Completed acquisition by Cott Beverages Limited of Macaw (Holdings) Limited

The OFT's decision on reference under section 22 (1) given on 28 November 2005. Full text of decision published on 12 December 2005.

Please note that square brackets indicate information that has either been excised or replaced by a range at the parties' request.

PARTIES

1. **Cott Beverages Limited (Cott)** is the UK subsidiary of Cott Corporation. It supplies own label and branded soft drinks, both carbonated and still, to multiple grocery retailers, independent cash and carry retailers and wholesalers.

2. **Macaw (Holdings) Limited (Macaw)** was a privately owned UK soft drinks manufacturer with a turnover of £[CONFIDENTIAL]. It supplies multiple grocery retailers with soft drinks, both carbonated and still.

TRANSACTION

3. On 10 August 2005, Cott acquired 100 per cent of the shares of Macaw for £75.7 million.

4. A satisfactory submission was received on 5 September 2005 after 5pm. Cott gave initial undertakings under section 71 of the Enterprise Act 2002 (the Act) on 14 November 2005. The statutory deadline for deciding whether to refer the merger to the Competition Commission is 3 January 2006 and the OFT's administrative deadline is 30 November 2005.

JURISDICTION

5. As a result of this transaction Cott and Macaw have ceased to be distinct enterprises. Since the parties' combined share of supply of own label carbonated soft drinks (CSDs) is 57 per cent (increment 21.3 per cent), the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. The OFT therefore

believes that it is or may be the case that a relevant merger situation has been created.

AREAS OF OVERLAP

6. The parties overlap in the manufacture and supply of dilutes, still drinks and CSDs.

Dilutes and still drinks

7. The dilutes segment includes squashes and cordials. Cott and Macaw overlap in the production and supply of dilutes but Macaw only entered this segment in late 2004. The parties' combined UK share of supply for dilutes is [5-10 per cent] (increment [<1 per cent]).

8. The still drinks segment encompasses a range of drinks from uncarbonated non-fruit drinks to juices with up to 25 per cent fruit content. Cott maintains that the parties' UK combined share of supply of still drinks is [5-10 per cent] (increment [0-5 per cent]).

9. Only one third party raised a concern, in relation to dilutes, but it was not supported by any evidence. Given third party reaction and the share data, the OFT does not believe that there is a realistic prospect that the transaction will lessen or has lessened competition substantially in either of these sectors and they will not therefore be considered further.

Carbonated soft drinks

10. The European Commission has considered the soft drinks segment on a number of occasions.[1] It has generally distinguished CSDs from other non-alcoholic beverages and noted a possible distinction between cola and non-cola CSDs.

Branded carbonated soft drinks

11. Each of the parties produces branded CSDs. Their UK combined share of supply of branded CSDs is low (approximately [0-5 per cent]) and the increment is of less than [<1 per cent]. In the absence of third party concerns and in view of the very low combined share of supply and increment, the OFT does not believe that there

[1] *Case No COMP/M.2504 Cadbury Schweppes/Pernod Ricard*, 29 October 2001; *Case No COMP/M.2276 The Coca Cola Company/Nestlè/JV,* 27 September 2001; *Case No IV/M.833 The Coca Cola Company/Carlsberg A/S,* 11 September 1997.

is a realistic prospect that this element of the transaction will lessen or has lessened competition substantially and therefore it will not be considered further.

Own label carbonated soft drinks

12. A very large proportion of the parties' production capacity[2] is allocated to the supply of own label CSDs.

13. In the UK, a relatively high proportion of the overall CSDs market is accounted for by own label products (although the volume share has declined from 28.3 per cent of volume in 2000 to 25 per cent in 2004 in the UK).[3] All leading grocery retailers offer their own ranges of CSDs and some segment their ranges by different degrees of quality. The manufacture and supply of own label CSDs is contracted out to companies such as Cott and Macaw.

14. According to third party comments, the own label segment has been price competitive and offers low margins to the suppliers. Prices have been declining over the past five years and the consolidation of the retail segment has resulted in increased contract volume requirements.

Procurement

15. Cott maintains that the inputs used for the production of own label CSDs are the same as those used for branded CSDs, and they are also common to the production of other types of non-alcoholic beverages. Given that the parties' combined share of supply of all CSDs is [10-20 per cent], their combined share of purchasing of any inputs is therefore less than [10-20 per cent]. In view of this and in the absence of third party concerns, the OFT does not believe that there is a realistic prospect that this element of the transaction will lessen or has lessened competition substantially and therefore it is not considered further.

MARKET DEFINITION

Product scope

16. Cott presented a number of arguments to support its contention that branded and own label CSDs are part of the same frame of reference. First, own label and branded CSDs are displayed in retail outlets alongside one another. Second, both products are substitutes from the supply side due to the fact that the production process is identical. Third, there is demand side substitution between both segments which is evidenced by the fact that 'buy one get one free' (BOGOF) promotions at the retail level lead to a reduction in the sales of own label products

[2] [CONFIDENTIAL] of Cott's volume and [CONFIDENTIAL] of Macaw's.
[3] Mintel Carbonates, February 2005 page 27.

during the promotional period. Cott claims generally that prices of branded CSDs constrain prices of own label CSDs, but it has not provided any convincing evidence to support this claim. It has also produced some anecdotal evidence such as tests showing that consumers cannot differentiate branded and own label products when performing a blind tasting, as well as some general information on switching between branded and own label products not specifically applicable to CSDs.

17. Previous OFT decisions have analysed branded and own label substitution, but the focus has tended to be on whether own label products constrain branded products, rather than the converse as is the case here, and therefore these past cases provide little guidance. The competitive constraint exerted by the supply of own-label products on the supply of branded products varies across products and sectors depending on, amongst other factors, the importance of branding. In this case, there are a number of factors which suggest that the price of branded CSDs does not constrain the price of own label CSDs and that own label and branded CSDs should be analysed under separate frames of reference.

18. At the wholesale level, grocery retailers do not opt between having own label CSDs or branded CSDs; rather, they tend to offer a full range of branded products and to have own label options available as well. There is not enough evidence that supermarkets would switch a sufficient amount of their procurement between own label CSDs and branded CSDs in the event of a small but significant non-transitory price increase to suggest that the products should be included in the same frame of reference. Also, it does not necessarily follow from the fact that branded and own label CSDs are displayed side by side that they are part of the same relevant market – retailers may simply be attempting to meet their potential consumer needs by offering a full range of products.

19. On the supply side, although the production processes of branded and own label CSDs are identical, the producers of major CSDs brands do not serve the own label segment. Indeed, major branded suppliers do not bid for own label supply contracts, and [CONFIDENTIAL].

20. At the retail level, the evidence of customers switching from own label CSDs to branded CSDs during BOGOF promotions is of limited evidential value in demonstrating substitutability between those products for the purposes of competition analysis. Substitutability between two products for such an analysis is assessed on the basis of the response by customers to a small but significant non-transitory price increase; a short-term 50 per cent discount in the price of branded CSDs is too big a difference to indicate the closeness of substitutability between branded and own-label CSDs because, due to the price differential between those products, such a discount will be out of all proportion to a 5-10

per cent price increase of a own label CSD. Cott also provided volume and price data which it claimed showed a competitive interaction between branded and own label CSDs. OFT analysis of the data on the two ranges of products did not indicate any statistical relationship consistent with close substitutability. Third party responses and customer surveys suggest that, due to the price differential between the two different categories of product and to the small proportion of customers that believe that own label CSDs are of similar quality to branded ones, customers are not likely to switch from own label to branded CSDs following a small but significant non-transitory increase in the price of own label CSDs. The limited evidence provided by the parties is not enough to suggest otherwise. Even if own label and branded CSDs were close substitutes at the retailer level, further evidence (such as retailers' margins) would be required to show that this led to substitution at the wholesale level.

Geographic scope

21. Cott submits that the UK is the appropriate geographic frame of reference given that competitors have at least a national coverage and customers tend to be active on a national basis; in addition, the relatively high level of transport costs in comparison with the low cost of the product causes import activity to be uneconomical and therefore limited.

22. Given the lack of evidence about the import activity between Great Britain and the island of Ireland, Great Britain may be the most appropriate geographic frame of reference consistent with some third party comments. Nonetheless, it is not necessary to conclude on this issue given that the assessment of this merger does not substantially change whether the geographic frame of reference is defined as being the UK or Great Britain.

HORIZONTAL ISSUES

Non-coordinated effects

23. The evidence suggests that the parties were two of four important bidders for own label CSD contracts in the UK, the others being Princes and Silver Spring. Bidding data from the parties and [CONFIDENTIAL] indicates that these are the only firms consistently and successfully bidding for contracts, with the exception of certain quite small contracts.

24. Reliable capacity data was unobtainable. On UK wholesale sales data by value, the parties' combined is 57 per cent (increment 21 per cent);[4] Princes has 26.4 per cent and Silver Spring 6.7 per cent; the post-merger HHI is 3991 and the increment is 1540, which indicates that the segment is highly concentrated and the increment is substantial. Customer concern supports the proposition that the merger may result, or has resulted in non-coordinated effects leading to higher prices than absent the merger. In addition, competitors were unconcerned, also on the basis of expected higher prices.

25. The following considers a number of potentially countervailing constraints before concluding that, taken together, they are insufficient to resolve the concerns raised by third party views and other evidence available.

Customers' ability to switch to alternative suppliers

26. Cott argues that there are a number of alternative suppliers in the market; that these suppliers are not capacity constrained, and that there are no switching costs. Third party evidence was consistent that the costs of switching are minimal. However, third party comments were also consistent that customers' ability to switch to other suppliers is significantly constrained by the absence of alternatives besides Silver Spring and Princes, as well as by insufficient spare capacity in the industry to accommodate large orders.

Alternative sources of supply

27. Although there are a few other smaller players active in Great Britain or the UK,[5] bid data provided by Cott and [CONFIDENTIAL] show that these players are not normally invited to bid for the main supermarket contracts. Consistently, customers of all sizes believe that Cott and Macaw were two of only three or four credible suppliers in this sector. The reasons for this are not completely clear, but a number of third parties stated that suppliers are capacity constrained; in addition, some third parties submitted that grocery retailers are satisfied with their current set of possible suppliers (Cott, Macaw, Princes and, to a lesser extent, Silver Spring) and have no interest in expanding this list. Finally, some alternative suppliers may also have been kept out of bidding lists due to uncertainty about their financial condition and to concerns about quality.

28. Some smaller CSDs producers and other non-alcoholic beverage suppliers maintained that they are not interested in bidding for new own label contracts

[4] Due to inconsistencies in the different sets of market share data provided by the parties throughout the process, the OFT calculated revised figures and sent these to the parties for confirmation that they were correct. The parties confirmed that this was the case; this share of supply figure is based on that revised calculation.

even in the event of a non-transitory 5-10 per cent price increase due to the low margins available in this market. Third party comments consistently suggested that economies of scale are essential in order to compete effectively in this segment and that smaller players are not competitive. In addition, [CONFIDENTIAL].

29. Finally, an internal document supplied by Cott corroborates the view that alternative suppliers are limited: it is said that although Macaw is exposed to an unhealthy customer mix since three customers account for approximately [CONFIDENTIAL] of its turnover, 'the risk is somewhat mitigated by a limited number of suppliers / competitors in the marketplace'.[6]

Spare capacity

30. Cott believes[7] that spare capacity in the market is around 485 million litres per year while the total size of the market is 1512 million litres per year.[8] However, the OFT's estimates of spare capacity levels[9] suggest that in the summer – when demand is at its peak – there is substantially less spare capacity available.[10]

31. Although it is difficult to say how precise these figures are, the perception that capacity is constrained is largely corroborated by customers and competitors; [CONFIDENTIAL].

Barriers to entry and expansion

32. Cott submits that new entry into the supply of own label CSDs is not costly and relatively inexpensive. It also argues that suppliers of other types of non-alcoholic beverages as well as of branded CSDs are potential entrants. No supporting evidence was provided for this argument.

33. However, third party comments consistently contradicted Cott's submissions; no third party contacted during the investigation believed that entry was likely, including those identified by Cott as potential entrants. The OFT was told by third parties that new entry into the own label CSDs segment is costly and economies of scale as well as sunk costs act as barriers to entry, in particular in view of the

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[5] Such as Villa Soft Drinks and Brooks Soft Drinks.
[6] [CONFIDENTIAL], dated 24 June 2005.
[7] However, these appear to be rough estimates, as it can be inferred from the methodology used to calculate them.
[8] We estimate that Macaw's total current production per year is 322 million litres and Cott's is 540 million litres.
[9] Based on figures provided by other suppliers combined with figures provided by the parties (when third party data was not available).
[10] Exact estimates are not provided so as not to facilitate undue market transparency.

limited customer base. Prices of own label CSDs have been declining in the past few years, and a number of firms have exited the market in the recent past (such as Crystal, Well Well Well and Charter). [CONFIDENTIAL] have denied any interest in entering this sector.

34. As seen above, expansion by existing suppliers seems to be constrained by the costs involved and the limited incentives for expansion. In considering expansion of existing capacity, a combination of estimates given by the parties and by third parties suggest that it would cost around £4-7 million to build a new production line able to produce 100 million litres per year. The payback period is estimated to be around 18 months. Nonetheless, one supplier has indicated plans to expand production; however, this increase in capacity is relatively small ([CONFIDENTIAL] million litres per year). Although the level of investment required does not seem to be very high on the face of it, third parties have consistently stated that they would not expand their production facilities at current margin levels particularly because grocery retailers do not tender for long-term contracts. These factors make a supplier's demand unpredictable and investments excessively risky. A number of third parties corroborate this view saying that the risk attached to expanding capacity and later not being able to secure a contract deter them from expanding capacity.

Buyer power

35. Cott argued that supermarkets have buyer power in relation to CSDs and quoted past OFT and Competition Commission cases to support its view. However, these cases do not involve all customers of Cott and Macaw, which as well as major grocery retailers include brand-owners, smaller grocery retailers, and cash and carries. In addition, they have not explicitly considered this segment or this merger. Cott has also provided a few letters from customers which it argues support the view that they have buyer power; nonetheless, the context in which these letters were exchanged is not clear, and they cover a limited number of customers. The strongest evidence of existing buyer power is that the largest four grocery retailers[11] purchase 79 per cent of the supply of own label CSDs in the UK and the supply of own label CSDs is not characterised by substantial switching costs or brand loyalty (at the wholesale level). The OFT has requested further evidence which would support the parties' arguments (in particular, for example, margin data over time for all customers) but the parties have not provided any convincing evidence.

36. Even assuming that customers had buyer power before the merger existed, it must be determined whether there will be sufficient buyer power post-merger to discipline supplier pricing. Cott suggests that, if it were to increase prices,

retailers would switch suppliers, switch at least some purchases of own label CSDs to branded CSDs, and retaliate by sponsoring new entry and/or encouraging suppliers of branded CSDs to enter the own label segment.

37. In the OFT's report 'Ex post evaluation of mergers',[12] it is said that grocery retailers could hypothetically exercise buyer power by threatening to switch supplier, imposing substantial costs on the supplier or even sponsoring new entry or expansion (either directly or through securing a long term contract). However, in this particular case, the evidence indicates that their ability to implement any of these tactics may be limited.

38. First, as seen above, the ability to switch suppliers is constrained by possible capacity restrictions and by the reduction in the already very limited number of suppliers brought about by this merger. Second, Cott and Macaw are only active in the soft drinks sector, which provides limited scope for supermarkets to impose costs on the merged entity by retaliation in sectors where competition is more robust. Cott and Macaw's sales of dilutes and still drinks account for a very small proportion of their total turnover and therefore customers are not able to impose costs on these products. Third, a number of customers said that they have very limited incentives to sponsor new entry due to the costs involved in setting up a production line *vis-à-vis* the low margins obtained by most players with CSDs. In addition, the possibility of other customers free-riding on their investment acts as a deterrent. The OFT was told that even if sponsorship was economically viable, it would imply costs for customers, with a consequent passing of costs through to end consumers. Fourth, self-supply by retailers was not cited as a credible countervailing constraint. Finally, smaller retailers cannot leverage large-scale demand in the manner that a larger retailer might.

39. No convincing evidence has been provided to support Cott's contention that grocery retailers would switch purchases of own label CSDs to branded CSDs, and evidence showing competitive interaction between the two categories is also limited (see above). In addition, as also seen above, [CONFIDENTIAL], and Cott has not provided any specific evidence to suggest otherwise.

VERTICAL ISSUES

40. This merger does not raise any vertical issues.

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[11] Tesco, Sainsbury, Asda/Wal-mart, and Morrison.
[12] March 2005.

THIRD PARTY VIEWS

41. The vast majority of customers raised the concern to the effect that this transaction eliminates important rivalry by merging two of only four significant suppliers of own-label CSDs in the UK. Conversely, competitors were generally unconcerned. In addition, a number of suggested potential entrants to the market maintained that they are not likely to enter it for the reasons discussed above.

ASSESSMENT

42. The parties overlap in the supply of dilutes, still drinks and CSDs. The OFT does not believe that there is a realistic prospect that the merger will result, or has resulted, in a substantial lessening of competition in the dilutes, still drinks and branded CSDs segments, nor in the procurement of inputs for these products, and therefore the investigation focused on the supply of own-label CSDs.

43. Cott submits that branded and own label CSDs should be considered under the same frame of reference. Nonetheless, a number of factors suggest that these two product groups should be considered separately. From the demand perspective, third party comments were consistent to the effect that customers are not likely to switch from own label to branded CSDs following a small but significant non-transitory price rise and the parties did not provide any convincing evidence to suggest otherwise. At the wholesale level, grocery retailers do not choose between the different categories of CSDs, but tend to offer a full range of branded products and to have own label options available. On the supply side, major branded CSD suppliers do not serve the own label segment and it seems unlikely that they would do so for strategic reasons, even though the production processes of both products are identical.

44. The limited level of import activity and the fact that competitors and customers tend to be active nationally suggest that Great Britain is the most appropriate geographic frame of reference.

45. The merger causes a loss of rivalry between two out of the four main competitors in this sector; the combined market share, the HHI and the increase in HHI are all high. The merger may give rise to competition concerns and the evidence made available to the OFT is not enough to suggest that there are sufficient competitive constraints to prevent the merger from resulting in a substantial lessening of competition.

46. First, the main grocery retailers do not seem to have other alternative sources of supply of own label CSDs besides the merged entity, Princes and Silver Spring. Bid evidence indicates that other suppliers of own label CSDs are generally not

invited to bid for the large supermarket contracts and seem to be capacity constrained; Cott has not provided enough evidence that these suppliers are credible alternatives and internal documents from Macaw suggest that in their perception the number of alternative suppliers is limited.

47. Second, it is not clear that there is sufficient spare capacity to facilitate switching should the prices of the merged entity be higher than they would have been but for the merger. The parties' estimates of spare capacity conflict with the figures obtained by the OFT from competitors themselves as well as with the general perception of market participants – both competitors and customers – that available capacity is limited.

48. Third, comments from third parties consistently indicated that new entry and expansion will not be timely, likely or sufficient to resolve the above concerns. The main reasons for this seem to be the low margins obtained from the production of own label CSDs, the decline in prices in the last few years, and the fact that supermarkets tend not to offer long term contracts, which makes investment risky. The evidence available to the OFT therefore indicates that entry and expansion might not be sufficient, timely or likely to defeat any attempt to increase prices. In addition, the flow of exit from the market in the recent past does not suggest the sector is attractive to new entry. Cott did not provide sufficient evidence to suggest otherwise. Furthermore, as seen in the discussion regarding the most appropriate frame of reference against which this case should be analysed, competitors in neighbouring markets do not seem to be interested in supplying own label CSDs, and imports are uneconomical.

49. Fourth, while on the face of it the UK shares of purchasing of own label CSDs of the largest four grocery retailers would suggest that they have sufficient negotiating strength to discipline supplier pricing, there are good reasons to believe that this may not be case, discussed in more detail above. The buyer power of smaller retailers is far less clear, and the available evidence does not indicate that these suppliers could resist an attempt to increase prices higher than they otherwise would have been absent the merger. There is therefore insufficient evidence to conclude that countervailing buyer power would discipline supplier pricing post-merger, in particular for smaller retailers.

50. Consequently, the OFT believes that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

UNDERTAKINGS IN LIEU

51. Where the duty to make a reference under section 22(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 the parties concerned such undertakings as it considers appropriate for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which has resulted, or may result, from it.

52. 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.[13]

53. The parties offered an undertaking [CONFIDENTIAL].

54. The OFT does not consider that this undertaking is capable of restoring the competitive dynamic in the supply of own-label CSDs that existed partiers pre-merger. In addition, [CONFIDENTIAL]. As such, the proposed undertakings are not clear cut and it is not obvious that they would resolve the competition concerns identified, and the duty to refer remains.

DECISION

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

[13] Paragraph 8.3.