fruit or herb rather than the base cheese (for example, labels tend to highlight the blended fruit in a more prominent colour or larger text font from the base cheese), which supports the parties' arguments on substitution between White Stilton and other base cheeses.
100. Several national multiples consulted by the OFT in the course of the investigation have expressed the view that all types of blended cheeses are in the same relevant market, irrespective of their base (for example, Cheddar, Wensleydale, Stilton, etc.). The OFT finds that this conclusion is supported by the fact that there is a positive and high correlation between the retail prices of the most popular blended cheeses sold at the four largest UK supermarkets, and that all blended cheeses are similarly priced.
101. Overall, the OFT is satisfied that the manufacture of White Stilton as a base for blended cheeses is part of a wider market including the manufacture of Cheddar, Double Gloucester, Wensleydale, etc. In any event, given that the present transaction does not raise any horizontal concerns in the narrowest candidate market of blended cheeses made from White Stilton, the OFT does not consider it necessary to conclude on the appropriate product scope relating to blended cheese.
102. The parties submit that the relevant geographic market in which to assess the transaction is national. The OFT has received no evidence to dispute

the representations made by the parties in favour of a national geographic market.

103. In the narrowest candidate market for the manufacture of White Stilton, the transaction would reduce the number of players in the market from four to three. Based on market share estimates provided by the parties for 2007, the parties' combined market share amount to [65 - 75] per cent (with a [15 - 25] per cent increment), in an already highly concentrated market, followed by Shirevale and Cropwell Bishop.

104. Considering, however, the impact of the transaction on a wider market including other cheeses like Cheddar, Double-Gloucester and Wensleydale, the OFT is satisfied that competitive constraints on the merged entity would sufficiently constrain any market power in the manufacture of White Stilton, that the parties may have post-merger.

105. On the above basis, therefore, the OFT has no competition concerns, as a result of the present transaction, in the supply of White Stilton.

## **VERTICAL ISSUES**

106. As mentioned above, the parties are two of the four manufacturers of White Stilton currently active in the UK, with a combined market share of [65 - 75] per cent, the other two producers being Cropwell Bishop and Shirevale. White Stilton is used almost solely as a base for blended cheese, as are other white, crumbly cheeses such as Wensleydale (although these are mostly consumed in their non-blended forms). The OFT has not been provided with the share of the manufacture of all white, crumbly cheeses used as the base for blended cheese (base cheeses) accounted for by the parties manufacture of White Stilton.

107. The parties are also active in the production of blended cheese, in which they blend the White Stilton they manufacture with dried fruit (for example, apricots, cranberries), and sell it to retailers and wholesalers. The parties' combined share in the production of all blended cheeses (that is, blended White Stilton and other blended cheeses) was [15 - 25] per cent in 2008 (Long Clawson [15 - 25] per cent, Millway [5 - 15] per cent).

108. Although the OFT does not know the parties' combined market share in the manufacture of base cheeses, on the conservative basis that the parties' combined market share of [65 - 75] per cent in the manufacture of White Stilton confers some market power 'upstream' in base cheese manufacture, the parties might have the ability post-merger to raise the input costs of their rival producers of blended cheeses (partial input foreclosure) or to stop supplying them with White Stilton as a base cheese for blending (total input foreclosure). However, with the exception of one third party, comments received by the OFT all point towards White Stilton as a base for blended cheese being in a wider market including other base cheeses and not being a 'must have'.

109. The OFT is therefore satisfied that the parties will have no incentive to implement a strategy of input foreclosure, as rival blended cheeses manufacturers will be in a position to easily purchase their base cheese from alternative producers of Double Gloucester, Wensleydale, Cheddar, etc.

## **ASSESSMENT**

110. The parties overlap in the manufacture of Blue, White Stilton and blended cheeses. Stilton is a protected name under EC regulations, and can only be produced, with a proper licence, in three East Midlands counties. Concerns arise only in relation to Blue Stilton.

111. With respect to market definition, the OFT considers it possible that the relevant UK-wide market may be slightly wider than Blue Stilton, including possibly Danish Blue, supplied by Arla (and Cambozola, whose volumes are very small). However, concerns based on concentration data also arise based on candidate market shares that include Danish Blue. Moreover, in the competitive effects assessment, the OFT takes the view that these are substantially less close alternatives for supermarkets in their pricing negotiations with Stilton suppliers, than each major Stilton supplier is to another. The six largest supermarket chains together sell around [85 - 95] per cent of Stilton in the UK, and the merger combines two of the three principal suppliers to these supermarkets of standard and mature Blue Stilton pursuant to large-volume contracts: while using a range of suppliers for niche, premium supply (for example, organic Stilton), these retailers have always awarded their mainstream contracts for standard and mature Stilton to the merging parties or T&T.

112. Competition for the big supermarket's regular contracts for standard and mature Stilton is unlikely to be affected by four of the five other licensed Stilton dairies, who are either much smaller or niche businesses. There is one other substantial producer, Cropwell Bishop, with two national supermarket contracts for premium supply. However, the OFT considers it unsafe to rely on this rival changing its family-run premium-end business model and expanding into a mass supplier, simply in response to a 3-5 per cent price rise for non-premium Stilton, and potentially undercutting its margins on existing business. Expansion by other very small Stilton dairies or new entry by producers of other cheeses, perhaps sponsored by the supermarkets, seem even less likely to occur, at least with the speed and scale needed to defeat price rises for large-volume Stilton supply contracts in the foreseeable future.
113. Furthermore, the OFT considers that although Millway has been struggling recently, it is not necessarily a spent force. It still has important UK and supermarket contracts, and its market share has been adjusted to take account of its current 2008 position. Even if, for the sake of argument, Millway would not have stayed an independent competitor without the merger, it does not follow that Long Clawson, the largest competitor, is the only conceivable purchaser of the assets. The purchase by Long Clawson results in the most highly concentrated market outcome possible, as it is the largest player, and will result in the largest HHI delta. Any purchaser apart from Long Clawson (and T&T) would not raise such competition concerns.
114. Despite the buyer power of supermarkets in many markets, therefore, the OFT takes the view that the present merger gives rise to a realistic prospect of a substantial lessening of competition. The OFT's concerns about the horizontal effects of the merger are stronger in relation to unilateral effects. However, given its decision to refer and its more than fanciful concerns also in relation to coordinated effects, the OFT is referring the transaction to the Competition Commission on the basis of both theories of harm. Finally, no exception to the duty to refer is relevant in this case.
115. Consequently, the OFT believes that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

## **DECISION**

116. This merger will therefore be referred to the Competition Commission under section 22(1) of the Act.

## **END NOTES**

1. Arla has informed the OFT that it is aware of another company Nordex Food which could also be supplying Danish Blue in the UK. In that respect, the reference to Arla as the monopoly supplier of Danish Blue would be technically inaccurate. The OFT has seen no further information relating to Nordex Food.