Anticipated acquisition by Pan Fish ASA of Marine Harvest N.V.

The OFT's decision on reference under section 33(1) given on 6 July 2006. Full text of decision published 25 July 2006.

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

PARTIES

1. **Pan Fish ASA** (Pan Fish) is an integrated fish farming company which produces, distributes and supplies salmon globally. Its salmon farming operations are located in Scotland, the Faroe Islands, Canada and Norway. It has two smokeries in France and a sales office in Japan. Pan Fish recently made a bid to acquire the whole of Fjord Seafood ASA (Fjord). As at 30 June 2006 Pan Fish owned over 90 per cent of Fjord, and it is expected that its stake will increase to 100 per cent in the near future.[1] Fjord produces and supplies farmed salmon and other species worldwide. Fjord's European operations are located in Norway, Belgium, Scotland and France. Pan Fish's estimated turnover in 2005 was £40.3 million.

2. **Marine Harvest N.V.** (Marine Harvest) – a joint venture between Nutreco Holdings NV (Nutreco) with a 75 per cent interest and Stolt Sea Farming Investments BV (Stolt) with the remaining 25 per cent - is a fish farming company that produces and supplies farmed salmon products. It has production and processing operations in eight countries including Norway, Scotland and Ireland. It also supplies sea trout and farms a number of species new to aquaculture. Marine Harvest's estimated UK turnover for 2005 was £61.6 million.

TRANSACTION

[1] For the purposes of this assessment, Pan Fish has been treated as having a controlling interest in Fjord. Based on the evidence available the Pan Fish/Fjord merger would not appear to give rise to a relevant merger situation under the Enterprise Act 2002

3. Pan Fish is proposing to acquire 100 per cent of the shares in Marine Harvest from Nutreco and Stolt. The administrative deadline for assessing this case expires on 6 July 2006.

JURISDICTION

4. As a result of this transaction Pan Fish (including Fjord) and Marine Harvest will cease to be distinct. The parties' combined share of supply of farmed Atlantic salmon in the UK is approximately 42 per cent by volume. As a result, 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 arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation. The ECMR does not apply.

RELEVANT FRAMES OF REFERENCE

5. The parties overlap in the production and sale of farmed salmon. The production of salmon involves four stages:

    a. breeding and growing juvenile salmon (smolts)

    b. farming salmon to market size (having transferred smolts to seawater cages)

    c. primary processing, which involves slaughtering, gutting, grading and packing the salmon, and

    d. secondary processing, which involves processing the gutted salmon to produce fillets, steaks, smoked salmon, pre-prepared meals and other products.

6. Smolts are young salmon raised in tanks in a hatchery for three to five months. They are then transferred to cages in freshwater lochs or tanks until they are 12 months old, when they are ready for transfer to seawater salmon farms. Salmon farms harvest the salmon, which takes around two years, and carry out the primary processing. The product resulting from the farming and processing stages is fresh gutted farmed salmon.

7. Gutted farmed salmon can be sold as a product in its own right or may be subject to secondary processing. Secondary processing is usually carried out by different companies. In this case, there is a minimal overlap between the parties in the supply of secondary processing of smoked salmon, with the merger only giving rise to a combined share of supply of less than [0-10] per cent (increment of less than [0-10] per cent). Given this, sufficient competitive constraints would appear to exist post-merger and competition concerns do not arise. Therefore secondary processing will not be considered further.

Smolts

8. The Competition Commission[2] (CC) and the European Commission[3] (EC) both considered that there was a distinct market for smolts, as no other product can be substituted for smolts and production technologies for smolts are distinct. The OFT found no evidence during the course of its investigation to suggest a departure from this approach is appropriate.

9. The geographic scope for smolts would appear to be no wider than national. This view is consistent with previous CC and EC cases. In particular, third party evidence suggested that smolt farming was predominately regional, as there are statutory restrictions preventing the movement of smolts within certain areas intended to stop the spread of disease. While a company could import smolts from a zone of equivalent health status to the UK, there is a voluntary Scottish industry Code of Good Practice that states that live fish imports should not occur. Furthermore, transport costs can be high and there is a risk in transporting live creatures.

10. Therefore, the relevant frame of reference is considered to be the supply of smolts within the UK.

Salmon

11. The different species of farmed salmon are Atlantic salmon, Coho, Chinook and Salmon Trout and 95 per cent of global (farmed) salmon production is based in Norway, Scotland, Canada and Chile. Within the EEA, farmed Atlantic salmon accounts for over 90 per cent of farmed salmon sold. The different species of wild salmon are Sockeye, Chum and Pink. Wild salmon accounts for less than 10 per cent of total salmon supply to the EEA.

12. The parties submitted that the appropriate product market was the production and sale of salmon, and that the various species of farmed salmon and wild salmon are substitutable. They argued that this indicated that the origin was immaterial for processors, manufacturers and the food service industry. Rather, cost was the decisive element in choosing salmon.

13. In the 2005 Marine Harvest JV case the EC found that the appropriate market was Atlantic farmed salmon in the EEA with no further subdivision according to species or origin of the farmed salmon. They considered that there were separate markets for wild salmon and organic salmon.

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[2] *Nutreco Holding NV and Hydro Seafood GSP Ltd: A report on the proposed merger*, December 2000, Cm 5004

[3] Case No COMP/M.3722, *Nutreco / Stolt-Nielsen / Marine Harvest JV*

14. In its Nutreco/Hydro decision in 2000 the CC concluded that the relevant market was that of farmed Atlantic salmon within the EEA. They found that many customers sourced salmon from both Norway and Scotland and these were regarded as effective substitutes, especially by the (price sensitive) catering sector. Furthermore, transport costs in the EEA were low. In particular, it was observed that there was a close correlation between Scottish and Norwegian salmon prices over time. However, the CC also found that there was a small segment of the market which regarded Scottish salmon as a differentiated premium product within the single, wider market for farmed Atlantic salmon.

Atlantic salmon

15. Farmed Atlantic salmon is often distinguished by its origin, e.g. Scottish salmon, Norwegian salmon etc. In 2005, 56 per cent of salmon consumed in the UK was Scottish in origin and 36 per cent was Norwegian.[4] In the EEA, 16 per cent of salmon consumed in 2005 was Scottish, 65 per cent was Norwegian and 13 per cent was Chilean.[5] Less than 10 per cent of Scottish salmon production and around 25 per cent of Norwegian salmon was exported outside the EEA. Chilean imports into the EEA approximately doubled between 2003/04 and 2004/05. We have therefore examined whether these different sources of salmon should be considered separately, in particular, whether Scottish salmon is a distinct segment.

16. Third party views on the issue were mixed. Most customers – and customers in this context could be secondary processors or retailers/wholesalers - considered the distinction between the different types of salmon to be very important. They stated that salmon farmed in Scotland is perceived to be of a higher quality than Norwegian salmon because it is has traditionally been less oily (due to slightly different diet), has a slightly slower growth rate and is reared in different conditions. Some customers also considered that Scottish salmon is fresher than Norwegian salmon (because of differences in transportation times).

17. However, this distinction appears to be more important for certain buyer types, which may, in turn, reflect the composition and requirements of their customer base. Some customers told the OFT that they only purchased Scottish salmon and were unable or unwilling to switch to other types of salmon. In particular it appears that smokeries and some niche suppliers have a distinct preference for Scottish salmon (which may also reflect the preferences of the end consumer). This is generally acknowledged to be the reason why Scottish salmon commands a price premium over Norwegian salmon.

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[4] Remaining consumption was made up as follows: Chile, 3 per cent; Faroe Islands, 3 per cent and others (including Ireland), 2 per cent

[5] Remaining consumption was made up as follows: Canada, negligible; Faroe Islands, 2 per cent and others (including Ireland), 3 per cent

18. There is no requirement for salmon to be labelled with origin. For many products, such as salmon fillets, steaks and meals (e.g. salmon en croute), retailers may not label the origin of the salmon. Therefore the end consumer may be unable to distinguish between salmon of different origins. However, a number of third parties submitted that for some products, in particular, smoked salmon and niche products, origin can be very important. Third parties indicated that consumers in the UK often demonstrated a distinct preference for Scottish origin salmon products. In some instances, retailers have taken a decision to only stock salmon of Scottish origin in response to consumer preference.

19. On the other hand, it was suggested that many secondary processors, food-service and catering customers were indifferent between Scottish and Norwegian salmon because cost is the main concern. Some customers noted that while the main demand is for Scottish salmon, if prices were too high they would consider buying Norwegian salmon. In addition, a number of customers already purchase both Scottish and Norwegian salmon and adapt quantities according to price.

20. The OFT analysis of salmon prices across Europe found that there was a strong price correlation between Scottish salmon, Norwegian salmon and salmon from the Faroes, with prices moving together over time. This price correlation was not observed in relation to Chilean salmon prices, where prices did not appear to move in line with Scottish and Norwegian salmon prices. Norwegian salmon is also subject to a minimum import price (MIP) into the EU following an anti-dumping complaint by Community producers, which may indicate that they are viewed as being in the same market.

21. The parties suggested that Chilean salmon prices are an increasing constraint on European salmon prices following an increase in imports in 2004 and 2005. They pointed to the slightly higher correlation coefficient with European salmon prices in 2005 compared to previous periods. However, the correlation is still lower than the correlation between UK and Norwegian salmon prices and appears to be primarily driven by a longer term trend in salmon prices rather than short term responses to competitive conditions. The OFT does not consider that the fact that Canadian and Chilean salmon prices have, like European prices, been increasing over recent years to necessarily be the result of any competitive interaction.

22. In Nutreco/Hydro the CC found that Canadian and Chilean salmon were not effective substitutes for European salmon because of the air freight costs (for fresh salmon), so were not considered effective substitutes. This view was supported by third parties in the context of this merger assessment. In particular, the majority of customers indicated that they do not and would not purchase Chilean salmon, because of the transport times involved; because it cannot be supplied fresh; and because it is perceived to be of a poorer quality. One third

party noted that the recent increases in oil prices have meant that transport costs for Chilean salmon are now even higher.

Other types of salmon and fish

23. In Nutreco/Hydro other fish species and other sources of protein were not considered substitutable for salmon because: on the supply side, salmon production had unique processes such that rapid substitution to another fish species was not possible; and on the demand side there was little evidence of short run responses to price changes between different fish species. The OFT did not find any evidence during the course of its investigation to suggest departing from this view.

24. As noted above, both the CC and EC have previously concluded that wild salmon constitutes a separate market from that of farmed salmon. The parties submitted that wild salmon is part of the same product market as farmed Atlantic salmon. To support this view they cited analysis of the Japanese salmon market which demonstrated that the prices of farmed and wild salmon were correlated over time. However, it is entirely possible that there are different consumer preferences in the Japanese and European markets. Furthermore, evidence from customers suggested that they considered that there was a significant distinction between wild and farmed salmon and did not consider the two were effective substitutes. In particular, wild salmon is more expensive than farmed salmon (up to 2-3 times); supply is seasonal; and there are concerns about the sustainability of wild Atlantic salmon stocks. At present, we do not consider that there is sufficient evidence to include wild salmon in the product scope.

25. With respect to organic salmon, there is no overlap between the parties in this segment. In any event, given organic salmon only represents a small proportion (approximately 1 per cent) of total salmon production, its inclusion in the product scope would not affect the analysis of the merger. Therefore, consistent with previous cases, organic salmon has been treated as being distinct from farmed salmon and has not been included in the product scope.

26. The OFT did not receive any evidence to indicate that any other types of farmed salmon should be included in the product scope (eg Coho, Chinook), albeit this does not make a fundamental difference to the analysis because of the small volumes farmed. This view is supported by the analysis undertaken in previous cases.

27. Finally, the OFT considered whether the market could be narrowed by production process, and in particular whether fish slaughtering could be considered a separate market. However, the parties do not undertake fish slaughtering for third parties nor contract out their slaughtering (although Marine Harvest is providing short-term slaughtering facilities to Pan Fish while they make structural changes

to their own facilities) and in Scotland all farmed salmon companies slaughter fish on-site. It is therefore not considered that fish slaughtering should be assessed as a separate frame of reference.

Conclusion

28. Based on the evidence available, in particular the strong correlation between the prices of Scottish and Norwegian salmon and third party feedback, the relevant frame of reference for the purposes of this assessment is consider to be farmed Atlantic salmon in the EEA. However, we note that there would appear to be a distinct set of customers who regard Scottish salmon as a differentiated premium product.

HORIZONTAL ISSUES

Smolts

29. While there is an independent sector producing smolts for sale to third parties, the majority of smolts are produced by vertically integrated farmers for their own use. In this instance, both Pan Fish and Marine Harvest produce smolts internally,[6] which they say is intended only for their own fish farming activities. The parties told the OFT that neither party anticipates being a purchaser or seller of smolts either now or in the future. They submitted that trading on the open market is limited to sales of surplus smolts or purchases of smolts when there is a shortfall (for example, Marine Harvest made an emergency purchase of [ ] smolts to replace smolts lost due to storm damage in January 2005). Neither Pan Fish nor Marine Harvest sold smolts in the UK in 2005, and Fjord sold [ ], less than 1 per cent of smolts sold on the open market.

30. Given that neither of the parties are actively engaged in the sale of smolts and their relatively small share of supply of smolts in the open market, the merger is not considered to give rise to competition concerns at the horizontal level. The impact of the merger at the vertical level is considered further below.

Salmon

Share of supply

31. The parties are the two largest salmon producers in the EEA. Post-merger the parties submitted that they will have a combined share of supply of farmed Atlantic salmon of approximately [25-35] per cent (increment [5-15] per cent) in the EEA. However, this share of supply estimate is based on a total sales figure which also includes some imports of Chilean salmon (which are not included in the

[6] Fjord does not produce smolts internally, but buys them from independent third parties

frame of reference). Therefore, the parties' actual share of supply may be higher. For example, if the parties' share of supply is limited to sales of Scottish and Norwegian salmon only, it rises to 36 per cent in the EEA. The large number of remaining farmed salmon suppliers in the EEA are all significantly smaller than the parties, with only one supplier (Leroy[7]) achieving a share of supply greater than 3 per cent. As a result of the merger the HHI will rise from 820 to 1360, representing a significant increase (67 per cent) in concentration.

32. The parties' share of supply of Scottish salmon is approximately 43 per cent in the EEA (by volume). Together they account for 47 per cent of total Scottish salmon production. The next largest producer is Scottish Seafarms[8] which produces 19 per cent of Scottish salmon harvesting volume.

33. It is also worth noting that the Pan Fish volumes used in the above share of supply estimates are currently lower than their long-term level. Pan Fish output has been reduced in recent years due to financial difficulties (the company was restructured in 2002 as it could not service its debt) and major disease problems. Production volumes were [ ] in 2001 and fell to around [ ] in 2004 and 2005. Pan Fish internal documents and the parties' submission suggest that Pan Fish's estimated production (absent the merger) is expected to recover in 2006, and by 2008 will be between [ ] and [ ] tonnes. Thus in future Pan Fish might be expected to be an even stronger / larger competitor to Marine Harvest than reflected by the current market shares.

34. The parties submitted that the expected increase in production needed to be viewed in the light of several other factors. Firstly, these figures include growth in Canada (from 4,500 tonnes to 26,000 tonnes), which will have no impact on sales in the EEA. Secondly, all Faroese producers had been hit by the ISA virus which almost wiped out 2005 production, and therefore not only Pan Fish but also other companies in the Faroese will see an increase in production between now and 2008. Thirdly, some of the increase has come from consolidation and expansion at existing Pan Fish sites and the parties also believe that their rivals will be increasing their own output. They argued that given these factors there was no reason to expect that Pan Fish's share of the market would necessarily increase absent the merger, even though its global production of salmon would be expected to increase. Nonetheless, it may still be reasonable to expect an increase in Pan Fish's production levels in future years, absent the merger.

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[7] The parties submitted that Leroy's share of supply was approximately 11 per cent. However, this share of supply would appear to be inconsistent with Leroy's share of EEA salmon production, which is approximately 3.3 per cent (Source: Kontali Analyse, Salmon World 2006), as compared to the parties share of 32 per cent. While this estimate does include the production of some other species of salmon (namely, big trout), the vast majority of total volumes, 91 per cent, are attributed to Atlantic salmon

[8] In which Leroy holds a 50 per cent stake

35. Overall, the merger represents a significant increment to the parties' share of supply, and therefore puts significant distance between them and the remaining competitors in terms of production volumes and economies of scale.

Competitive constraints

36. It takes approximately two years to grow a salmon ready for harvest, so farms typically plan and set production levels at least this far in advance. When the salmon are harvested, prices are negotiated bilaterally with customers on a daily basis. This negotiation happens primarily on the spot market, although some three, six or 12 month fixed contracts are negotiated (which may have some linkage to the spot price). Competition primarily occurs on quantity, with the market clearing price being set at the point where demand meets supply on that particular day.

37. It would appear that the parties are close competitors, particularly in relation to Scottish salmon. This is confirmed by responses from third parties, and previous competition inquiries where Nutreco has cited its largest competitors as Stolt, Pan Fish, Fjord and Cermaq. It may be the case that by virtue of their size (and thus efficiency and ability to meet round year demand[9]), relative to other suppliers, the parties are each others strongest competitors, especially in relation to the supply for larger customers.

38. A significant number of third parties raised concerns about the merger. The major concern, raised by several of the parties' largest customers (amongst others), was that switching away from the merged entity would not be possible as smaller suppliers would be unable to cope with the demand. For large customers, switching away from Pan Fish may necessarily involve switching to a portfolio of smaller suppliers (which may itself involve additional costs). Many third parties also raised concerns that the remaining suppliers would simply follow any price increases instigated by the parties. For example, one customer suggested that if a major player like Marine Harvest raises prices, the smaller farms do the same, as they do not have the available spare product to supply the customers that wish to switch away from the larger producers.

Short term

39. The parties argued that buyers of salmon in the UK are typically large sophisticated companies which multi-source across a range of suppliers. They submitted that despite their large size, customers rarely purchase more than [ ]

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[9] In Nutreco/Hydro the CC found that a larger multi-site operation was better able to plan and phase production all year round and could still deliver harvested fish should particular sites be unable to produce, for example because of storms. See para 4.142

tonnes in a year from any single supplier. For example, the parties between them had only [ ] UK customers that took over [ ] tonnes in 2005. The parties contended that all but the very smallest of rivals would be capable of supplying customers of this scale and that customers have proven themselves willing and able to switch in response to differences in prices, quality or terms in the past.

40. In order for the above argument to hold, competitors would need to be able to adjust capacity to respond to the increased demand arising from customers switching away from the parties. However, at least in the short term (two years), competitors are unable to increase capacity – since they are limited by the growth patterns of current fish stock – and they will either have to refuse to supply these new customers, or instead supply them in preference to their current customers, who themselves would then need to seek alternative sources of supply. Evidence from third parties therefore suggests that, if demand cannot be satisfied by other suppliers, the merged party will essentially be a residual monopolist. In this case, the merged entity would be expected to take residual demand (i.e. that demand which cannot be served by smaller competitors) and set a monopoly price to those customers. As competitors cannot increase supply in the short term, they will also be in a position to raise prices.

41. The parties submitted that they would not seek to restrict supply, and thereby increase prices, in the short term as the costs involved over the 2-3 year lifecycle would be wasted. However, these costs are sunk and the parties would be expected to maximise profits according to their marginal costs and revenues, which will only involve the costs of processing (which account for approximately 9 per cent of production costs). The parties responded by arguing that the opportunity cost of withholding the salmon is very close to the full price of the fish. Thus, the resulting large opportunity cost of destroying, rather than selling the fish, clearly makes the likelihood of withholding production a less rather than more profitable strategy.

42. They further submitted that each site has a set level of standing biomass consent which it is illegal to exceed. Harvesting of fish could therefore not be significantly delayed because biomass consent levels would be exceeded. Delaying harvest also jeopardises the saleability of fish as they need to be within a specific size and weight range. Moreover, a certain percentage of fish (between 3-20 per cent) reach sexual maturation after about 18 months in the sea at which time salmon flesh loses colour and becomes less firm, resulting in a significantly downgraded price. Freezing fish would only delay the sale of output and building suitable freezing stores would be costly.

43. Given this, the parties considered that the only strategy which could actually remove fish from the market would be to simply destroy large quantities of fish (i.e. through landfill). They submitted that this would not only be an expensive

strategy, but would also be a very difficult and unpalatable to carry out in practice, given that it would be highly transparent and politically sensitive.

44. Despite the arguments made by the parties, restricting supply would still appear to be an economically rational decision if it results in sufficiently high prices. For example, it may be more profitable to sell 70 per cent of production at a higher price, than 100 per cent at a lower price, even once the costs of withholding or destroying are taken into account. Apart from the biomass constraints, there is nothing legally preventing the parties from pursuing such a strategy. Furthermore, the parties do not appear to have considered the possibility that the destroyed fish could be sold for lower value purposes and thus recover some of the costs involved.

Long term

45. We also considered whether competitors would have the incentive and ability to increase production in the longer term in response to a price increase. Production in the salmon farming industry depends on both the capacity of processing plants and the availability of suitable farming sites and licensing consents. It appears that there is some unused or underutilized capacity in the industry, although it is difficult to assess how much and at which level of the supply chain this exists (if at all).

46. The parties submitted that primary processing capacity is not fixed, and that it can very easily be increased or decreased, for example, by increasing the number of shifts or by processing six days a week (although the parties were reluctant to accept that they would be able to increase such capacity in Scotland – due, they said, to the remoteness of the plants and lack of local labour). The parties own six out of an estimated 70 processing plants in Norway, and say that they have excess capacity. In Scotland they stated that they own three out of at least seven salmon processing plants. However, the extent of any excess capacity at these remaining processing plants is unknown. It is worth noting that while Pan Fish submitted that it did not have any long term plans regarding capacity, internal documents about the merger suggest that [ ].

47. With regards to salmon farming site capacity, the parties submitted that competitors, particularly in Scotland, have significant ability to expand their production at existing sites. It is difficult to assess the extent of excess capacity in the industry. Evidence from the parties suggests that there may be excess capacity as site utilisation rates are estimated at around 50 per cent. Notwithstanding this estimate, it is however unclear what the maximum sustainable utilisation rate is. The parties indicated that Pan Fish could achieve utilisation rates of [ ] per cent in Scotland and [ ] per cent in Norway. They further submitted that according to current biomass limits, there could be up to 138,000

tonnes of spare capacity in the hands of competitors (i.e., greater than the total 2005 production of Scottish salmon).

48. The above capacity utilisation figures are in line with those reported by the EC Commission Regulation on provisional anti-dumping duties (2005) which indicated that capacity utilisation has not exceeded 56 per cent in any year since 2001. Therefore, this theoretical excess capacity has existed over a long period despite changes in demand conditions and price increases. This suggests that these estimates may have little competitive relevance (the EC also reported that it did not find the estimates meaningful).

49. The parties argued that competitors would be able to identify and respond to any reduction in production volumes. The parties told us that overall industry data is kept on smolt release as well as vaccinations and feed sales, and therefore competitors would be able to adjust future production in response to any attempt by the parties to restrict supply over the longer term. However, it is unclear whether competitors would have the necessary incentive to engage in such a response. Given the nature of the industry, excess or increased levels of production are usually associated with lower prices (e.g. supply exceeds demand and therefore the market clears at a lower price), therefore, lower smolt release could be viewed as translating into higher prices in two years time.

50. Furthermore, even if there is excess capacity and competitors can increase long run supply, the total quantity of salmon produced may be expected to fall as a result of the merger. Smaller suppliers may not be as efficient as the parties due to their lack of scale (this may be one reason why their shares of supply are comparatively low). Therefore, if competitors were to increase production, this may not be sufficient to restore competition to its pre-merger level since they may face a higher cost of production (i.e. the cost of being less efficient).

51. As noted above, customers raised concerns that the remaining suppliers were more likely to follow any price increases instigated by the parties, rather than compete. Some third parties believed that the parties were effectively price setters in the sector, with smaller rivals having neither the ability nor incentive to respond to a price increase. One third party suggested that smaller farmers were 'privately cheering' the merger as prices will increase.

52. These responses suggest the intensity of competition which existed in the sector occurred predominantly between the parties. This would appear to be consistent with the EC assessment of the Marine Harvest JV. In this case the EC did not find that the merger would significantly affect competition, citing that a number of competitors to Marine Harvest would remain post-merger: Pan Fish, Fjord and Leroy. However, following subsequent consolidation in the industry, the number of 'larger' suppliers will be significantly reduced to that of the parties, and

possibly Leroy, post-merger. As a result, if smaller players are inclined to 'follow' any price increases rather than increasing production, the merger could be expected to lead to a significant reduction in competition, both over the short and longer term.

Scottish salmon

53. As discussed above, we concluded that there appeared to be a segment of customers who are unwilling (or unable) to substitute Norwegian salmon for Scottish salmon. We therefore considered whether the merged entity might be able to identify and target price increases to customers who have a distinct preference for Scottish salmon.

54. Similar concerns were raised in the Nutreco/Hydro case. In that instance, the CC concluded that price discrimination was possible, and while some large retailers might be able to resist price increases, they may choose to pass them on to (the relatively price-insensitive) consumers of Scottish salmon. Smaller retailers on the other hand would be forced to accept price increases and pass them on. While some consumers could switch to larger retailers, the CC thought that, on balance, small retailers and some consumers would lose out. Third party evidence suggests that this merger may give rise to similar effects. A number of customers told us that they have a policy of only sourcing Scottish salmon, and that smaller suppliers cannot cope with their demand.

55. Different customer types have different preferences: smokeries, niche secondary processors, some supermarkets, and in particular Scottish consumers appear to have distinct preferences for Scottish salmon over salmon from other origins. On the other hand, food service / catering customers appear to be particularly price sensitive and willing to substitute between different salmon types to keep costs down. The OFT has not seen disaggregated price data to assess whether different customer types are, on average, charged different prices. However, it is recognised, not least by the parties, that Scottish salmon can carry a price premium (see paragraph 59).

56. Customer preferences can therefore be ascertained to some extent by an observable characteristic (the nature or location of the customer's business). Furthermore, it might be expected that the price sensitivity of certain customers could be established through the process of negotiation (in that customers who are indifferent between Scottish and Norwegian salmon have a stronger negotiating position). The parties themselves have acknowledged in the course of the OFT's investigation that customers with a preference for Scottish salmon can, to some extent, be identified.

57. However, the parties argued that price discrimination was not an economically credible strategy and that these customers are likely to be difficult to target in

practice. Firstly, because they can be difficult to identify (particularly where customers are engaged in more than one use of salmon) and multi-source their requirements. Secondly, even those who could be identified could be protected by customers for the large volumes of Scottish salmon that would be prepared to switch to Norwegian salmon.

58. In relation to this second point, the parties claimed that any 'captive' Scottish salmon customers would form a relatively small proportion of a wider group of customers who currently purchase Scottish salmon, but would be willing to switch (termed 'flexible' customers). Given this, they submitted that the following chain of events would occur:

    a. following a price increase the parties captive customers would attempt to source Scottish salmon from other (cheaper) competitors

    b. those rivals would then find it profitable to switch away from supplying some of their existing customers in order to supply these captive customers. In turn these displaced customers will turn to other sources of supply, such as the parties, but as they are flexible customers it will not be possible to charge them the higher Scottish price as they can threaten to switch to Norwegian salmon

    c. competition between the different rival Scottish suppliers would therefore drive down the price paid by these captive customers towards a generally prevailing Scottish price paid by flexible customers. Given that captive customers only take up a small part of the overall market, rivals should have more than sufficient production to meet their demand

    d. at the end of this process, nothing has substantially changed. Captive customers are being supplied by rivals, while the merged firm will be supplying only flexible customers. Prices will not have changed.

59. There are a number of reasons why we do not consider the above theory to be credible in this case. Firstly, it relies on the assumption that competition is effective within the wider EEA market for farmed Atlantic salmon. Secondly, it assumes that the alternative competitors would be a cheaper source of supply; this may not necessarily be so. Thirdly, if such a process of arbitrage were to exist, it would be difficult to explain the premium between Scottish and Norwegian salmon. At present Scottish salmon commands, on average, a 30-50 Euro cent premium over Norwegian salmon. However, it would appear that actual premium charged to individual customers varies, with some customers not paying a premium, while others pay a higher premium. Therefore, it may be the case that price discrimination is already occurring on some level. While the process of arbitrage outlined by the parties may offset the ability of the parties to price discriminate to some degree, it would not appear sufficient to prevent the parties from currently charging higher prices to customers with a distinct preference for

Scottish salmon. To the extent that any price differential is constrained by the competition between the parties – and the comments of customers would suggest that it is - then this will be lost as a result of the merger.

Recent price increases

60. Several third parties also indicated that they believe salmon prices have already increased as a result of the anticipated merger. One customer told the OFT that it was already seeing significant supply shortages and upward cost pressure, which they attributed to the merger, and which they believe will inevitably lead to increases in retail prices. Another customer told the OFT that since the takeover prices had risen by over 40 per cent and that their view was that monopoly power is being used to push through these prices. A different customer, who only buys Scottish salmon, told us [ ].

61. The parties submitted that while there have been significant price increases in 2006, it was incorrect to interpret these as a result of the merger. Firstly, the parties are currently prohibited from implementing the merger and are continuing to operate as independent entities. Second, the price increase was a result of demand being greater than expected when the decisions on current production were taken. They submitted that prices began to increase in 2005 due to low smolt release in 2003 and continued to rise in 2006 reflecting a further smolt release in 2004.[10] The supply situation was tightened further by storms in both Scotland and Norway in 2005 which destroyed a significant number of fish. This reduction in supply has been combined with an increase in demand due to, for example, healthy eating considerations and concerns in relation to other food sources (e.g. avian influenza).

62. The OFT notes the third party concerns in relation to claimed merger related price increases and the response of the parties. At this time, the OFT considers that the evidence in relation to the price increases and its relationship with the merger are inconclusive.

Nutreco/Hydro – previous comments made by the CC

63. In its report on Nutreco/Hydro the CC identified a number of competition concerns in relation to the merger. In particular, they identified strong concerns regarding its effect on the market for aqua feed, but they also identified concerns in relation to potential price discrimination against purchasers of Scottish salmon. The CC considered that with an EEA-wide share of Atlantic salmon of 15.5 per cent, the merged entity would not be in a position to exercise market power at the European level. However, in their conclusions the CC stated:

[10] In the UK there was a 12 per cent reduction in smolts released in 2003, compared with 2002, and a further 7 per cent reduction between 2003 and 2004

'We have concerns about the further growth of Nutreco within the UK context, given its already strong position in the feed market and the enhanced position that it would gain as a result of the merger in the gutted salmon market. If Nutreco's market share were to reach 25 per cent at EEA level, then we would have concerns about possible further effects in the UK.'[11]

64. The parties submitted that the CC's comments in the Nutreco/Hydro case were clearly made in relation to the vertical concerns arising from that merger – the combination of a significant feed producer with a salmon farmer. They considered that such concerns did not arise in the present case, which in fact removes the structural link between feed and salmon in relation to Marine Harvest. The parties therefore argued that the CC's comments were inapplicable in this case and cannot, in any event, be interpreted as a rule of thumb for all horizontal mergers in the salmon sector.

65. It is true that the CC's statement is somewhat ambiguous and it has not been possible to determine how strongly this conclusion is linked to the vertical concerns identified by the CC. However, irrespective of whether the CC's statement was intended to apply to horizontal mergers, the concerns identified in relation to this merger and set out above remain valid, even in the absence of the CC's report.

Conclusion

66. Given the factors outlined above, we consider that, absent any constraints in the form of entry and expansion or buyer power (discussed below), the merger may give rise to a substantial lessening of competition in the UK both in the short and long term. In particular, the merger may be expected to lead to an increase in price or decrease in quality for farmed Atlantic salmon in the EEA, thus harming UK consumers. This substantial lessening of competition would be felt more acutely amongst the segment of customers with a distinct preference for Scottish salmon, as post-merger the parties may be able to target additional price increases to these customers. In the presence of a two year constraint on changes in output levels, the short term the effects of the merger are exacerbated.

Barriers to entry and expansion

67. The parties estimate that the cost of entry to the EEA farmed salmon market, on a scale necessary to gain a five percent market share, would be approximately £44 million. The parties submitted that the minimum efficient scale for a Scottish salmon farmer is 3,000 – 5,000 tonnes involving a cost of around £3.7 - £6 million. In addition to these costs, the process of applying for licenses may represent a barrier to entry.

[11] See paragraph 2.133

68. An application for a new salmon production site in Scotland requires three separate permissions: a seabed lease from the Crown Estate; a Development Consent which is granted with the seabed lease (although this may soon be issued by Local Authorities); and an authorization to discharge trade effluent from SEPA. The application process takes approximately nine months. However, the entire development process can take from 18 months to two years, as consultation with regulators and other stakeholders is recommended, and an Environmental Impact Assessment and other surveys need to be carried out.

69. In Norway, licences can be granted within six months. The Fishery Authority announces the availability of new licences after the Norwegian National Budget and invites applications. The licences issued in 2004 cost the equivalent of £600,000.

70. The parties told the OFT that in the last three years Marine Harvest has made a number of successful applications for licences. Fjord has acquired one licence in Scotland and one in Norway. In 2005 three applications for new sites were received by the Crown Estate (one by Marine Harvest and one by Fjord Seafood). Since June 1999 nine new salmon farms have been approved for development consent in Scotland (the last approval was in July 2002). The parties gave us details of 21 licences that had been granted in Norway between 2004 and 2006.

71. We have not identified any examples of recent new entry in the sector. The above evidence suggest that new entry would be difficult: there are high investment and working capital costs; revenue streams would not be earned for two to three years; and applying for a licence seems to be time-consuming and not straightforward.

72. Expansion by current salmon farms is a more likely scenario. The parties submitted that, given that both the Scottish and Norwegian fish farming sectors are characterised by large numbers of independent suppliers with spare capacity, any attempt to increase prices would result in expansion by these competitors. It is possible that competitors could increase production, as there appears to be some underutilised or unused sites. However, as discussed above, it is unclear how much usable spare capacity currently exists in the sector and whether competitors would have the necessary incentive to expand.

73. Based on the evidence available, barriers to new entry would appear to be high. Furthermore, it is questionable whether sufficient incentive exists for existing players to expand production on a sufficiently large scale to offset the effects of loss of competition between the parties.

Buyer power

74. The parties submitted that as trading negotiations take place by phone on a daily basis, customers may choose their preferred supplier daily and as a result, buyer power is exercised often. Some examples of customer switching, both between Pan Fish and Marine Harvest and other competitors were provided. The parties also gave examples of customers negotiating better contracts.

75. Based on information supplied by the parties, smokeries account for [ ] per cent-[ ] per cent of total sales. This group of customers tends to have a particular preference for Scottish salmon, so they may have limited alternative sources of supply. The parties also sell a large proportion of volumes to retailers, wholesalers and the food processing industry. It is possible that there is some buyer power within some of these chains of distribution, as large supermarkets and the food catering industry might be able to resist price increases to some extent. However, it could be expected that smaller retailers will be in a worse negotiating position post-merger.

76. A number of customers expressed concerns regarding the reduction in the number of suppliers post-merger, particularly with regards to Scottish salmon. Some stated that switching business to different salmon suppliers is extremely difficult, for example due to the limited availability of the raw material. They considered that the merger would limit the supply of salmon, which would have the effect of increasing prices. Several other customers (particularly large customers) indicated that in the event of a price increase, while it may be possible to switch some volume to alternative sources of supply, the remaining competitors were not of sufficient size to supply the volumes needed. Therefore, customers would not be able to switch away entirely.

77. The parties submitted that only small number of customers accounted for a large proportion of their sales,[12] with most large buyers multi-sourcing and splitting their volume between the several buyers. The parties argued that even if customers switch only a small part of their total volume from one supplier to another, this would leave that supplier with a large quantity of fish that it would be forced to dispose of in the spot market. A number of customers indicated that they did multi-source, but often the bulk of their supply was provided by Pan Fish or Marine Harvest. In some instances, the parties represented both the primary and secondary sources of supply. This was particularly the case where the customers demonstrated a preference for Scottish salmon.

78. The existence of concerns at all levels of the supply chain, including from the largest customers and major supermarkets, could be taken to suggest that there is

[12] For example, 6 out of 62 Marine Harvest UK customers account for 80 per cent of revenues, and 3 out of 52 Pan Fish UK customers account for 50 per cent of Pan Fish revenues

insufficient buyer power to mitigate the expected competitive effects of the merger. The exercise of buyer power also requires sufficient alternative and credible choices for customers to switch to. In the short-term, supply volumes are essentially fixed. Therefore, the ability to switch would be limited as competitors would have to stop supplying one customer in order to meet the demands of another. Over the longer term, switching may become a more credible option. However, this relies upon competitors expanding production to accommodate new customer volumes. As discussed above, it is questionable whether such expansion would occur. Therefore, countervailing buyer power would appear to be insufficiently strong to offset the competition concerns identified.

VERTICAL ISSUES

Aqua feed

79. Previous cases have concluded that the supply of aqua feed[13] is a national market. This view was supported by third parties. Neither of the parties produces or supplies aqua feed. However, following the merger they will be one of the largest purchasers of aqua feed. Of 190,000 tonnes of aqua feed sold in the UK in 2005, the parties purchased [ ] tonnes ([ ] per cent).

80. The parties submitted that, as the feed industry is concentrated, the larger feed suppliers have significant bargaining power in relation to UK salmon producers. In particular, they argued that the larger the salmon producer, the less ability it has to switch large contracts to other suppliers. Furthermore, they submitted that it is necessary to have multiple suppliers because of security of supply issues and that the larger feed suppliers tend to be 3-4 per cent less expensive that the medium sized suppliers.

81. Third party views on the effect of the merger in aqua feed were mixed. One third party was concerned that the merger may affect its margins, but also felt that consolidation in the UK salmon industry should be welcomed as it lowers the costs of production. Another third party expressed concerns that the merger may incorporate a long term feed contract with Skretting (a subsidiary of Nutreco, who previously owned 75 per cent of Marine Harvest), which could worsen trading conditions, possibly leading to feed mill closures and a less competitive market which would harm smaller farmers.

[13] The CC considered that salmon and trout feed, which are manufactured on the same production lines, are in the same product market. This market was not considered to include other animal feed. The geographic market was thought to be UK wide as less than 5 per cent of supply in the UK was represented by imports (see *Nutreco/Hydro*). The EC also found that there were national markets for aqua feed (see *Marine Harvest JV* decision)

82. However, all three companies have already contracted with Skretting for the vast majority of their feed supply; therefore it does not appear that competition in the aqua feed market will be significantly affected as a result of the merger. Furthermore, we found no evidence to suggest that any long term supply agreements have been made in connection with the sale from Nutreco to Pan Fish. As customers, the parties also have an incentive to ensure that multiple sources of aqua feed remain post-merger.

Smolts

83. The parties estimate that 10.5 million smolts were supplied on the open market in the UK in 2005. Of this amount, Pan Fish Scotland purchased [ ] million, Fjord purchased [ ] million and Marine Harvest purchased [ ] million, in total equivalent to [ ] per cent of UK smolt production (sold in the open market).

84. One third party expressed concerns that the merged entity will effectively be a monopsony buyer of smolts. Post-merger the parties may be in a stronger negotiating position regarding the procurement of smolts. However, as noted earlier, the parties purchase only a small proportion of their smolt needs on the open market, as they produce most in house and only sell on to the open market when there is a surplus (less than 1 per cent in 2005). Furthermore, there would appear to be a number of other salmon farmers present in the market who buy smolts from independent suppliers.

85. We also considered whether the parties might exploit their position by supplying smolts to independent salmon farmers, in order to weaken independent smolt farmers and eventually threaten smolt supply to competitors in the farmed salmon market. However, the smolt market is not as commercially attractive as the farmed salmon market; all of the parties' UK-based competitors have in-house smolt production facilities; and the parties rely on independent smolt farmers in emergency situations. Therefore, the parties' incentive to attempt to reduce rivalry in the smolt market post-merger would appear to be limited.

THIRD PARTY VIEWS

86. Third parties raised a number of competition concerns regarding the merger, which are discussed in greater detail above. In particular, customers both at the wholesale and retail level expressed concerns about possible price increases and lack of choice post-merger. Competitors did not raise any concerns about the merger.

87. A number of third parties also raised concerns about the impact of the merger on employment in Scotland and the environment. These matters are not relevant to the OFT's competition assessment in this case and have not been taken into account.

ASSESSMENT

88. The parties overlap in the production of salmon. The relevant frame of reference is considered to be the supply of farmed Atlantic salmon in the EEA. However, there would also appear to be a segment of customers who demonstrate a distinct preference for Scottish salmon, and are unable or unwilling to switch to other types of Atlantic salmon (i.e. Norwegian salmon).

89. The parties are the two largest producers of salmon in the EEA and post-merger they will have a combined share of supply of Atlantic salmon of between [25- 35] per cent and [30-40] per cent (increment between [5-15] per cent and [10-20] per cent) in the EEA, and a combined share of Scottish salmon of approximately [40-50] per cent (increment [10-20] per cent) in the EEA. The parties would appear to be each others closest competitors and the remaining players in the sectors are substantially smaller. The merger therefore represents a significant increment to the parties' share of supply and puts significant distance between them and the remaining competitors in terms of production volumes and economies of scale.

90. Short term competitive constraints on the parties' behaviour post-merger would appear to be limited, as competitors are unable to adjust output volumes for at least two years. The parties have argued that they would not restrict output in the short term (and thereby raise prices) by destroying fish as the opportunity costs of the 2-3 year lifecycle were significant, and such a strategy would be unpalatable. However, there are no major legal impediments to restricting supply and to do so would remain economically rational where prices were sufficiently high.

91. Over the longer term, the parties argued that competitors would expand production by utilising the significant excess capacity which exists in the sector. However, it is unclear whether competitors have the ability or incentive to use this spare capacity. Furthermore, even if competitors did respond by increasing production, we do not believe that this would be on a sufficiently large enough scale to offset the loss of competition arising as a result of the merger.

92. It is considered that the parties could identify those customers with a preference for Scottish salmon either by observable characteristics or through the process of price negotiation. The parties themselves admit that customers with a preference for Scottish salmon can, to some extent, be identified. As a result, the merged entity may be able to target price increases to these customers. Therefore, we consider that the loss of competition identified would be felt more acutely amongst this segment of customers.

93. 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 OF REFERENCE

94. Where the duty to make a reference under section 33(1) of the Act is met, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, accept from such of the parties concerned undertakings as it considers appropriate for the purpose of remedying, mitigating or preventing the SLC concerned or any adverse effect which has or may be expected result from it.

95. The OFT has therefore considered whether there might be undertakings in lieu of reference which would address the competition concerns outlined above. The OFT's guidance on undertakings in lieu of reference 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.'[14]

96. In lieu of reference to the Competition Commission, the parties offered the following alternative divestments packages:

    a. [ ]

    b. [ ]

    c. [ ].

97. The proposed divestments would have the effect of reducing the parties' production capacity in Scotland to a level similar to that which might exist on the part of one of the parties absent the merger. However, the impact of the divestment on the parties share of production (and thus sales) of farmed Atlantic salmon on an EEA wide basis is less clear. In particular, we did not consider that a reduction for all of the options offered in the parties combined share of supply of farmed Atlantic salmon in the EEA by a decrement of less than [0-5] per cent would be sufficient to remove the competition concerns outlined above. In light of this, we are of the view that it is not sufficiently clear that acceptance of the parties proposal would remedy, mitigate or prevent the competition concerns identified. On this basis, the OFT rejects the parties' proposed undertakings in lieu.

DECISION

98. This merger will therefore be referred to the Competition Commission under section 33(1) of the Act.

[14] See Mergers Substantive Assessment guidance para 8.3