

Completed merger between Stonegate Farmers Limited and Deans Food Limited

The OFT's decision on reference under section 22(1) given on 13 September 2006. Full text of decision published 3 October 2006.

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

PARTIES

1. **Stonegate Farmers Limited** (Stonegate) is active in the supply of hens' eggs which it sells in both shell (shell eggs) and processed forms (processed egg). It sources the majority of its shell eggs from independent third parties, and outsources the processing of its eggs. Whilst Stonegate has no processing capacity of its own, it operates at all stages of the shell egg supply chain, from the hatching and rearing of chicks, the collection of laid eggs through to packing and onward supply.
2. **Deans Food Group Limited** (Deans) is also active in the supply of shell eggs and processed egg. It too sources the majority of its shell eggs from third party producers and operates at all stages of the shell egg supply chain. However, unlike Stonegate, Deans has processing facilities of its own and produces all of its supplies of processed egg in-house.

TRANSACTION

3. The transaction was completed on 23 June 2006 by the creation of a new company, Noble Foods Limited, which acquired the majority of the shares in Stonegate and Deans. The principal shareholders in Stonegate and Deans (respectively, Mr Michael Kent and Mr Peter Deans) each acquired 50 per cent of the shareholding in Noble Foods.
4. The merger was notified to the OFT on 30 June 2006. The administrative target date for a decision is 15 September 2006 and the statutory deadline is 22 October 2006. The parties gave initial undertakings to the OFT on 22 August 2006.

JURISDICTION

5. As a result of this transaction Stonegate and Deans have ceased to be distinct. The parties overlap in the operation of a supply chain that encompasses the production, packing and supply of shell eggs and the supply of processed egg. During 2005, their combined shares of the UK supply of shell eggs and processed egg amounted to [40-50] per cent and [35-45] per cent respectively. The share of supply test in section 23 of the Enterprise Act 2002 (the Act) is consequently met. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

RELEVANT MARKET

Product scope

Shell egg production

6. The parties submit that there are three principal categories of shell egg depending on the living conditions that producers provide for each laying hen. These are (in ascending order of production costs and consumer perceptions of quality) cage eggs, barn eggs and free range eggs.
7. Customers indicated that there was limited scope for demand side substitution between these categories of shell egg. Whereas eggs of higher quality could meet demand capable of being satisfied by lower quality eggs, the reverse is not generally true. On the evidence before it, the OFT does not believe that supply side substitution (eg from cage egg production to free range egg production) is feasible in the short term.
8. In the UK, shell eggs may also be differentiated by one of two quality assurance/food safety standards: the Lion scheme and the UKEP scheme. The Lion scheme has considerably wider recognition and prevalence (85 per cent of all shell eggs are produced to the Lion standard) relative to the UKEP scheme. Lion eggs may therefore constitute a separate product from UKEP eggs and other types of shell eggs when considering frames of reference.
9. The relevant frame of reference for shell egg production therefore comprises cage egg, barn egg and free range egg segments. Lion eggs may also constitute a separate product from UKEP eggs and other types of shell egg.

Shell egg packing

10. Shell eggs are transported from the farm to a packing centre to be checked for quality, weighed and then packed before being supplied to customers. Some shell eggs (principally cage eggs) are also packed on the production farm. The parties submit that there are approximately 1,000 alternative egg packers in the UK. Supply side substitution is technically possible between the packing of different cage, barn and free-range eggs – the processes are fundamentally the same. However, such supply side substitution between different types of egg may be constrained by an inability to source egg producers of the required type. Nevertheless, as share of supply data have been supplied on the basis of all eggs, and as the OFT does not consider that these shares vary significantly between types of eggs, the competition analysis in this case is on the basis of a frame of reference that consists of the packing of all types of shell egg. This is without prejudice to the possibility of the product/service scope being narrower.

Supply of shell eggs

11. Customers contract with suppliers for the delivery of their requirement for packed eggs. In practice, egg suppliers are all vertically integrated in that they also operate at the packing and/or production stages within the overall supply chain. This does not mean that all suppliers meet all of their own requirements in-house. In the main, suppliers also contract with third parties for the production, packing and processing of shell eggs.
12. For shell eggs, the demand side comprises three principal customer types: retailers, processors and commercial customers (eg wholesalers and caterers). Larger customers from all segments suggested that the scale of the supplier was relevant for purposes of ensuring consistency and frequency of supply of this perishable product. This may make switching supply between different types of customer difficult. Different suppliers do appear to focus on specific customer groups. In particular the available evidence indicates that the demands of large retailers can be met, for the most part, only by large egg suppliers. Comments received from the customer types indicate that they have variable degrees of buyer power. In this case, given the differences between them, the OFT has analysed the merger on the basis of the supply of all shell eggs and the supply of shell eggs segmented by customer types.

Supply of processed eggs

13. Shell eggs are processed either by hard boiling or by extracting the yolk and the white and producing a liquid or a powdered egg product. There is limited demand side substitution between hard-boiled eggs on the one hand and liquid or

powdered egg on the other. Comments from the parties and some third parties suggest that there may be limited demand side substitution between liquid and powdered egg. Given that neither Stonegate or Deans is active in the supply of powdered egg, and that Stonegate does not supply hard boiled eggs, the OFT's analysis assumes a narrow product segmentation consisting of the supply of liquid egg.

Geographic scope

Shell egg production

14. The parties submit that they collect eggs from a geographically diverse spread of egg producers and then assemble eggs for delivery within the UK. The OFT therefore considers that the relevant geographic scope is the UK.

Shell egg packing

15. The available evidence indicates that UK egg packers focus their activity on the domestic market. The OFT has found no evidence that suppliers sourced packing services from continental packers. It therefore considers that the relevant geographic scope is the UK.

Supply of shell eggs

16. The parties submit that, although only modest volumes of all types of shell egg are currently imported from mainland Europe, it is nonetheless a credible threat for customers to []. The OFT has been provided with evidence of some retailers having sourced relatively small volumes of shell eggs from continental Europe, and of retailers being able to source in principle from abroad.
17. However, evidence from various third party customers in all categories points to heavy emphasis placed on the Lion standard on shell eggs. The OFT considers that this, together with transport costs, may limit the scope for sourcing shell eggs from continental Europe and may explain why the volumes imported are relatively low. Evidence of customers having sourced from abroad is insufficient to indicate that the geographic scope for actual competition in the supply of shell eggs is wider than the UK.

Supply of liquid egg

18. A body of third party comment emphasises the importance of processed egg being produced from Lion standard shell eggs. Without prejudice to the possibility of the geographic scope for the supply of liquid egg being wider, the OFT's

competition analysis in this case is based on the cautious premise that it is no wider than the UK.

HORIZONTAL ISSUES

Production of shell eggs and packing of shell eggs

19. On whatever basis egg production is segmented in terms of caged eggs, barn eggs, or free-range eggs, the parties' combined shares of supply in the UK are consistently below the level of 25 per cent between the years 2002 and 2005. Given the absence of any adverse third party comment and that competitive constraint continues to be posed by alternative producers, the OFT considers that the merger does not give rise to any significant concerns in this segment. Shell egg production is not considered any further in this case.

20. In regard to shell egg packing, both Stonegate's and Deans' business models provide that large proportions of their supplies of eggs ([] per cent and [] per cent respectively) are packed in-house. Neither party packs any significant volume of shell eggs for third parties and in the absence of adverse third party comment directed at the effects of the merger on the supply of egg packing to third parties, the OFT considers, given the evidence before it, that the merger does not give rise to any significant concerns in this segment. Shell egg packing is not considered any further in this case.

Supply of shell eggs

Shares of supply

21. The parties are the largest pre-merger and post-merger suppliers of shell eggs in the UK. Their estimates of their combined shares of supply amount to [40-50] per cent (increment [10-15] per cent).
 - Their estimates of their combined shares of the supply of shell eggs to UK retailers are higher – [60-70] per cent (increment [15-25] per cent) in 2005, up from [50-60] per cent in 2002 (Mintel, using a different data set, estimated the parties' combined share to be 72 per cent in 2002-03).¹ The parties also estimated that their closest remaining competitor, [], had a share of supply of around [5-10] per cent to the retail market during 2005 whilst all others had less than five per cent.

¹ Eggs, Market Intelligence, June 2004

- Combined shares of the supply of shell eggs to processors amount to [] per cent (increment [] per cent). However, customer profile information provided by the parties indicates that Deans does not supply third party processors and that the share of supply figures represent sales to its own processing arm. No third party concerns were raised in this segment. The supply of shell eggs to processors is therefore not considered any further in this case.
- Combined shares of the supply of shell eggs to commercial customers in the UK amount to [] per cent (increment [] per cent) during 2005. Some commercial customers have more alternative sources of supply than retail customers. Nonetheless, customers expressed similar concerns to those voiced by retailers since the parties are the largest suppliers. However, given the parties' position in relation to all shell egg supply and to the supply of shell eggs to retailers, it is not necessary for the OFT to conclude on this product segment.

Closeness of competition between the parties

22. As the largest egg suppliers in the UK, Stonegate and Deans each offer extensive national coverage. Their logistical operations facilitate timely delivery in large volumes. Customers' switching behaviour, the parties' consistent shares of supply, their own internal documents indicating that [] and customer comments all evidence the extent to which Stonegate and Deans have been each other's strongest competitors over a sustained period and that significantly less competitive constraint has been posed by smaller suppliers. Information provided by the parties shows that, in the supply of shell eggs to retailers, when one party increased its share of supply to a retailer, the other party lost almost – in some instances entirely – the equivalent share. For the [] largest UK supermarkets, the shares of supply that were switched between the parties over the past six years ranged from around [15-25] to [30-40] percentage points (representing considerable volumes of eggs).
23. A significant number of customers across all market segments were concerned about the competitive effects of the merger.
24. The merger therefore raises significant horizontal concerns in the supply of all shell eggs, shell eggs to retailers and liquid egg to all types of customer.

Countervailing buyer power

25. In relation to the supply of shell eggs to retailers, the parties submit that these large customers enjoy substantial buyer power as a result of their size. They estimate that more than [55-65] per cent of the total purchase of shell eggs is

accounted for by just three customers (Tesco, Asda and Sainsbury) and that the top five customers (with the addition of Morrisons and Somerfield) account for [75-85] per cent of purchases.

26. The OFT does not discount the possibility of the major retailers having buyer power. These are clearly important customers who represent an important route to market for shell egg suppliers. Although possibly constrained by a need to source the bulk of their total requirement from one supplier, such larger retailers may still have the ability to discipline the merged entity by switching a sufficient proportion of that total requirement to an alternative supplier, by threatening to source from outside the UK or by threatening to build up a smaller supplier in the UK. However, as shown above, the scale of past switching between Stonegate and Deans by major supermarkets has been considerable and it is not clear to the OFT, on the evidence before it, that shell egg suppliers other than the parties currently have the capacity to fulfil requirements on this scale. Therefore, it seems reasonable that some countervailing buyer power has been lost as a result of the merger. Indeed, the OFT was told by some large customers that they considered that they did not possess sufficient buyer power to offset the effects of the merger given that all the remaining alternative competitors operated on such a significantly smaller scale. Based on the evidence before it, the OFT considers that some customers will retain buyer power. However, these customers are not representative of the entire customer base.

Barriers to expansion and entry

27. The parties propose that all stages of the egg supply chain are characterised by relatively low entry barriers. Given also that the business of egg supply is to consolidate the production of many hundreds of farms and co-ordinate the packing and delivery of those aggregated volumes to their customers in an economically efficient manner, they submit that there is scope for a competitor to expand in the market without incurring any significant sunk costs. Indeed, internal documents disclosed by the parties to the OFT show that [].
28. A body of third party comment indicates that new entry into an industry characterised by declining profitability would be difficult and would not be achievable at a scale and within a short enough period of time to remedy any adverse effects that may arise from the merged entity's increased market power.
29. There is some evidence of expansion in recent years, but none to indicate that this has been of significant scale relative to the size of the parties. Glenrath, for example, won its first contract to supply Tesco in 1983 and after 20 years of growth has achieved less than 10 per cent of the supply of shell eggs to retail customers. The parties submit as evidence of the ease of entry and expansion the

example of Freshlay: an egg producer which started to supply eggs to retailers and managed to obtain supply contracts with Tesco, Asda and Safeway, growing its share of shell eggs to these particular retailers to around [] per cent (approximately [] per cent of the total supply of shell eggs to retailers). Deans, however, remained consistently larger than either Stonegate or Freshlay. In 2003 Deans acquired Freshlay. The OFT has found no evidence that significant expansion has taken place since.

30. Much of the parties' own expansion over the past decade or so has been attributed to their acquisitions of competitors.
31. Third party comment suggested that future expansion might also be limited by a lack of packing facilities suitable to meet the scale requirements of the major retailers – and the need for planning permission to expand egg production facilities (particularly in the free range segment). Based on third party comments to the OFT, perhaps the greatest hurdle in expanding activities in the supply of eggs is the difficulty in gaining access to a sufficient supply of eggs in the first place. A significant number of third party egg producers are already tied in to supply contracts with a fragmented base of egg producers. The OFT considers that retailers or processors are unlikely to award a large egg supply contract to a supplier that could not demonstrate an ability to source the required volume of eggs. It may however be possible that one or more third party suppliers could expand to a size of some significance with the support of one or more major supermarkets. However, it remains insufficiently clear to the OFT that this kind of expansion could take place in a short enough period of time to offset the loss of competition between the merging parties. In addition, some third parties submitted that, because of the perishable nature of eggs, egg suppliers are not inclined to take the risk of obtaining large quantities of eggs without certainty of demand (from retailers, wholesalers or processors) for a similarly large volume.

Supply of liquid egg

32. The parties' estimates of their combined shares of the supply of liquid egg in the UK amount to [] per cent (increment [] per cent). They also estimate that their four remaining closest competitors have shares of supply ranging between [0-5] per cent and [5-15] per cent.
33. All customer respondents in this sector expressed concerns about the impact of the transaction on their business. A body of those concerns is directed at the loss of competition specifically vis à vis Stonegate and Deans.
34. Views on countervailing buyer power were mixed. Some customers submitted that switching opportunities are constrained by long lead times and costs required

for thorough testing of liquid egg when used as an ingredient in the manufacture of an end-product.

ASSESSMENT

35. The parties' commercial activities overlap in a supply chain that encompasses the production, packing and supply of shell eggs and the supply of liquid egg. For the purposes of a competition assessment in this case, the relevant geographic frame of reference is considered to be no wider than the UK.
36. The merger does not, in the view of the OFT, raise substantial competition concerns at the production level of the supply chain (given that the parties' combined shares of supply and the lack of third party concerns) or at the packing level (since neither party packs significant volumes for third parties). The substantial shares of supply of shell eggs to processors ([] per cent) do not raise concerns given that Deans' share represents its own in-house supply. The OFT does not consider that it is necessary to draw any conclusions on the impact of the merger on the supply of shell eggs to commercial customers.
37. The parties' combined shares of the supply in the UK of all shell eggs and shell eggs to retailers amount to [] per cent and [] per cent respectively. The OFT considers that the merger raises concerns as a result of the loss of close competition between the parties.
38. The views of third party commentators on countervailing buyer power are mixed. Some were unconcerned by the merger and submitted that they could constrain the merged entity's pricing behaviour by threatening to switch a proportion of their total requirement to alternative suppliers, to source from abroad or to build up smaller suppliers. Other third parties raised credible concerns that the small size of the remaining competitors post-merger constrained their ability to switch between sources of supply. It does seem to the OFT that whatever countervailing buyer power could be exercised previously has been diminished to some extent by the merger, though not necessarily in respect of each retailer that sources from the parties. Over the short to medium term at least, fewer customers can now switch significant proportions of their egg requirements than could before the merger. Overall, on the basis of the evidence before it, the OFT considers that the extent and degree of countervailing buyer power amongst customers as a whole is unclear.
39. In the liquid egg segment, combined shares of supply in the UK amount to around [] per cent. All customers were concerned at the loss of competition between Stonegate and Deans. Here too, the views of third party commentators on countervailing buyer power are mixed.

40. On the evidence before it, the OFT considers that it cannot accept the parties' proposition that competition concerns for the supply of shell eggs and processed egg can be offset by low barriers to entry and expansion – although the parties arguments are not without some merit. Indeed, the OFT considers that some expansion of third party suppliers in the short term will take place as a result of the merger. But on the basis of third party comment and of the overall stability of the market operators' shares of supply over a long period, the OFT does not consider on the basis of the available evidence that sufficient timely expansion could offset the loss of competition between the merging parties.

CONCLUSION

41. Consequently, the OFT believes 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.

UNDERTAKINGS IN LIEU

42. Where the duty to make a reference under section 22(1) of the Act applies, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, and for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which has or may have resulted from it or may be expected to result from it, accept from such of the parties concerned undertakings as it considers appropriate.
43. The OFT's Mergers Substantive Assessment Guidance states that undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut, and those remedies are capable of ready implementation.²
44. Stonegate and Deans offered essentially behavioural undertakings to the effect that [].
45. Whilst very much welcoming the willingness of the parties to put forward remedies, the OFT does not consider that these proposals are capable of maintaining the competitive dynamic in the supply of shell eggs and liquid egg, for the reasons set out below.
46. The OFT's guidance states a clear preference for structural remedies. In this case, the proposed remedies raise the following serious questions: [].

² Paragraphs 8.3 and 8.4

47. The OFT therefore does not believe the undertakings offered are sufficiently clear cut to address the competition concerns outlined above.

DECISION

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