

Completed acquisition by Dairy Crest Group plc of the dairy business of East of England Cooperative Society Limited

ME/3496/08

The OFT's decision on reference under Section 33(1) given on 19 March 2008. Full text of the decision published on Friday 28 March

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

PARTIES

1. **Dairy Crest Limited (Dairy Crest)** is the main trading subsidiary of Dairy Crest Group plc active in the dairy sector.
2. **East of England Co-operative Society Limited (EofE)** is a cooperative society active in East Anglia. EofE's activities include convenience store retailing, funeral and travel services, as well as a dairy business. The turnover associated with the dairy business in the last financial year was £ [] million.

TRANSACTION

3. The transaction, which was completed on 16 February 2008, involves the acquisition by Dairy Crest of various assets pertaining to EofE's dairy business, excluding its dairy in Ipswich which is due to close this month. Therefore the transaction refers to the distribution, but not the production, of dairy products.
4. An informal merger submission was received by the Office of Fair Trading (OFT) on 23 January 2008 and the OFT's administrative deadline for

deciding whether to refer the merger to the Competition Commission (CC) is 19 March 2008.

JURISDICTION

5. As a result of this transaction Dairy Crest and EofE's dairy business have ceased to be distinct. The parties' combined share of supply of fresh processed milk to doorstep and middle ground customers is above 25 per cent and as a consequence the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

MARKET DEFINITION

6. The parties overlap in the supply of fresh processed milk.
7. The parties also overlap in the procurement of raw milk, the supply of cream, and the supply of certain other non-dairy products (such as fruit juice, bakery goods and eggs). In the procurement of raw milk, Dairy Crest's share of supply in England and Wales¹ is just below [15-25] per cent, and the increment is less than [0-5] per cent. In the supply of cream, the competitive overlap between the parties is very small: Dairy Crest uses the majority of its cream internally, and EofE sells the vast majority of its production to a single client who is also a major source of raw milk to EofE. EofE's production of cream is less than [0-5] per cent of the cream produced by Dairy Crest. In non-dairy products Dairy Crest submits that it has an approximate market share of less than [0-5] per cent on a national basis, and EofE's sales are very marginal. No third parties raised any concerns in relation to these segments. Therefore, these overlaps (procurement of raw milk, supply of cream and of certain other non-dairy products) are not considered further.

¹ See OFT *Anticipated merger between First Milk Limited and Milk Link Limited* 12 December 2007 (*First Milk / Milk Link*). In that case the OFT took the view that England and Wales formed part of a single geographic market for the procurement and supply of raw milk. Whether Scotland is included in this geographic market makes no substantive difference to the assessment.

Product scope

8. The CC concluded in *Arla / Express*² that fresh pasteurised non-flavoured cow milk (or 'fresh processed milk') represented a distinct product. On the demand side, there was found to be little substitution with other products, while on the supply side evidence from processors suggested that it was not easy to switch into the production of fresh processed milk from the production of other dairy products. This is in line with evidence obtained in more recent OFT merger investigations in the sector.³ The evidence before the OFT does not suggest that it should deviate from this product frame of reference in this case and therefore fresh processed milk is considered to be a distinct product.
9. In *Arla / Express* the CC also noted that the supply of fresh processed milk can be segmented into supply to three categories of customers. This is on the basis that each category requires different standards, has variable levels of buyer power, varying geographic arrangements and different milk sourcing methods. The categories are:
 - supply to national grocery retailers
 - supply to doorstep customers, and
 - supply to middle ground customers (that is, all customers who are neither national grocery retailers nor doorstep customers).
10. In this case, the parties overlap in the supply of fresh processed milk to the middle ground and doorstep segments.
11. It is worth noting that the term middle ground is effectively a 'catch-all' definition and, as such, it encompasses a variety of different types of customers with different purchasing behaviours and a range of requirements in terms of service type and level (for example frequency of deliveries, number of drop points and container size). Middle ground customers range from small single store newsagents and petrol stations to

² Competition Commission report on *Arla Foods amba / Express Dairies plc* of 15 October 2003 (*Arla / Express*).

³ OFT *Completed acquisition by Dairy Farmers of Britain Ltd of Associated Co-operative Creameries Ltd* 3 December 2004 and OFT *Completed acquisition by Dairy Crest Group plc of the doorstep and depot based middle ground milk businesses of Arla Foods UK plc* 26 October 2006 (*Dairy Crest / Arla*).

smaller supermarket chains, prisons, and local authority school milk contracts.

12. Consistent with past cases and in the absence of evidence to the contrary in this case, we have analysed this merger by reference to customer segmentation outlined above, although it is recognised that some blurring may exist between the different segments (doorstep, middle ground, national multiples).

Geographic scope

Doorstep

13. In previous cases, the CC and the OFT concluded that the geographic frame of reference for doorstep deliveries is limited to individual rounds, at least in the short term.⁴ On the demand side, doorstep consumers generally have only one choice of supplier and therefore do not have the opportunity to switch. On the supply side there are strong economies of density which mean that it would not be economic for houses in the same street to be served by several different milkmen. The OFT did not identify any evidence during the course of its investigation which would suggest that it may be appropriate to deviate from the view taken in past merger cases.

Middle ground

14. As discussed earlier, the middle ground is not a homogeneous group, with customers in this category ranging from individual stores to smaller supermarket chains. As such, the geographic scope will vary between customers. On the demand side, different types of customers within the middle ground sector will have different requirements, and this leads to different geographic frames of reference. Some of the largest middle-ground customers require national contracts, whereas smaller customers will require a small amount of milk to be delivered to a single site and this could potentially be fulfilled by any local supplier whose delivery area covered the customer's location.

⁴ See for example *Arla / Express*; OFT *Completed acquisition by Claymore Dairies Ltd of the milk businesses of Allarburn Farm Dairy Ltd* 3 May 2006.

15. Even amongst customers with centrally negotiated 'national' contracts, there is likely to be a distinction between those that can be serviced from a few major sites/dairies (for example, a factory or, in the case of a retail chain, its distribution centre), and those requiring localised delivery arrangements and infrastructure (for example, individual stores). Regional factors may be important for the latter type of customer in determining supply options.
16. On the supply side, whilst milk can be transported long distances from dairy to depot (in some cases up to 160km) and then further (30 to 50km) from depots to customers, it is clear from the evidence before the OFT that different processors are stronger in different parts of the country, which may suggest that competition tends to be predominantly regional.
17. Accordingly, in line with previous OFT merger decisions in this sector,⁵ consideration has been given to the competitive effects of the merger in the narrow geographic area where both parties supply middle ground customers (Anglia), as well as the effect of the transaction at a national level.

HORIZONTAL ISSUES

Unilateral effects

Doorstep

18. Overlaps in the doorstep market are limited to the Anglia region,⁶ where the combined share of supply is around [85-95] per cent (increment of [20-30] per cent). However, as noted above, the geographic frame of reference for doorstep deliveries is limited to individual rounds, with operators effectively operating as local monopolists. On this basis, there is no overlap between the vast majority of the parties' doorstep rounds. Dairy Crest identified only a small number of locations where there may be limited overlap or adjacency between the parties' doorstep rounds.

⁵ OFT *Completed acquisition by First Milk Limited of a 15 per cent stake in Robert Wiseman Dairies plc* 7 April 2005 and *Dairy Crest / Arla*.

⁶ ACNeilsen region.

19. Dairy Crest contended that all doorstep operators are constrained by the loss of sales to alternative sources of supply, namely retailers. This was noted in past cases such as *Arla / Express*, where the CC said that 'to the extent that the price of doorstep deliveries is constrained, it is not from roundsmen working contiguous regions but rather the possible loss of further doorstep sales to alternative sources of supply, namely retailers'.⁷ In this context, it is worth noting that fresh processed milk may be considered a 'known value item' and therefore an important aspect of competition between grocery retailers.⁸ In support of this Dairy Crest submitted that individual pricing on their respective rounds do not differ according to whether those rounds are covered (in whole or in part) by other doorstep providers. In addition, the CC noted in *Arla / Express* that the volume of fresh processed milk sold through doorstep deliveries has been in constant decline over the past decade or so with customer switching to grocery retailers, and Dairy Crest estimated the decline rate to be around ten per cent per annum.
20. Given the effective lack of material competition between the parties and the fact that the principal competitive constraint on either party derives from third parties (notably retailers), the OFT considers that the transaction does not eliminate an important competitive constraint in the doorstep segment.

Middle ground

21. Across England and Wales Dairy Crest's post merger share of supply to the middle ground is estimated to be around [25-35] per cent (increment less than [0-5] per cent). On a regional basis, overlaps occur in two locations, London and Anglia. In the London area the overlap of the merging parties is limited, with an increment of [0-5] per cent, resulting in a [30-40] per cent share of supply.
22. In the Anglia area the increment is substantially higher, with Dairy Crest's share of middle ground supply rising from [20-30] per cent to around [35-45] per cent, based on data submitted by the parties.

⁷ Para 2.64.

⁸ Note however that evidence considered by the CC in its provisional findings in the Groceries Inquiry indicated that overall basket value is also relevant for consumers when comparing prices between grocery retailers (para 5.100).

23. Whilst the increment is significant, the parties submit that these shares overstate the mergers' impact on competition. Around [70-80] per cent of EofE's total sales to middle ground customers (across the Anglia and London regions) comprise supplies of milk to EofE's own retail operations or other retail cooperative societies with whom EofE has had strong trading relationships. They also argue that, in the Anglia region, EofE's supplies to middle ground customers other than its own retailers and cooperative societies represent only less than [0-5] per cent of the market, according to the parties' own estimates.
24. This evidence is supported by the very limited customer switching between the two parties, which was confirmed by customers – none indicated that they had switched between the two parties, although one did identify Dairy Crest as an alternative to EofE and one customer said it is supplied by both.
25. Dairy Crest contends that Dairy Farmers of Britain, a farmers' cooperative, will act as a strong competitor in the post merger market, thereby mitigating any risks of unilateral effects. However, the parties' market share estimates for Dairy Farmers of Britain seem to significantly over-estimate its participation in the market in comparison with share of supply data provided by third parties. Furthermore, the evidence before the OFT indicates that Dairy Farmers of Britain's scope of supply is limited to a part of the Anglia area. Accordingly, the OFT is not persuaded that Dairy Farmers of Britain will offer a viable alternative for customers across the whole of the Anglia region.
26. Dairy Crest submits that a relatively diverse fringe of smaller suppliers currently operate in the market. Although there was some divergence between the information provided by Dairy Crest and that presented by third parties in relation to the composition of this fringe, the majority of responding customers indicated that fringe players are indeed alternative suppliers.
27. For larger middle ground customers, the availability of suppliers who can supply larger volumes is questionable. However, the limited supply of EofE pre-merger to larger middle ground customers (apart from supplies to EofE's own retailers and to other cooperatives) suggests that the competition for these customers might not be substantially reduced by the merger. In addition, in particular in view of the fact that middle ground is

not a properly defined frame of reference, larger customers within this segment are likely to be supplied by the same companies active in the supply to national multiples (a segment which is not affected by this merger).

28. In previous cases the OFT has considered in detail the issue of supply to schools although this is not considered to be a separate market segment. The OFT does not have data that allows it to calculate the total supplies to schools in the Anglia region per annum, but the increment will be in any circumstance limited, since EofE supplies only just above [5-15] per cent of the total volume supplied to schools in the Anglia area by Dairy Crest. In Arla / Express the CC concluded it likely to be possible to re-organise arrangements to attract a wider set of suppliers to schools, for example, by combining procurement and delivery of milk with other fresh food products provided by existing wholesalers. No third party raised any concerns about the impact of the merger on the supply of fresh processed milk to schools.
29. Only one middle ground customer raised competition concerns about the merger, on the grounds that the number of alternative suppliers would fall from three to two. However, when prompted, this customer did not clarify the reasons why other fringe suppliers in the market could not meet its needs. One competitor raised concerns relating to the length of supply contracts with upstream suppliers; however these were not merger specific and are dealt with in the vertical issues section below.

Coordinated effects

30. There have been a number of cases under Chapter I of the Competition Act 1998 involving the milk sector in the past few years, which indicates that this is a sector susceptible to coordination.
31. Coordinated effects can take the form of tacit or explicit collusion in various respects, including pricing, tendering, customer allocation, geographic and/or product market sharing. Collusion may arise in circumstances where (i) market participants have the ability to align their behaviour in the market, (ii) the firms have the incentive to maintain that coordinated behaviour (including whether there is the ability to enforce that strategy through detection of cheating and a credible punishment mechanism) and (iii) the coordinated behaviour is sustainable in the face of

other external competitive constraints.⁹ However, an assessment of potential coordinated effects should not be limited to these structural elements: other factors relevant to the behaviour of the parties to the merger and, more generally, to that of all participants in any potential coordination must also be considered.

32. The relevant question in a merger control context is whether the merger has resulted or may be expected to give rise to concerns relating to coordinated effects, by exacerbating or heightening existing concerns (for example, by making coordination more perfect, more durable or more complete), or creating the potential for new coordination in this sector.¹⁰ The following sections assess both the current position as regards the existing susceptibility of the middle-ground segment to collusion, and the likely impact of the merger. The OFT does not believe that the merger causes any coordinated effects concerns in the doorstep segment in view of the market features detailed in the unilateral effects section above. In particular, the fact that the parties are constrained by the loss of sales to alternative sources of supply, namely grocery retailers, strongly suggests that coordination would not be sustainable.

Ability to align behaviour

33. There are a number of features of the milk sector which could facilitate coordination: the product is homogeneous; the market is mature and relatively stable; there is a degree of transparency in supplier-customer relationships; and dairies are often customers of one another through agency agreements. As demand for fresh milk appears to be relatively inelastic, any increases in price are unlikely to significantly reduce demand for fresh milk. In addition, the mature nature of the market and lack of growth mean that deviation from any coordination will be less likely than if the market was growing rapidly.
34. However, given that the middle ground segment consists of a highly differentiated customer base with individually negotiated contracts, the

⁹ This approach is consistent with that taken by the Court of First Instance (CFI) in its judgement in *Airtours vs Commission* of 6 June 2002 (Case T-342/99 *Airtours v Commission* [2002] ECR II-2585), and also with the OFT's Mergers - substantive assessment guidance, paras 4.11-4.16.

¹⁰ The critical question in merger analysis is that of merger effects, rather than features of the market. In the terms of section 22 of the Act, the question is whether the merger 'has *resulted*, or may be expected *to result*, in a substantial lessening of competition' (emphasis added).

market does not seem to be characterised by a strong level of price transparency as to precise wholesale prices paid by individual customers. This might well call into question market participants' ability to align their behaviour in the market. Nevertheless, there might be transparency as to input and retail prices that might limit the degree of uncertainty regarding wholesale prices to within a narrow band.

35. For school contracts, coordination could potentially be easier due to the predictability of demand for school milk from year to year. The areas themselves are also easily defined according to local authority boundaries which permit allocations by assignment of territories and, in many cases, the set of firms potentially submitting realistic bids is likely to be small and quite stable. Public tendering of contracts might also increase transparency.

Incentive to maintain coordination

36. For coordination to be maintained, competitors must be able to detect cheating, as well as have a credible punishment mechanism.
37. Given that it is easy to detect customer switching and that the number of bidders present in Anglia is relatively small and stable, it would appear relatively straightforward for market participants to detect whether cheating has occurred.
38. In this sector, a possible punishment mechanism could be simply the threat of retaliation through repeat interaction over time. Market participants have the ability to increase production¹¹ and win additional customers from each other, which could act as sufficient disincentive to deviate from any tacit or express coordination.
39. In terms of market symmetry,¹² the market structure will continue to be relatively asymmetric post-merger, with Dairy Crest as the clear market leader (in particular if Dairy Crest's estimates of Dairy Farmers of Britain's market share are overestimated). Indeed, the merger increases the

¹¹ Dairy Crest noted the prevalence of excess capacity within its submission.

¹² Symmetry is important because, if firms have a similar market share, capacity utilisation, cost structure and sell very similar products, then every firm will benefit similarly from the establishment of coordination, and each will have a similar incentive to maintain coordination rather than deviate from it and suffer similarly from retaliatory action.

asymmetries between market participants which will reduce the parties' ability and incentive to coordinate.

Sustainability

40. Successful, sustainable coordination presupposes that it will not be disrupted by new entry or expansion by market players who are not involved in the coordination, and/or by substantial buyer power among customers. In the case of the middle ground segment, barriers to entry do not seem to be particularly high if entry is on a small scale. Although barriers are likely to be higher in relation to the supply of larger middle ground customers, as the scale of entry needs to be larger, as discussed above EofE's sales to larger customers are limited.
41. Given the profile of the relevant customers, it would be inappropriate to rely on buyer power as sufficient to disrupt attempts at supplier coordination.
42. On the basis of the evidence before it, the OFT believes that there are several features of the affected sector (that is, supply of fresh processed milk to middle ground customers in Anglia) that make coordination difficult. In particular, the ability to align behaviour is hampered by lack of transparency, the ability and incentive to coordinate is limited by the asymmetry of the market (which is amplified by the merger) and the sustainability of any coordination is jeopardised the relatively low barriers to entry.

Impact of the transaction

43. With reference to the factors discussed above, the question to be answered in this case is whether the specific characteristics of the transaction raise the likelihood of such coordinated effects occurring in the future.
44. Given the asymmetry of the market, the more potentially plausible coordination theory is that fringe competitors would follow Dairy Crest as the coordination leader, acting in a passive way to price increases in the post merger environment.

45. The reduction of suppliers in a concentrated market can itself facilitate or help stabilise collusion if prevailing competitive constraints on the merging parties are weakened (as long as other necessary market conditions are present). On this issue, the parties submit that there is very little scope for the transaction to increase the likelihood of coordination as, pre-merger, EofE did not compete in a vigorous manner with Dairy Crest (in particular, EofE mainly supplied its own downstream operations and other cooperatives with whom it has strong links) and therefore the merger did not significantly change this scenario.
46. The OFT has also considered whether the merger will eliminate a 'maverick' supplier, that might otherwise have disrupted or could disrupt coordination post-merger. Evidence before the OFT suggests that there are at least four firms with a share of supply of between two and six per cent in the Anglia middle ground market, and that there is substantial over capacity. There is no evidence that EofE was a maverick player before the merger, as it did not seem to compete in a vigorous manner with Dairy Crest. This is supported by the lack of customer switching between the two suppliers. The parties consider Dairy Farmers of Britain as a maverick, but evidence on this is not conclusive.
47. As discussed above, the OFT does not consider that EofE placed a significant constraint on Dairy Crest, and therefore does not consider that leader-follower coordination would be more likely as a direct result of the merger. Further factors which support this view include the relatively diverse nature of the middle ground customer base and the relatively larger number of fringe suppliers. These fringe suppliers, as well as suppliers to national multiples who place a constraint in relation to the larger middle ground customers, would have the incentive and ability to disrupt any coordination in the supply of fresh processed milk to the middle ground in the geographic area of overlap.
48. Of those customers and competitors who responded to the OFT, none have raised the issue of coordination as an issue.

Conclusion

49. In light of the above, and on the basis of the evidence before it, the OFT therefore considers that there is no plausible theory of harm in relation to coordinated effects. Accordingly, the OFT does not consider 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 through coordinated effects.

BARRIERS TO ENTRY

50. In *Arla / Express* the CC identified certain possible barriers that may impede potential new suppliers of fresh processed milk from supplying the national multiples. However, based on the evidence before it the OFT believes that such barriers are less substantial for supply to middle ground customers, which generally have less demanding requirements in terms of quality, service and distribution. New entrants could gain a foothold by operating on a smaller scale, concentrating on supplying a number of middle ground customers within a limited geographic region, rather than being reliant on a few large customers requiring delivery to a large number of stores. The CC identified a number of examples of recent entry or expansion on a scale able to service middle ground customers.¹³ In the course of this investigation competitors told the OFT that barriers to expansion are particularly low.
51. The OFT has found no information in the course of its investigation to warrant reassessment of these findings. Further, in this instance a full assessment of barriers to entry and expansion is unnecessary as it does not have a substantive impact on the decision.

BUYER POWER

52. Since doorstep customers have only one choice of supplier, their buyer power is limited.
53. In *Arla / Express* the CC did not believe that most middle ground customers have significant buyer power, in contrast to the national multiples. Possible exceptions were the few large national retail chains.
54. In this case it is not necessary to conclude on the issue of buyer power as it does not have a substantive impact on the decision.

¹³ CC *Arla / Express* report, para. 5.148

VERTICAL ISSUES

55. The OFT considered two vertical issues in its assessment of this case. The first was whether the merged entity could restrict supply or raise the price of fresh milk to downstream rivals (such as bottled milk buyers and wholesalers) to render them unable to compete with its own downstream operations. The parties rejected such a proposition as being at variance with their incentives to maximise processing capacity utilisation rates. The parties argue that the existence of alternative sources of supply and substantial spare capacity would render any attempt to foreclose the market in such a manner ineffective. Further, they argue that, due to the disparate nature of the customer base and the existence of competitors downstream, any attempt to win a substantial proportion of customers of those competitors would be commercially unviable. No third parties raised concerns of this nature during the course of the OFT's investigation.
56. The second issue considered relates to upstream raw milk supply. Concerns over potential vertical effects in relation to the supply of local raw milk were identified by one response to the OFT's open call for information. However, previous investigations have made no distinction between local raw milk and other raw milk supplies¹⁴ and there is no suggestion from third parties that competition in the supply of raw milk overall would be substantively effected by the merger.
57. Overall, the evidence before the OFT does not support any credible theory of vertical effects arising from the merger.

THIRD PARTY VIEWS

58. Concerns about this merger were only raised by one customer and one supplier to the parties. These concerns have been dealt with above.
59. The Department for Environment Food and Rural Affairs (DEFRA) considered that the merger would not give rise to concerns in the doorstep segment due to the lack of competition between the parties and the availability of alternative sources of supply, such as supermarkets. In respect of the middle ground segment DEFRA felt that the primary issue for

¹⁴ See, for example, *First Milk / Milk Link*.

concern was that of coordination, but did not expand on this issue, which is dealt with in some detail above.

ASSESSMENT

60. Dairy Crest and EofE overlap in the supply of fresh processed milk to doorstep and middle ground customers.
61. In relation to the doorstep segment, despite the high shares of supply and substantial increments in the Anglia region, the parties do not overlap on individual rounds. Therefore, there was little, if any, pre-merger competition between the parties' doorstep businesses, even in regions where both had a presence, due to the local monopoly aspect of individual doorstep rounds. In addition, there are significant external competitive constraints on the doorstep segment, which is in decline, placed in particular by grocery retailers. This is consistent with the OFT's and the CC's conclusions in previous cases involving this segment.
62. In relation to the supply to middle ground customers, in the London area increments to Dairy Crest's share of supply are too small to raise any competition concerns. In the Anglia area, although the increment is more significant, the OFT also does not believe that the merger will cause competition concerns. Of primary importance to this assessment is the lack of current competitive interaction between the merging parties. The limited supply of EofE to middle ground customers other than its own retailers and cooperatives makes it unlikely that competitive conditions post merger will be substantially weakened.
63. In addition, there is an active fringe of competitors who offer an alternative for middle ground customers, as well as alternatives outside the middle ground segment who could nonetheless supply middle ground customers. In this issue it is worth reminding that middle ground is in effect a 'catch all' concept to describe customers who are not national retailers and not doorstep. In addition, the evidence before the OFT does not suggest that specific groups such as schools would be vulnerable to detrimental effects of the merger.
64. In relation to coordinated effects, while the milk market structure in general may be conducive to coordination, the OFT does not believe that, in this case, the affected sector is particularly favourable to coordination nor that

the merger will make any coordination more likely or stronger. This is due to some characteristics of the middle ground market discussed in the coordinated effects section above, as well as to the weak competitive interaction between EofE and Dairy Crest discussed in the assessment of unilateral effects.

65. Consequently, the OFT does not believe 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

66. This merger will therefore **not be referred** to the Competition Commission under section 22(1) of the Act.