CMA
Competition & Markets Authority

COMPLETED ACQUISITION BY LINERGY LIMITED OF ULSTER FARM BY-PRODUCTS LIMITED

Statement of issues

26 August 2015

The reference

1. On 28 July 2015, the Competition and Markets Authority (CMA), in exercise of its duty under section 22(1) of the Enterprise Act 2002 (the Act), referred the completed acquisition by Linergy Limited (Linergy) of Ulster Farm By-Products Limited (UFBP) for further investigation and report by a group of CMA panel members (the inquiry group).

2. The CMA must decide:

   (a) whether a relevant merger situation has been created; and

   (b) if so, whether the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition (SLC) within any market or markets in the UK for goods or services.

3. In this statement, we set out the main issues we are likely to consider in reaching our decisions, having had regard to the evidence gathered to date including evidence set out in the phase 1 decision document of 17 July 2015 (the phase 1 decision, published on our webpages on 21 August 2015). This does not preclude the consideration of any other issues which may be identified during the course of our investigation.

4. We are publishing this issues statement in order to assist parties submitting evidence to focus on the issues we currently envisage being relevant to our inquiry and to invite parties to notify us if there are any additional relevant issues that they believe we should consider.

5. Throughout this document, where appropriate, we refer to Linergy and UFBP collectively as 'the Parties'.

Background

6. The transaction had two stages: first, under a share purchase agreement dated 8 May 2015, Linergy acquired 100% of UFBP; and, second, under a share purchase agreement dated the same day, SAPI acquired 30% of the combined Linergy/UFBP. SAPI is active in the processing of animal by-products in Italy and, through its subsidiaries, in a number of other countries, including Northern Ireland through UFBP, which it acquired in June 2012.

7. The Parties both process animal by-products (categorised into Category 1 and Category 3) and fallen stock through rendering plants located in Northern Ireland.

8. The phrase 'animal by-products' refers to what remains of an animal after meat and offal for human consumption, and other uses, has been removed.[1] The phrase 'fallen stock' refers to animals that have died on farms and therefore need to be disposed of by the farmer.

9. The disposal and processing of fallen stock and animal by-products is heavily regulated and disposal must be in accordance with UK and EU law. There are two principal categories of animal by-products (Category 1 and Category 3), distinguished according to their risk of transmitting transmissible spongiform encephalopathy. Category 1 is the highest risk material and Category 3 is the lowest risk material. The regulations allow for Category 3 material to be processed in a Category 1 plant (although the outputs would all be treated as Category 1) but renderers may not process Category 1 material, or fallen stock, in a Category 3 plant.

10. The outputs from rendering are meat and bone meal (MBM)[2] and tallow.[3] The outputs from rendering Category 3 material can be used in a broader range of products than the outputs from the rendering of Category 1 material, and are therefore more valuable. While meat processors pay a gate fee to renderers for the disposal of Category 1 material, for some Category 3 animal by-products, renderers often pay meat processors for raw material (ie there is a negative gate fee).

11. Linergy operates a Category 1 plant and UFBP a Category 3 plant. Direct competition is therefore currently limited. However, assessment of the effects

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[1] Customers for the disposal of animal by-products are slaughter houses, deboning plants, and other food processors, and also retailers, eg butchers, etc. However, they are also suppliers of raw materials for processing into output. We refer to all these sources collectively as meat processors.
[2] MBM is typically about 48–52% protein, 33–35% ash, 8–12% fat, and 4–7% moisture.
[3] Tallow is a rendered form of beef or mutton fat, processed from suet.

of the merger needs to take account of the counterfactual (the position in the absence of the merger), which is discussed in paragraphs 18 to 23.

12. A description of the products, markets, and participants in those markets is set out in the phase 1 decision.

Market definition

13. Market definition is a useful analytical tool, but not an end in itself, and identifying the relevant market involves an element of judgement. The boundaries of the market do not determine the outcome of the CMA's analysis of the competitive effects of a merger in a mechanistic way. In assessing whether a merger may give rise to an SLC, the CMA may take into account constraints outside the relevant market, segmentation within the relevant market, or other ways in which some constraints are more important than others.[4]

14. The Parties are active in the supply of the following services and products.

    (a) The processing of:

    (i) Category 1 animal by-products (non-fallen stock);

    (ii) Category 3 animal by-products (non-fallen stock); and

    (iii) fallen stock.

    (b) The supply of:

    (i) Category 1 MBM;

    (ii) Category 1 tallow;

    (iii) Category 3 MBM; and

    (iv) Category 3 tallow.

15. In the CMA's phase 1 investigation, Linergy submitted that there were separate product markets for the three categories of processing by-products and fallen stock, and no other parties expressed a different view. On the output side, we were told that MBM and tallow could compete with a broad range of substitute products, depending on whether they were Category 1 or

[4] *Merger Assessment Guidelines* (CC2 Revised/OFT1254), September 2010, paragraph 5.2.2. The *Merger Assessment Guidelines* have been adopted by the CMA (see *Mergers: Guidance on the CMA's jurisdiction and procedure* (CMA2), January 2014, Annex D).

Category 3. We will consider the appropriate scope of the product markets as necessary to inform our competitive assessment.

16. The phase 1 decision concluded that the relevant geographic frame of reference was Northern Ireland. We were told that transport costs were significant, especially for fallen stock. The phase 1 decision notes that the great majority of the Parties' customers are within 70 to 80 miles of the plants, and that, where meat processors have used plants in the Republic of Ireland, this may have reflected vertical linkages. However, the Parties argued that the relevant geographic market was wider for the reasons set out below:

    (a) Some Northern Ireland meat processors send material for processing to the Republic of Ireland (with some Republic of Ireland plants being closer to the Parties' plants than that of the only other major renderer in Northern Ireland, Foyle Proteins).

    (b) Some of the material processed by the Parties is sourced from the Republic of Ireland.

    (c) Some meat processors based in Northern Ireland send material for rendering in Scotland.

    (d) Catchment areas do not necessarily indicate an appropriate geographic frame of reference for assessing competitive constraints.

17. The CMA will therefore consider the appropriate scope of the relevant geographic markets for products and services.

Assessment of the competitive effects of the merger

Counterfactual

18. We will assess the possible effects of the merger on competition compared with the competitive conditions in the counterfactual situation (ie the competitive situation that would have existed absent the merger).[5]

19. As noted in the phase 1 decision, in May 2012, Linergy and SAPI entered into a memorandum of understanding (MoU) expressing Linergy's and SAPI's intention, subject to regulatory approvals, to merge Linergy and UFBP in the event that SAPI acquired UFBP. The MoU also envisaged that SAPI would own 30% of the shares in the merged entity. It included terms governing the valuation of Linergy and UFBP. The Parties stated it was not guaranteed or

[5] *Merger Assessment Guidelines*, section 4.3.

inevitable that they would attempt a merger if SAPI acquired UFBP. The MoU set terms should the merger not proceed (including due to failure to get regulatory approval), which included a mechanism which the Parties told us was intended to take account of changes in the valuation of UFBP and Linergy between the date of the MoU and the time the Parties abandoned any intention to merge. If used, it allowed SAPI and Linergy to share in UFBP's and Linergy's profits/losses during SAPI's ownership of UFBP in proportion to the shareholding that it was intended SAPI would acquire in Linergy.

20. In October 2012, UFBP closed its Category 1 plant and, currently, it only operates a Category 3 plant. In December 2012, Linergy abandoned earlier plans to build a Category 3 plant and, currently, it only operates a Category 1 plant. It is possible that the MoU may have had the effect of causing each of the Parties to make their decisions in anticipation of a possible future merger. The phase 1 decision considered that the MoU might have incentivised each party to internalise the effect of its actions on the other party's profits. The phase 1 decision found that this raises the possibility that, in the absence of the MoU but taking account of changes in the market since 2012, it is realistic to assume that: (i) Linergy would have built a Category 3 plant; and/or (ii) UFBP would not have closed its Category 1 plant. Accordingly, in this counterfactual, Linergy and UFBP would have both operated a Category 1 and a Category 3 plant.

21. At phase 1, the Parties disagreed that the MoU had the aforementioned effects on their incentives. They said that the decision to close UFBP's Category 1 plant and the decision not to proceed with Linergy's new Category 3 plant were independent commercial decisions based on assessments of regulatory requirements, costs and market prospects at the time.

22. In considering the counterfactual against which to assess the merger, we will therefore consider what would have been likely to have happened if the merger had not taken place and which events should be considered as part of the merger process. In particular, we will consider whether:

    (a) UFBP would still have closed its Category 1 plant in October 2012 and, if not, whether it would have been expected to continue to operate this plant or to have closed it at a later date prior to completion of the merger. If it would have been expected to continue to operate the plant, we will need to consider the extent of the competitive constraint it would have presented;

    (b) Linergy would have proceeded with plans to build a Category 3 plant (or have made any other major investments);

(c) UFBP would have been bought by another party if it had not been purchased by Linergy and whether it may have been purchased previously by a party other than SAPI. If so, what effect this would have had on its operations; and

(d) other factors or developments would have changed the nature and extent of competition in the relevant markets.

23. In making our assessment, we will consider possible alternative scenarios and decide upon the appropriate counterfactual situation based on the facts available to us, including taking a view on the interpretation of past actions.

Theories of harm

24. Theories of harm describe the possible ways in which an SLC could arise as a result of a merger and provide the framework for our analysis of the competitive effects of the merger.[6] We have set out below the theories of harm which we intend to investigate. However, we may revise our theories of harm as our inquiry progresses. Also, the identification of a theory of harm does not preclude an SLC being identified on another basis following further work by us, or the receipt of additional evidence. We welcome views on all the theories of harm set out below.

Theory of harm 1: horizontal unilateral effects in relation to Category 1 materials, fallen stock and Category 3 materials

25. If the counterfactual was found to apply such that either or both of the additional rendering plants mentioned in paragraph 20 would have been operational, then the effect of the merger would be to remove one competitor in Category 1 and fallen stock rendering, and/or Category 3 rendering.

26. The removal of one party as a competitor could allow the merger Parties to increase prices, lower quality, reduce the range of their services and/or reduce innovation. After the merger, it is likely to be less costly for the merged entity to raise prices (or lower quality) because it will recoup the profit on recaptured sales from those customers which would have switched to the other party.[7] For a variety of reasons including competitors' lack of capacity, many meat processors may lack credible alternative suppliers to the merger Parties.

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[6] *Merger Assessment Guidelines*, section 4.2.
[7] *Merger Assessment Guidelines*, section 5.4.

27. For this theory of harm to be credible we will need to address whether the Parties would have been expected to have been close competitors and whether competitive constraints from inside the market (existing competitors) are sufficient to prevent any SLC.

28. On the basis of the evidence currently available to us, issues that we are likely to consider, for Category 1 materials, Category 3 materials and fallen stock, include:

    (a) the spare capacity of rivals;

    (b) the extent of rivalry and strength of the competitive constraint offered by renderers located further away, given the importance of transport costs;

    (c) how competition is affected by regulations concerning the treatment and transport of animal by-products and fallen stock (including differences and restrictions affecting competition from outside Northern Ireland);

    (d) how renderers compete and the importance of factors such as pricing, capacity, service etc;

    (e) the process through which meat processors choose suppliers of the relevant services;

    (f) the factors underlying meat processors' choices of supplier and the extent of switching between suppliers (including the importance of any ownership relations/vertical linkages between renderers and suppliers);

    (g) whether ownership relations/vertical linkages between renderers and meat processors influence how those renderers compete to serve independent meat processors;

    (h) the history of past negotiation/tendering behaviour and what this reveals about the extent of competition between the Parties, and between the Parties and other renderers, prior to the merger;

    (i) the effects on the market and how meat processors responded when UFBP closed its Category 1 plant in 2012; and

    (j) whether behaviours and requirements differ between types of meat processor (eg suppliers of different sorts of material, and between those with and without vertical linkages).

29. Other relevant countervailing factors are discussed in paragraphs 39 to 43.

Theory of harm 2: Vertical effects (foreclosure)

30. Linergy's shareholders include meat processing companies. We will therefore consider under this theory of harm whether the merged entity may have the ability and incentive to foreclose competing independent meat processors in Northern Ireland in order to benefit its own shareholder meat processors by refusing to deal with independent processors or charging them higher prices. This theory of harm relates specifically to foreclosure;[8] vertical relationships may be considered in relation to theory of harm 1 in so far as they might be relevant to horizontal unilateral effects.

31. The importance of rendering as an input and the limited alternative options available might provide the Parties with the ability to foreclose independent customers. However, the incentive to do this will depend on how any losses the Parties might incur (eg the loss of animal rendering profits) would compare with any gains that might be realised in other markets (eg higher profits from meat processing). This would depend on whether the shareholder meat processors would gain additional business from any foreclosed meat processors and whether they might make higher margins as a result of the reduced competition in the meat processing market (because of a fall in livestock prices or higher meat product prices).

32. Issues that we are likely to consider include:

    (a) the spare capacity of rival renderers and the availability to meat processors of alternative options;

    (b) the extent to which meat processors related to the Parties would be likely to gain additional business;

    (c) the extent of competition in the market for livestock procurement;

    (d) the extent of competition in the markets for meat products; and

    (e) whether the volumes concerned would be likely to be sufficient to result in an SLC.

Theory of harm 3: Coordinated effects

33. Coordination can occur where potential competitors choose not to compete with each other, in the expectation that rivals are likely to respond in a similar way. This reduction in competitive intensity can arise where participants in a

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[8] *Merger Assessment Guidelines*, section 5.6.

market have similar incentives and can observe what rivals are doing. In consequence, there may be implicit understanding in relation to pricing, market share, not seeking to poach each other's customers etc, without there being any form of explicit contact or agreement (ie this theory of harm does not consider explicit collusive conduct).[9]

34. The concern under this theory of harm is that the merger may make coordination more likely if it does not already take place, or more effective/stable, if it does take place. The other significant renderer in Northern Ireland, Foyle Proteins, operates only a Category 1 plant, and so we can exclude changes in coordination as a consequence of the merger in respect of Category 3 material in Northern Ireland. There are some factors that suggest that coordination in relation to Category 1 material could in principle be possible. For example, even though prices are negotiated individually, there may be a degree of price transparency. This is because there is only a small number of market participants and because of the existence of vertical integration/cross-shareholdings, meaning that renderers are likely to know how rivals are pricing. For fallen stock, monitoring of coordinated behaviours would be relatively easy as prices are submitted to a centralised system by fallen stock collectors on at least an annual basis and are externally published.

35. We are minded to consider whether the merger could increase the likelihood of coordination between renderers. Issues that we are likely to consider when considering the effects of the merger include:

(a) whether there is any evidence of coordination already occurring;

(b) whether there is sufficient visibility of parties' market shares, pricing etc, to allow renderers to monitor rivals' behaviour;

(c) whether any credible reactive strategy, that would deter deviation, is available if renderers become aware of rivals failing to coordinate;

(d) the long-term and short-term incentives for renderers to behave in a coordinated manner;

(e) whether different renderers are likely to have the same incentives (eg depending on their size, their vertical links with meat processors etc) and, if not, whether different renderers, or the threat of their expansion, could undermine any attempts to coordinate;

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[9] *Merger Assessment Guidelines*, section 5.5.

(f) whether the Parties are or have been 'maverick' operators, who have had specific incentives or policies and whose activities would likely undermine any attempts at coordination; and

(g) whether any meat processors or other suppliers would be able to identify suspected coordinated conduct and, if so, would be able to take actions to resist or undermine it.

Possible theory of harm: horizontal effects in relation to the supply of tallow and meat and bone meal

36. The merger will result in the removal of a supplier of tallow and MBM, the outputs from the processing of animal by-product materials. This could result in higher prices, lower quality or a reduction in the range of services and/or innovation.

37. However, we understand that tallow and MBM are widely traded and can be sourced internationally from many companies. We also understand that both tallow and MBM can be constrained by other commodities that are alternatives for certain uses. No concerns have been raised with us relating to the markets for the supply of tallow and MBM.

38. We are not currently minded to investigate the possibility of the merger giving rise to horizontal effects in relation to the supply of tallow and MBM. However, should any party consider that we should investigate this possible harm, it should tell us and provide a reasoned submission.

Countervailing factors

39. We will consider whether there are countervailing factors that would be likely to prevent or mitigate any SLC that we may find. In particular, we intend to consider the matters set out below.

40. **Entry and expansion**. We will consider how easy it is to enter and expand in the market for processing animal by-products (Category 1 and Category 3) and fallen stock, and whether such entry and/or expansion could be expected to be timely, likely and sufficient to prevent any SLC.[10] To do this we will:

    (a) look at the history of actual entry, expansion and exit and review any future plans;

[10] *Merger Assessment Guidelines*, section 5.8.

(b) examine the factors that might inhibit entry or the expansion of existing competitors; and

(c) consider the cost of expanding or developing new facilities, and the importance of scale, reputation, existing contractual relationships, vertical linkages and the importance of location and transport costs.

41. **Negotiating power.**[11] We will assess whether any meat processor suppliers of Linergy and UFBP can exercise countervailing negotiating power through their ability to switch away from the Parties to other options and whether the negotiating power of these suppliers would be sufficient to protect other suppliers from the effects of an SLC. We will also consider the likely impact of the merger on any pre-existing countervailing buyer power.

42. **Efficiencies.** We will examine any arguments made in relation to efficiencies arising from the merger. In particular, we will examine whether any potential efficiencies are rivalry-enhancing and could be expected to offset any loss of competition.[12]

43. We are not currently aware of any other countervailing factors.

Possible remedies and relevant customer benefits

44. Should we decide that the merger has resulted, or may be expected to result, in an SLC in any market(s), we will consider whether, and if so what, remedies might be appropriate, and will issue a further statement.

45. In any consideration of possible remedies, we may have regard to their effect on any relevant customer benefits in relation to the merger and, if so, what these benefits are likely to be and which customers would benefit.

Responses to the issues statement

46. Any party wishing to respond to this issues statement should do so in writing, by no later than 5pm on 9 September 2015. Please email linergy.ulsterfarm@cma.gsi.gov.uk or write to:

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[11] By negotiating power we refer to meat processors' position relative to renderers and their ability to exercise different options in regard of the two elements of the merger: the supply of material that can be processed into MBM and tallow, and the purchase of a waste handling and disposal service. See *Merger Assessment Guidelines*, section 5.9.

[12] *Merger Assessment Guidelines*, section 5.7.

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