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## Anticipated merger between First Milk Limited and Milk Link Limited

No: ME/3352/07

The OFT's decision on reference under section 33(1) given on 12 December 2007. Full text of decision published 20 December 2007.

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

### **PARTIES**

1. **First Milk Limited** (First Milk) is a farmer-owned co-operative with around 2800 members. It procures raw milk from its members and supplies the majority to third party processors. It also processes some raw milk itself to produce cheese and other dairy products. First Milk has a 15 per cent stake in Robert Wiseman Dairies plc (Wiseman), a producer of fresh milk, and a 40 per cent share in Westbury Dairies, a joint venture with Milk Link Limited and Dairy Farmers of Britain Limited.<sup>1</sup> First Milk's UK turnover was £484 million in the year ended 31 March 2007.
2. **Milk Link Limited** (Milk Link) is a farmer-owned co-operative with around 1650 members. It procures raw milk from its members and processes the majority itself to produce cheese and other dairy products. It also supplies some raw milk to third party processors. Milk Link has a 20 per cent share in Westbury Dairies, which as noted above is a joint venture with First Milk

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<sup>1</sup> See the OFT decision of 7 April 2005 regarding the completed acquisition by First Milk Limited of a 15 per cent stake in Robert Wiseman Dairies plc, and the OFT decision of 26 February 2004 regarding the completed acquisition by Milk Link Limited, First Milk Limited and Dairy Farmers of Britain Limited of assets of United Milk Limited, namely the Westbury milk processing plant.

and Dairy Farmers of Britain Limited. Milk Link's UK turnover was £492 million in the year ended 31 March 2007.

## **TRANSACTION**

3. First Milk and Milk Link propose to merge under the process set out in section 51 of the Industrial and Provident Societies Act 1965, with their members becoming members of a new combined co-operative. The parties filed a satisfactory submission on 12 October 2007. The administrative deadline is therefore 7 December 2007.

## **JURISDICTION**

4. As a result of this transaction First Milk and Milk Link will cease to be distinct. The UK turnover of both First Milk and Milk Link exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

## **MARKET DEFINITION**

5. First Milk and Milk Link overlap in (i) the procurement and supply of raw cows' milk, (ii) the production and supply of cheese, (iii) cheese packing, and (iv) the production and supply of other dairy products. Neither party produces fresh milk (although fresh milk is produced by Wiseman, in which First Milk has a 15 per cent stake).
6. The dairy products other than cheese that are produced and supplied by both parties, as referred to under (iv), are butter, skimmed milk powder and buttermilk powder (all produced from raw milk), and whey powder and whey butter (by-products). In previous decisions the OFT found that the markets for these products were at least EU-wide.<sup>2</sup> As the parties' combined shares in those markets are very small and no third party raised concerns with the OFT in relation to these dairy products, the OFT believes that the merger does not raise competition concerns in relation to these

products. On this basis, the OFT has not further considered these products. Further, on this basis the OFT does not consider the parties' shares in Westbury Dairies to give rise to competition concerns, as the Westbury Dairies plant only produces dairy products other than cheese.

## **Raw milk**

### Product market

7. Raw cows' milk is produced by dairy farmers and is then collected and transported to processors to be processed into fresh milk or dairy products such as cheese. In previous decisions the OFT noted that on the demand side, processors cannot substitute other products for raw milk to produce dairy products, while on the supply side, switching from other farm activities to dairy farming is difficult and takes time due to the need for specific equipment, buildings, knowledge and land in an area with a suitable climate.<sup>3</sup> The parties submitted that this was still correct and third parties supported this. The OFT therefore considers that the procurement and supply of raw milk is the appropriate frame of reference.

### Geographic market

8. Raw milk is very perishable and must be transported to processors within 24 hours of collection. In previous OFT decisions, a 100 mile radius was considered to be, on average, a viable range for delivery of raw milk to processors.<sup>4</sup> In these decisions the OFT also noted that there were no clear geographic breaks across Great Britain and that therefore a chain of substitution was likely to operate.
9. The parties submitted that the geographic market was Great Britain. This was supported by most third parties. However, two third parties suggested that Scotland may form a separate market, because some consumers have a preference for fresh milk and cheese made from Scottish milk and there

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<sup>2</sup> For example, the OFT decision of 26 February 2004 regarding the completed acquisition by Milk Link Limited, First Milk Limited and Dairy Farmers of Britain Limited of assets of United Milk Limited, namely the Westbury milk processing plant, paragraph 14.

<sup>3</sup> Most recently the OFT decision of 3 May 2006 regarding the completed acquisition by Claymore Dairies Limited of the milk business of Allarburn Farm Dairy Limited, citing earlier decisions.

<sup>4</sup> Idem.

are costs associated with transporting raw milk from the main milk fields in England to processing plants in Scotland. In a previous decision, the OFT also received some evidence as to whether Scotland could constitute a separate market for raw milk, but the OFT did not need to reach a conclusion in that case.<sup>5</sup> In 2000, the Competition Commission found that a considerable amount of trade in raw milk occurred between Scotland and the rest of Great Britain.<sup>6</sup>

10. In the present case, while the OFT accepts that there are local elements to the collection/supply of raw milk, it has not been necessary to conclude on whether the geographic frame of reference should be narrower than Great Britain. The OFT notes that the geographic overlap between the parties, in terms of the procurement of raw milk, is limited if areas within Great Britain were to be considered separately (see below at paragraphs 36 and 49). It should be noted, however, that in future cases involving consolidation in the milk sector, the OFT will seek to test the robustness of a Great Britain-wide market definition in the light of evidence on demand and supply-side substitutability and would not at this stage preclude the possibility of narrower markets.
11. No market participant submitted that the market was wider than Great Britain. Imports of raw milk into Great Britain are negligible at well below one per cent. Third parties noted the costs of transport to and from the continent and the perishable nature of the product. The weight of evidence is therefore that the geographic market for raw milk is in any event no wider than Great Britain.<sup>7</sup>
12. Based on the evidence above, the OFT has assessed the merger with Great Britain as the relevant geographic frame of reference.

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<sup>5</sup> OFT decision of 7 April 2005 regarding the completed acquisition by First Milk Limited of a 15 per cent stake in Robert Wiseman Dairies plc.

<sup>6</sup> *Scottish Milk. Report on the supply of fresh processed milk to middle-ground retailers in Scotland*, December 2000 (paragraph 4.23).

<sup>7</sup> The parties did, however, refer to a report prepared for the Department for Environment, Food and Rural Affairs (Defra), which states: 'There is clear statistical evidence that the UK (British) raw milk market is relatively well integrated with other EU Member States, despite the fact that there is relatively little trade in liquid milk' (*The potential for GB-European trade in liquid milk*, September 2007, page 66).

## Cheese

### Product market

13. The parties submitted that there is a separate market for cheese, but that there is no basis for further segmentation. This is in line with previous OFT decisions.<sup>8</sup> However, although some third parties supported this, other third parties suggested a separate market for cheddar. This is the main type of cheese produced by the parties. The OFT received limited consumer buying data from one third party that, according to this party, indicates that consumer switching between cheddar and other types of cheese is unlikely to be high. Another third party stated that consumers see each type of cheese as different and that they buy different types for different occasions. Some third parties also noted that supply-side substitution is costly (for example in terms of new equipment) and time-consuming, as production processes differ and cheese generally requires a (varying) period of maturation.
14. The parties submitted that if cheddar is to be distinguished from other types of cheese, then the relevant market should include other hard cheeses besides cheddar. According to the parties, these comprise, at a minimum, two hard territorial cheeses (Red Leicester and Double Gloucester), as these cheeses are made by a process that is very similar to the production process for cheddar and so producers of cheddar can switch overnight to the production of these hard territorial cheeses and vice versa. A third party supported the inclusion of hard territorial cheeses.
15. The parties argued that any market for cheddar should also include hard cheeses from outside of the UK, such as Leerdammer, Edam, Gouda and Emmental, as well as processed cheese slices and hard cheeses that in the UK are sold as 'value' cheeses, which are similar to cheddar but cannot legally be sold as cheddar. However, the OFT received no evidence on switching possibilities on either the demand or the supply side in respect of these other hard cheeses.

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<sup>8</sup> Most recently the OFT decision of 22 December 2006 regarding the completed acquisition by First Milk Ltd of the majority of the retailer branded cheese operations of Dairy Crest Group plc, citing earlier decisions.

16. Based on all of the evidence available to it, the OFT has taken a cautious approach and has considered cheddar together with two hard territorial cheeses (Red Leicester and Double Gloucester) as a separate product frame of reference (referred to for convenience below as 'cheddar').
17. As there was some third party concern regarding the parties' position specifically in relation to the provision of own-label cheddar to supermarkets, the OFT has also considered whether own-label cheddar could constitute a separate product frame of reference. The parties argued that there is substitution between own-label and branded cheddar on both the consumer level and the retailer level. According to the parties, for example, in case of a price increase by producers of own-label cheddar retailers can increase their product offering of branded cheddar at the expense of own-label cheddar. The parties also stated that the distinction between own-label and branded cheddar is blurred, with for example Dairy Crest's Davidstow cheddar being sold in some of the major supermarkets with the supermarket's name also displayed on the pack. No third parties submitted that there is a separate market for own-label cheddar and some third parties confirmed that there was significant consumer switching between own-label and branded cheddar. Nor is the OFT aware of substantial brand loyalty and price premiums charged for branded cheddars, (unlike the evidence, for example, it found in relation to carbonated soft drinks).<sup>9</sup> On this basis, the OFT believes that it is appropriate not to distinguish in the competitive assessment in this case between branded and own-label cheddar; accordingly they are treated as one product frame of reference.
18. Cheese is sold to consumers through retail outlets as well as to foodservice and ingredients customers. The parties submitted that these sectors do not constitute different markets, as the product supplied in each channel is the same and both the parties and their major competitors supply into each channel. The majority of the parties' sales are made through the retail channel ([80-100] per cent for First Milk and [50-70] per cent for Milk Link) and third party comments focussed on the retail channel. However, it is not necessary for the OFT to reach a conclusion in this respect, because, as

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<sup>9</sup> See the OFT reference decision of 28 November 2005 and the Competition Commission report of 28 April 2006 in *Cotts/Macaw*, where the evidence suggested that retailer-labelled carbonated soft drinks (CSDs) were in a separate market from branded CSD products.

set out below, the merger does not raise competition concerns irrespective of whether these channels are considered separately or not.

### Geographic market

19. The parties submitted that the geographic market for cheese is at least EU-wide and potentially worldwide, as there are substantial imports into and exports from the UK. For example, figures provided by the parties show that the volume of cheese imports is almost as large as the volume of UK cheese production. In previous decisions, the OFT considered the geographic market for cheese to be at least EU-wide.<sup>10</sup>
20. Imports of cheddar are also significant. The parties estimated that around 30 per cent of UK cheddar sales is sourced from outside of the UK, primarily from Ireland but also from New Zealand, Australia, Canada and continental Europe. This was broadly confirmed by third parties. The parties also noted that Dairy Crest, a major UK cheese manufacturer, has cheddar production plants in Ireland as well as England, from which it also supplies cheddar across the UK, and this supports a geographic frame of reference that is wider than just the UK.
21. Several third parties suggested that the geographic market for cheddar is the UK. One third party referred to the strong cultural preference for cheddar in the UK. Some third parties submitted that provenance of cheddar is important, as some consumers have a preference for cheddar of British origin (generally labelled as English, Welsh or Scottish, or with the name of the creamery). However, the parties argued that there is no separate market for British origin cheddar. They stated that only some of the cheddar sold in the UK is labelled as British, with, for example, most 'value' cheddar without an origin label and with only 11 out of Tesco's 39 own-label cheddar lines labelled as being British in origin (six as English, three as Scottish and two as Welsh).
22. In view of the significant level of imports of cheddar and the significant volume of cheddar that is sold without British origin labelling, the OFT considers that the weight of evidence supports a geographic frame of reference that is at least UK-wide rather than as narrow as British or,

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<sup>10</sup> See footnote 8.

separately, English, Welsh or Scottish cheddar. The OFT considers that the geographic frame of reference for cheddar and hard territorial cheeses in this case is the UK (which includes substantial imports from the Republic of Ireland and, to a lesser extent, from other countries).

## **Cheese packing**

### **Product market**

23. The parties noted that in a previous decision the OFT considered cheese packing as a separate product frame of reference.<sup>11</sup> The OFT noted that this was a cautious approach, since it found that cheese packing may be a subset of wider food packaging services. However, there are no demand-side substitutes for cheese packing as all cheese needs to be packed.
24. In this case, the OFT has not received evidence that indicates a different approach should be taken. Accordingly, the OFT has again taken a cautious approach and has considered cheese packing as a separate product frame of reference.

### **Geographic market**

25. In its previous decision, the OFT found that the majority of cheese consumed in the UK is packed in the UK. In this case, the parties argued that the market is at least EU-wide, as equivalent packing facilities are present elsewhere in the EU and cheese packed in those facilities is sold in the UK. The OFT did not receive third party comments on the geographic scope of cheese packing. Accordingly, the OFT has taken a cautious approach and has considered the UK as the relevant geographic frame of reference.

## **RAW MILK**

### **Market shares**

26. Raw milk is procured from dairy farmers mainly by three types of purchasers: co-operatives, milk brokers and processors. These purchasers

then process the milk they obtain into dairy products and/or sell milk on to (other) processors. The main co-operatives in Great Britain are First Milk, Milk Link and Dairy Farmers of Britain. They keep some of the milk they procure from their farmer-members for their own processing activities (according to the parties, around [20-40], [70-90] and [50-70] per cent respectively) and sell the remainder of their milk on to other processors. Milk brokers sell all the milk they procure to processors (except for those that are active as a processor as well as a broker). Finally, the processors that procure milk directly from farmers use almost all of this milk for their own processing activities. These processors generally also buy some of their milk requirements from co-operatives and milk brokers, in other words they 'dual source' their requirements.

27. The parties submitted that in Great Britain the combined share of all co-operatives in the procurement of raw milk has in the past three 'milk years' (the year from 1 April to 31 March) declined from 55 per cent in 2004/5 to 46 per cent in 2006/7. This share is made up of the milk procured by First Milk ([10-20] per cent in 2006/7), Milk Link ([5-15] per cent), Dairy Farmers of Britain ([10-20] per cent) and some small co-operatives (combined share of [0-10] per cent). Hence, after the merger the parties will procure [20-30] per cent of raw milk in Great Britain.
28. The main processors that procure milk directly from farmers are Dairy Crest (with, according to the parties, a share of procurement of [10-20] per cent in 2006/7), Arla ([10-20] per cent) and Wiseman ([5-15] per cent).<sup>12</sup> The volumes of milk procured direct by these processors have grown in the past three milk years. For example, Dairy Crest's share was [5-15] per cent in 2004/5 (whereas now it is comparable in size to Dairy Farmers of Britain, as is the case for Arla).
29. The parties estimated that milk brokers procured 7.6 per cent of milk in 2006/7. This includes Meadow Foods, which also operates as a processor

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<sup>11</sup> OFT decision of 22 December 2006 regarding the completed acquisition by First Milk Ltd of the majority of the retailer branded cheese operations of Dairy Crest Group plc.

<sup>12</sup> As noted above, First Milk holds a 15 per cent stake in Wiseman. In an earlier decision (see footnote 1) the OFT found that this conferred material influence and that the acquisition of this stake did not raise competition concerns. The OFT does not consider that this stake materially affects its analysis in the present case, as Wiseman does not supply raw milk to third parties and there is no material overlap between the parties and Wiseman in the production of dairy products (Wiseman produces fresh milk and by-products and the parties produce cheese and by-products).

(share of [less than five] per cent). The largest pure broker is Sorn Milk, with a share of [less than five] per cent.

### **Unilateral effects in the supply of raw milk to processors**

#### Concerns from market participants and arguments of the parties

30. A few customers submitted that after the merger there will be few alternatives available for processors that do not obtain their own milk directly from farmers. According to these customers, the only remaining significant alternative is Dairy Farmers of Britain. These customers argued that it is not a feasible option for them to obtain direct supplies from farmers within a reasonable period, as the parties' farmer-members are subject to long notice periods, exit payments and capital retention periods.
31. However, the parties argued that, in addition to obtaining raw milk from Dairy Farmers of Britain and other smaller co-operatives, direct procurement is clearly viable for processors, as demonstrated by the significant switching that has occurred in the past. They noted that in the past three years First Milk has lost [ ] farmer-members that switched to direct supply (on a current membership of around 2800) and Milk Link has lost [ ] farmer-members (on a current membership of around 1650). The parties also referred to the decline in the combined share of procurement by co-operatives and the equivalent increase in direct procurement (see paragraph 27). In addition, the parties provided examples of large, medium-sized and small processors that had recruited farmers to supply them directly. Some of these farmers had been members of co-operatives, while others had previously supplied other processors directly. Some third parties agreed that direct procurement from farmers is feasible within a reasonable period.
32. Brokers are also alternative sources of supply, according to the parties. A few third parties submitted to the OFT that brokers did not constitute an effective alternative supply, because of their limited volumes and a higher level of insecurity associated with supply by brokers. However, the parties noted that brokers already supply large processors and they argued that the volume Milk Link supplies to third parties is smaller than the volume supplied by the largest brokers (see paragraphs 29 and 35). Hence, if brokers are discounted as effective sources of supply, then, in the parties' view, the same argument should apply to Milk Link.

33. The parties acknowledged that their farmer-members are subject to a notice period of one year. In addition, as farmers can only give notice by certain dates, effectively the notice period ranges from one year to (for some Milk Link members) two years. However, the parties submitted that these notice periods are necessary in order to fulfil their processing and supply commitments, the majority of which are long-term arrangements. Also, they noted that processors frequently have long-term purchasing arrangements with their suppliers which those processors cannot terminate at short notice, and hence the parties' members' notice periods do not significantly affect those processors if they intend to switch to direct supply. Finally, the parties submitted that other parties that procure milk directly from farmers may have shorter notice periods and that [ ].
34. The parties provided the OFT with their internal membership rules and submitted that their members are not subject to any payments upon resignation. They accepted that resigning members could not access the capital sums they had contributed to the co-operative, but they noted that this applies equally to remaining members. These capital sums are only paid to resigning and retiring members, albeit to resigning members at a later date (five years after resignation, compared to three years after retirement (Milk Link) or staggered payments from the first to the fifth anniversary of retirement (First Milk)). The parties also pointed out that resigning members will in fact no longer have to pay any further sums to the co-operative's capital. Further, the parties noted that the additional payments that were occasionally made in the past to distribute unallocated profits at the end of the financial year (the so-called '13<sup>th</sup> payment'), have not been paid at any point in the past five years.
35. The parties also submitted that, as Milk Link processes the large majority of its milk, the merger will result in the addition of only a very limited volume of milk supplied to third parties to First Milk's volume. The parties stated that while Milk Link supplies [ ] million litres per annum (mlpa) to third parties, it also purchases [ ] mlpa from First Milk. This results in a net increase of [ ] mlpa in First Milk's milk supply to third parties after the merger ([less than five] per cent of total milk production). In addition, the parties noted that Milk Link purchases most of this volume from other third parties (including Dairy Farmers of Britain and brokers) to meet its

processing needs and as such, the real increment as a result of the merger is only [ ] mlpa ([less than five] per cent of total milk production).<sup>13</sup>

36. Furthermore, according to the parties, Milk Link is only a net seller of milk in its large milk field in the south west of England, which is not an area covered by First Milk. Hence, if, for example, Scotland were to be considered separately, the merger will not have any material effect as Milk Link already has very few farmer-members in Scotland. The parties also noted that their smallest customers will not be affected by the merger due to the lack of material overlap between the parties' supply areas in respect of these customers.
37. One third party argued further that it is difficult to attract enough farmers in an area to ensure efficient collection and that after the merger farmers will be (even more) unwilling to leave the security of the merged entity. However, the parties noted that collection of milk is often done by independent hauliers, which collect milk from farms [ ] and deliver the milk to various processors thereby enabling efficient collection. The parties further referred to the resignation of farmer-members in the past and noted that as former members can again become members, there is no reason for farmers not to attempt a switch to direct supply if it economically beneficial for them to do so.
38. Finally, some third parties noted that the merger is a step on the way to the recreation of Milk Marque. This was a large co-operative that was (voluntarily) broken up after the Monopolies and Mergers Commission (now the Competition Commission) had found that Milk Marque had exploited its monopoly position in the market.<sup>14</sup> Milk Marque split into Milk Link, Axis and Zenith, the latter two of which (after mergers) became First Milk and Dairy Farmers of Britain. However, the OFT notes that the share of milk procurement in Great Britain by co-operatives has decreased significantly since the Commission's findings and that the current merger does not include Dairy Farmers of Britain.

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<sup>13</sup> The parties submitted that the reason for these purchases is that Milk Link's processing facilities are in Scotland while its main milk field is in south west England. Therefore, while Milk Link has surplus milk in the south west, it has to buy in milk in Scotland to feed its production facilities.

<sup>14</sup> Report by the then Monopolies and Mergers Commission, *Milk. A report on the supply in Great Britain of raw cows' milk*, June 1999.

## Assessment

39. The parties have a joint share of the procurement of raw milk in Great Britain of [20-30] per cent. They use some of this milk in their own processing facilities and supply the remainder to third parties, mainly other processors. The OFT considers there are other significant parties active in the procurement of raw milk from farmers, including another large co-operative (Dairy Farmers of Britain), smaller co-operatives, large processors who use direct supply and milk brokers.
40. A few third parties expressed concerns that after the merger there would not be sufficient alternative suppliers of raw milk for processors that did not procure milk directly from farmers.
41. However, the OFT considers that it is feasible for processors to switch all or part of their milk requirements to direct supply by farmers. In the past few years the share of direct procurement by processors in British raw milk production has grown. The OFT has obtained evidence of processors switching from procurement from co-operatives to direct procurement and farmers switching supplies both away from co-operatives to processors and between processors. In addition, processors can (and indeed some already do) dual source raw milk, for example from co-operative(s) and/or milk broker(s) as well as directly from farmers.
42. In this regard, the OFT does not consider that co-operative membership rules, in particular notice periods or capital retention rules, would prevent switching by disincentivising farmers from moving to direct supply, and this is supported by the evidence of switching (referred to above). In addition, the OFT considers there is insufficient evidence to support the argument that direct supply is not feasible because processors find it difficult to attract enough farmers in an area to ensure efficient collection, and this is supported by the parties' argument that collection of milk is often done by independent hauliers, which collect milk from farms [ ] and deliver the milk to various processors, thereby enabling efficient collection.
43. The OFT also took into account that due to Milk Link's limited milk supplies to third parties, the merger will result in the addition of only a small volume of milk supplied to third parties to First Milk's volume. In addition, Milk Link is only a net seller of milk in its large milk field in the south west of

England, which is not an area covered by First Milk. Hence, if, for example, Scotland were to be considered separately, the merger will not have any material effect as Milk Link already has very few farmer-members in Scotland and these supply its own processing facilities.

44. For these reasons, the OFT does not consider that the merger raises material unilateral effects concerns in relation to the procurement and supply of raw milk in Great Britain.

#### **Coordinated effects in the supply of raw milk to processors**

45. Collusion may arise when a market meets certain conditions (see for example the OFT's *Mergers Substantive Assessment Guidance*, paragraphs 4.11 to 4.16, and the OFT decision of 11 December 2006 regarding the anticipated acquisition by Wienerberger Finance Service BV of Baggeridge Brick plc). The relevant question in a merger control context is not whether a market is susceptible to coordination in general, but whether the merger may be expected to increase the probability that post-merger, firms in the same market will tacitly (or explicitly) coordinate their behaviour to raise prices, reduce quality or curtail output.
46. The OFT has considered whether the merger increases the probability that firms will collude (tacitly or explicitly) by reducing competition within the relevant markets. Although no third party raised coordinated effects as a concern, in September the OFT issued a Statement of Objections as a result of its investigation under Chapter I of the Competition Act 1998 into the Dairy Products Retail Price Initiatives. In this Statement of Objections the OFT alleged that certain retailers and certain dairy processors had colluded in respect of the retail price of certain dairy products. On 7 December the OFT announced that certain of these companies had admitted involvement in anti-competitive practices.
47. As regards the probability of (increased) coordination in relation to raw milk, the current Competition Act 1998 investigation involves certain dairy processed products and not raw milk. The OFT has not obtained any evidence during the course of its review of this merger that the market for raw milk is currently the subject of tacit or explicit collusion.

48. In any event, there is insufficient evidence presently available to support a theory that the merger raises concerns by creating a material risk that this merger will 'tip' the market towards coordination or make existing coordination more effective, durable or widespread. In reaching this conclusion the OFT takes into account that, on the evidence before it, the merger does not (i) create a structural forum for contact between potential members of a collusive oligopoly that did not previously exist; (ii) eliminate a firm that currently acts as a 'maverick' in the sense of acting as a binding constraint on coordination due to incentives contrary to those of other major firms in the market; (iii) increase symmetry and therefore incentive to coordinate; indeed, on the contrary, the merger increases asymmetry between the merged firm and the next largest milk suppliers, as it will by some distance become the largest entity that procures raw milk (albeit one without unilateral market power, as discussed above).

#### **Buyer power in the procurement of raw milk**

49. The parties submitted that there is no risk that the merger will allow them to exercise buyer power and pay lower prices to farmers. Firstly, the parties are both co-operatives that aim to maximise returns for their farmer-members. Also, the parties argued that they face strong competition in procuring milk from farmers from the large processors such as Dairy Crest, Arla and Wiseman as well as the other large co-operative, Dairy Farmers of Britain. In addition, the parties noted that competition between them to attract farmers is very limited and that in the past three years hardly any farmers moved from one to the other. Their main milk fields are in different parts of Great Britain. First Milk's milk fields are mainly in the west of Scotland, the west of Wales and those parts of England close to the Scottish and Welsh borders. Milk Link's milk fields are mainly in the south west of England, with a much smaller field in Cumbria.
50. The OFT has not identified a credible buyer power theory that raises concerns given its share of procurement, its lack of downstream market power, and its corresponding lack of incentive to depress output by procuring less raw milk from its own members.

## **Entry, expansion and buyer power**

51. Given that the merger raises no horizontal concerns it is not necessary to consider the extent to which competition concerns could be resolved by countervailing constraints of entry, expansion and buyer power of customers.

## **CHEESE**

### **Market shares**

52. The parties provided figures for the shares of supply of cheddar and two hard territorial cheeses (Red Leicester and Double Gloucester) sold in the retail channel in the UK. These show that First Milk and Milk Link have shares of [20-30] and [5-15] per cent respectively, with a combined share of [30-40] per cent.<sup>15</sup> The parties' largest competitors are Dairy Crest (share of [15-25] per cent), Kerrygold (part of the Irish Dairy Board; share of [10-20] per cent) and Lactalis (share of [5-15] per cent).
53. The parties submitted that their share in the sale of cheddar outside the retail channel to foodservice and ingredients customers is lower, with a share of [0-10] per cent for First Milk and a share of [10-20] per cent for Milk Link, with a combined share of [15-25] per cent.

### **Unilateral effects**

54. The OFT has primarily focused on whether expansion of output by rivals in response to unilateral price increases by the merged firm would render such action unprofitable.
55. The parties submitted that there is significant spare capacity. The figures provided by the parties show that spare capacity in the UK and Ireland amounts to 38 per cent of UK retail sales of cheddar and the two hard territorial cheeses, while the parties' combined spare capacity represents a significantly smaller share of their retail sales. In the UK alone, there is significant spare capacity as well. This means that the parties' competitors

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<sup>15</sup> As the parties submitted that the production of Red Leicester and Double Gloucester represents around nine to 10 per cent of cheddar production for all major producers, the shares of supply would be similar if these hard territorial cheeses were excluded.

can increase their production in response to any price increase by the parties. Although cheddar takes from around one month to a year to mature, depending on whether it is mild or more mature cheddar, the parties noted that cheese producers (including themselves) generally are maturing cheddar in excess of their current order book, which allows them to increase even their sales of mature cheddar relatively quickly.

56. The parties also noted that competition from Irish cheddar producers is strong. They stated that imports from Ireland grew by around 20 per cent between 2003 and 2006 and that this trend is expected to continue, with significant further investment in Irish cheese making facilities.
57. No evidence from third parties contradicted the above information of spare capacity of rivals.
58. Two third parties did raise a concern about the parties' position in the supply of own-label cheddar. However, the evidence suggests that branded and own-label cheddar compete sufficiently closely, and that rivals with spare capacity can supply substantially increased volumes of branded or own-label cheddar. Accordingly, retailers can leverage such alternative options to discipline the merged firm.<sup>16</sup>
59. Overall, therefore, the OFT believes that the supply-side constraints facing the merged firm preclude unilateral effects concerns. In particular, the evidence suggests that rivals have the ability and incentive to expand output to defeat price increases by the merged firm.

### **Coordinated effects**

60. The OFT considers that the current levels of spare capacity and the level of imports from, in particular, the Republic of Ireland, make it unlikely that collusion is sustainable. In addition, as with raw milk, there is no evidence that the merger will result in the creation of a structural forum for coordination or that either of the parties acts as a maverick, and the merger also increases asymmetry.

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<sup>16</sup> Even in respect of 'British-origin' cheddar, the parties noted that [ ]. Also, the parties provided examples of small British creameries that are supplying cheddar to supermarkets and have recently expanded on the basis of further supermarket orders.

61. Based on all of the evidence before it, the OFT believes that there is insufficient evidence that the merger makes collusion more likely, or more effective, durable or widespread.

### **Entry, expansion and buyer power**

62. Given that the merger raises no horizontal concerns it is not necessary to consider the extent to which competition concerns could be resolved by countervailing constraints of entry, expansion and buyer power.

### **CHEESE PACKING**

63. The parties submitted that First Milk and Milk Link pack [20-30] and [10-20] per cent of cheese in the UK respectively, with a combined share of [30-40] per cent. They noted that First Milk's share includes cheese packed for Dairy Crest (representing [5-15] per cent of UK cheese packing), but that from 2009 Dairy Crest will undertake its own packing in a new packing plant. Dairy Crest confirmed this. This will significantly reduce the parties' share of UK cheese packing.
64. The parties submitted that most cheese producers have in-house packing facilities. Third parties confirmed this and noted the importance of in-house packing to cheese producers, as in-house packing is more efficient and gives the producer control over the entire production process. In-house packing is included in the share figures set out above. The parties did not provide share figures for packing for third parties, but submitted that Milk Link undertakes negligible packing for third parties and that First Milk's only significant third party packing is for Dairy Crest. This resulted from Dairy Crest's sale of its own-label cheese operations to First Milk in 2006, but, as noted above, First Milk will no longer pack for Dairy Crest from 2009.
65. No third parties raised concerns about the effect of the merger on cheese packing. Third parties also stated that there were several alternative suppliers of packing services. The parties also submitted that there is significant capacity in cheese packing and that some cheese producers have recently invested in expansion of their packing facilities.
66. Based on the evidence set out above, the OFT considers that the merger does not give rise to competition concerns in relation to cheese packing.

## VERTICAL ISSUES

67. Both parties are active in the procurement and supply of raw milk as well as the processing of raw milk into cheese and other dairy products. Some third parties expressed concern that after the merger the parties may restrict supplies of raw milk to competing processors or may increase the price of raw milk charged to competing processors.
68. The OFT has considered whether the merger gives the parties the ability and the incentive to pursue such a foreclosure strategy to increase their market shares downstream in the production of, in particular, cheese. The margin data provided by the parties were inconclusive. However, it is noted above that the parties have only limited spare capacity in the production of cheese, so following any successful foreclosure strategy they have only limited ability to take on contracts lost by competitors.
69. Further, as set out above, the parties procure around [20-30] per cent of raw milk in Great Britain. That means that [70-80] per cent is procured by other parties, mainly processors directly but also other co-operatives, including Dairy Farmers of Britain, and milk brokers that sell the raw milk on to third parties. Milk Link's sales of raw milk to third parties are limited and are generally located in a different area of Great Britain from First Milk's milk fields. Moreover, if the parties ceased to supply a competitor with raw milk then they would need to find a new customer for that raw milk. This may, in turn, be expected to displace milk that is currently supplied to that new customer which would then become available to supply the competitor. The OFT therefore considers that there is insufficient evidence that after the merger the parties will have the ability and incentive to pursue a foreclosure strategy.
70. A third party alleged that in the autumn of 2007 First Milk cancelled supplies to customers while continuing to supply its own processing facilities. However, First Milk provided the OFT with an internal paper, dated August 2007, regarding its 'force majeure policy' to deal with shortages in the supply of raw milk. This paper states that First Milk's own facilities would be treated in the same way as First Milk's customers, with similar reductions in supplies applying across the board. The OFT considers, as noted above, that processors would have several alternative

sources for the procurement of raw milk, including direct supply from farmers as well as other co-operatives and brokers.<sup>17</sup>

## **THIRD PARTY VIEWS**

71. Third party views were mixed. Some third parties raised concerns, which are discussed above. The majority of third parties did not express concerns.

## **ASSESSMENT**

72. First Milk and Milk Link overlap in (i) the procurement and supply of raw cows' milk, (ii) the production and supply of cheese, (iii) cheese packing, and (iv) the production and supply of other dairy products such as butter and skimmed milk powder.
73. The parties have a joint share of the procurement of raw milk in Great Britain of [20-30] per cent. On the evidence available, the OFT has no unilateral effects concerns: the principal constraints on the merged firm preventing it from unilaterally withholding raw milk and raising price are the substantial supply options open to customers to switch to, notably the other large co-operative, Dairy Farmers of Britain, direct supply from farmers and also from a number of smaller co-operatives and milk brokers. Nor could the OFT identify a sufficiently persuasive and substantiated theory that this particular merger of two co-operatives at the raw milk level would materially increase the risk of coordinated effects at any level of the supply chain.
74. In relation to cheese, the parties have a combined share of UK retail sales of cheddar – including two similar hard territorial cheeses, Red Leicester and Double Gloucester – of [30-40] per cent. On the evidence available, the OFT concludes that the lack of brand loyalty and associated premium pricing of branded products suggest that branded and own-label cheeses of this type constrain one another, and that the case for a market of 'British-origin' cheddar is not compelling. Although the parties have a significant share of total sales, the OFT believes the merged firm would find it

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<sup>17</sup> In addition, it is difficult to see how the merger would materially change the current circumstances in Scotland given that Milk Link has very few farmer-members in Scotland, and these supply its own processing facilities (see also paragraphs 36 and 43).

unprofitable to reduce output and raise price given the ability and incentive for rivals with spare capacity in the UK and Ireland to expand output. The OFT also ruled out coordinated effects concerns resulting from the merger given the resulting structure of supply and presence of a substantial number of rivals with spare capacity.

75. No material issues are raised in respect of cheese packing, considered in more detail above, or in respect of other dairy products. The OFT also found that the merger did not give the parties the ability and incentive to pursue a foreclosure strategy due to the availability of sufficient alternative sources of supply of raw milk and the geographically separate location of the parties' milk fields.
76. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

## **DECISION**

77. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.