

Anticipated acquisition by Robert Wiseman Dairies plc of the fresh milk business of Scottish Milk Dairies Limited

The OFT's decision on reference under section 33(1) given on 19 October 2005. Full text of decision published 27 October 2005.

Please note square brackets indicate information excised or replaced by a range at the request of the merging parties or third parties for reasons of commercial confidentiality

PARTIES

1. **Robert Wiseman Dairies plc (Wiseman)** is a public company whose shares are listed on the London Stock Exchange. The company produces fresh processed liquid milk (fresh milk) at processing facilities in Aberdeen, East Kilbride, Glasgow, Manchester and Droitwich.
2. **Scottish Milk Dairies Limited (SMD)** is a wholly-owned subsidiary of **First Milk Limited (First Milk)**. SMD processes fresh milk and UHT milk at its dairy in Glasgow and markets these products to customers mainly in the Glasgow area. SMD's turnover in the financial year ended 31 March 2005 was £9.4 million. SMD's parent, First Milk, is a farmer-owned dairy cooperative with approximately 3,600 members. First Milk procures raw milk from its members, collects it and then delivers it to milk processors such as fresh milk dairies, cheese producers and food processing factories. First Milk acquired a 15 per cent stake in Wiseman in 2004.¹

TRANSACTION

3. On 9 August 2005 Wiseman announced that it had agreed terms for the acquisition of the goodwill (customer list), certain employees and assets of the fresh milk business of SMD. Wiseman is not acquiring the SMD processing

¹ OFT decision of 17 April 2005 on the completed acquisition by First Milk Limited of a 15 per cent stake in Robert Wiseman plc (the First Milk/Wiseman decision).

facility. The administrative deadline in this case expires on 21 October 2005.

JURISDICTION

4. As a result of this transaction Wiseman and the fresh milk business of SMD will cease to be distinct. The OFT believes that the business being acquired constitutes an enterprise for the purpose of section 23 of the Enterprise Act 2002 (the Act). The parties have a combined share of supply in fresh milk to middle ground customers in Scotland of more than 25 per cent; therefore, the share of supply test in section 23 of 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.

BACKGROUND

5. In the last decade there have been two reports by the Monopolies and Mergers Commission (now, and referred to here as, the Competition Commission (CC)) on the supply of milk in Scotland. In December 1996, the CC reported on the proposed merger of Wiseman and Scottish Pride Holdings plc under the Fair Trading Act 1973 (FTA) (the Scottish Pride Report).² In December 2000, the CC reported, under the monopoly provisions of the FTA, on the supply of fresh processed milk to middle ground retailers in Scotland (the Scottish Milk Report).³ More recently, the CC reported under the FTA on the proposed merger between Arla Foods (Arla) and Express Dairies which again considered the supply of fresh milk, though here the focus was Great Britain as a whole.⁴
6. Immediately following its acquisition of Scottish Pride in 1997, Wiseman accounted for around 80 per cent of all fresh milk sales in Scotland, with a commanding size disparity over its next-largest rivals, the North of Scotland Milk Co-operative Society⁵ (with 5 per cent, but active only in the north) and Drakemire Dairy Foods Limited (since acquired by SMD) and Gilmour's Dairy (Gilmour), each with 2 per cent.

² Robert Wiseman Dairies plc and Scottish Pride Holdings plc: A report on the proposed merger, December 1996 (Cm3504).

³ Scottish Milk: A report on the supply of fresh processed milk to middle-ground retailers in Scotland, December 2000 (Cm 5002).

⁴ A report on the proposed merger between Arla Foods amba and Express Dairies plc, September 2003 (Cm 5983).

⁵ Now known as Claymore Dairies and majority-owned by Arla. Claymore Dairies only supplies milk to customers in the North of Scotland. The OFT's investigation into whether Wiseman's 2001 actions vis-à-vis Claymore in this area infringed Chapter II of the Competition Act 1998 has been the subject of recent judicial scrutiny: see *Claymore Dairies Ltd v OFT* [2005] CAT 30, 2 September 2005.

7. In the Scottish Pride Report, the CC examined effects of the merger on different customer groups. In relation to Scottish middle ground customers – the segment at issue in the current transaction – the CC concluded that Wiseman, with a 70 per cent post-merger share of supply, would enjoy market power.⁶ In its view, supply-side constraints were insufficient to alleviate concerns arising from the loss of Scottish Pride as a major supplier to the middle ground because (i) the very small locally or regionally-based rivals remaining were likely to be ‘passive’ in response to a price rise, being deterred from competing vigorously with Wiseman because it could retaliate by targeting their customers ‘one by one’;⁷ and (ii) neither supply from the North of England or from Scottish cash and carry stores or new entry were sufficient, individually or in combination, to deter profitable price rises by Wiseman.
8. The CC therefore concluded that the merger would harm competition and lead to higher wholesale prices than absent the merger in the market for the supply of fresh milk to customers in Scotland other than the national supermarket groups (i.e., to middle ground customers).⁸ The CC recommended that Wiseman be required to give behavioural undertakings to: (i) supply regular audited reports to the Director General of Fair Trading (DGFT, referred to below as OFT) on its prices to various categories of customers in Scotland; and (ii) obtain the OFT’s prior written consent for the acquisition of (the assets of) any milk processor in Scotland. Wiseman gave such undertakings to the Secretary of State on 28 February 1997 (the Undertakings).
9. Since then Wiseman has received OFT consent and has subsequently acquired two Scottish milk processors: Gilmour in April 1999 and Aberdeen Milk Company Limited (AMCo) in May 1999. Pursuant to the Undertakings, the current transaction is also subject to the OFT’s prior written notification to Wiseman that in the opinion of the OFT the acquisition is unlikely to give rise to any of the adverse effects specified in the Scottish Pride Report.
10. In 2000, the Scottish Milk Report reflected divergent views as to whether Wiseman enjoyed a monopoly against the public interest and led to no remedial action. However, as to the two acquisitions by Wiseman that were approved by the OFT under the Undertakings, the CC unanimously concluded that both transactions, with the subsequent closing down of their processing capacity, were steps that were likely to have been taken, at least in part, for the purpose of maintaining Wiseman’s monopoly position, and that its actions were likely to have

⁶ The CC also had concerns regarding Wiseman’s market power over hotel/catering customers (50 per cent post-merger share), but not in the national supermarket segment (where the combined share reached 88 per cent), because these customers enjoyed countervailing buyer power.

⁷ See paragraph 2.88 of the Scottish Pride Report.

⁸ See paragraph 2.91 of the Scottish Pride Report.

been, to some extent, attributable to this position. The CC was also unanimously of the opinion that given the strength of Wiseman's position in Scotland, any acquisition it made – other than the most trivial – would almost be bound to have the effect of maintaining its monopoly position.⁹

11. Since the Scottish Milk Report the structure of Scottish milk supply has evolved, not least due to Arla, whose presence in Scotland is scheduled to expand (see further below). In relation to Scottish middle ground retailers, Wiseman's share has dropped ten percentage points since the findings in the Scottish Pride Report (from 70 per cent to 66.5 per cent at the time of the Scottish Milk Report, to [50-60] per cent today), but it is still over [] times that of its nearest rival (Graham's: [10-20] per cent). SMD's share of supply in this customer segment ([0-10] per cent) has not changed significantly since the Scottish Milk Report. The OFT believes that it is appropriate to take the conclusions of these two CC Reports into account in the competitive assessment of the transaction.

COUNTERFACTUAL

12. The OFT's guidance states that the best guide to the appropriate counterfactual will, in most cases, be the prevailing conditions of competition.¹⁰ However, as also noted by our guidance on the failing firm defence, the OFT may need to take into account, for example, whether market exit by a merging party is the only realistic alternative to the merger, and whether no such alternative results in a more competitive outcome than the merger going ahead. Alternatives include acquisition by another buyer, or exit or 'failure' of the relevant business.¹¹ If these criteria are met, the merger cannot be said to 'result in' (i.e. be the cause of) a substantial lessening of competition. The OFT has consistently required sufficient compelling evidence that each of these criteria is met.¹²
13. While not expressly raising a 'failing firm' defence, First Milk has stated that it does not consider the SMD business to be viable going forward. []. This might suggest that the relevant counterfactual is that SMD would exit the market notwithstanding the merger. However, the OFT has not received financial statements to support the contention that the fresh milk operation of SMD would not be viable. Nor is it obvious that Wiseman would be the only potential acquirer of the SMD business. First Milk's stated rationale for selling the business to Wiseman is that (i) First Milk has a minority interest in Wiseman and so might expect to obtain some continuing, if indirect, benefit from the sold business; and

⁹ See paragraph 2.92 of the Scottish Milk Report.

¹⁰ Mergers: Substantive assessment guidance, paragraph 3.24.

¹¹ Ibid, paragraph 4.36.

¹² See e.g., First West Yorkshire/Black Prince, OFT decision of 27 May 2005, citing previous cases.

(ii) Wiseman is more likely than any other purchaser to continue to obtain the raw milk for this business from First Milk.

14. While the exit of SMD from the fresh milk market in Scotland might be likely and imminent (although we do not have sufficient evidence at this time to support this) the acquisition of this business by Wiseman does not appear to be the only realistic alternative. The SMD fresh milk business could instead be acquired by a supplier other than Wiseman, which may represent a less anti-competitive outcome; another possibility could be that SMD exits the market, which may prompt vigorous competition as suppliers compete to supply the customers of the exiting firm. The effect of the merger could be that customers are passed to Wiseman at current terms and prices and so receive none of the benefits of the merger or of competition for their custom. Even if the customer list was acquired by a processor other than Wiseman, the acquirer might have been expected to pass on some of the merger benefits to the former SMD customers to encourage those customers to remain with the new supplier. Overall, the evidence from the parties has not established that there is no realistic less anti-competitive alternative outcome to the merger.
15. The remainder of the OFT's assessment proceeds on the basis that the effects of the merger be judged against prevailing conditions of competition as a reasonable guide to the future absent the merger.¹³

MARKET DEFINITION

16. The activities of the parties overlap in respect of supply of fresh milk to middle ground customers in Scotland. SMD does not supply national supermarket chains. The effect of the merger, if any, in respect of raw milk procurement and supply is not significant; it is considered below under vertical competition issues.

Product market

17. The parties submit that the appropriate frame of reference is the market for the supply of all types of fresh milk to all types of customers in Great Britain. On the demand side, the OFT has found there is little substitutability between fresh milk and other products. On the supply side, processor evidence suggests that it is not easy to switch production from other types of dairy products to fresh milk without considerable investment and time.
18. In the Arla/Express Report, the CC, consistent with its findings in the Scottish Pride Report and Scottish Milk Report, identified three different customer

¹³ There is also no reason to think that the ultimate decision would be different if the merger were compared to either market exit or acquisition by a buyer other than Wiseman.

segments for fresh milk supply:

- national multiples (larger supermarket chains);
- middle ground customers – all customers who are neither national multiples nor doorstep customers; and
- doorstep customers.

19. The parties do not believe that any distinction should be made in economic terms between the supply of fresh milk to middle ground customers and supply to national multiples because the multiples set a benchmark retail price for which there are established differentials in the middle ground. In the Arla/Express Report, the CC stated that there were competitive interactions between the sectors but, whilst some blurring of boundaries was acknowledged, the differing standards required by customers and the fact that a large volume of supply to the national multiples was at that time limited to the four largest processors, led the CC to conclude that it was worthwhile considering supply to national multiples and middle ground customers separately.
20. The CC has indicated previously that national multiples and middle ground customers have different levels of buyer power, source their fresh milk using different methods and have varying geographic arrangements for milk procurement.¹⁴ The supply of fresh milk to Scottish middle ground customers (the parties' area of customer overlap in fresh milk supply) will therefore be considered separately in this case.

Geographic market

21. The parties submit that the geographic market is as wide as Great Britain. This is due to the distances over which fresh milk can be transported, which have increased in recent years. The parties note that there are large overlaps between the areas supplied by rival companies, resulting in what they believe to be an unbroken chain of substitution operating throughout Great Britain.
22. In the Scottish Milk Report the CC was split in its views on the relevant geographic market for the supply of fresh milk to middle ground customers.¹⁵ In coming to its conclusions, the CC looked at various factors, including the extent to which there have been price differences between Scotland and England, transport costs and consumer preferences. However, in the Arla/Express Report

¹⁴ See, for example, CC Arla/Express Report, from paragraph 2.34.

¹⁵ Two members believed the market to be Scotland alone, two members were of the view that there was a single Great British market in the supply of fresh processed milk to the middle ground.

the CC found that the geographic scope for the middle ground could be more regional in nature.

23. The parties note that dairies located in Northern England¹⁶ can supply Scottish and/or English fresh milk to the middle ground in Scotland. However, a number of middle ground customers have suggested a preference for Scottish milk. Although two larger middle ground customers noted that it was viable to source fresh milk from further afield than the Central Belt of Scotland, there is currently scant evidence to support the view that this holds true for smaller middle ground customers, given transport costs and a potential lack of customer initiative to investigate non-local supply sources. Proceeding on a cautious basis, middle-ground customers in the Greater Glasgow/Central Belt area are unlikely to turn in sufficient volume to supply sources in the North of Scotland or the North of England to render unprofitable a hypothetical monopolist's small but significant price increase.
24. It is also relevant to consider SMD's area of operation; of the 15 weekday 'runs' operated by SMD, one goes to Edinburgh and one to Ayrshire but the other 13 are all within the Glasgow area.
25. We have therefore focused the competitive assessment of this merger on the Greater Glasgow/Central Belt area. It has not been necessary in this case to determine whether the geographic scope should be local (Greater Glasgow) or regional (Central Belt of Scotland) because the competitive assessment will not differ materially in any case.

HORIZONTAL ISSUES

Introduction

26. This transaction combines by far the largest industry player in the supply of fresh milk to middle ground customers in Scotland on the one hand, with a firm with a relatively modest share of supply, on the other. Generally speaking, the smaller the increment in share of supply, the smaller the likely effect of the merger on competition (absent any evidence that the share of supply understates the importance of that particular firm in the market, e.g. because it is a maverick, or a particularly close competitor, or due to planned expansion by the firm in question).
27. However, it may also be appropriate to proceed with caution in a first phase merger investigation in circumstances where (i) recent findings indicate that one of the merging parties enjoys market power and (ii) the market is characterised by

¹⁶ Arla in Newcastle and Associated Cooperative Creameries (now owned by Dairy Farmers of Britain) in Blaydon.

conditions that could be regarded as conducive to coordination. In this case, Wiseman appears to have market power, a fact supported by third party inquiries and consistent with previous CC findings; the issue of coordination is dealt with below.

28. The key question to be addressed is whether there is a realistic prospect of a substantial lessening of competition, i.e. whether the merger may be expected to enhance Wiseman's apparent market power such that it could charge prices that are higher (by a non-trivial amount) than absent the merger. This is not a formalistic assessment of whether the transaction increases share of supply, thereby strengthening a player with a putative 'dominant' position for purposes of non-merger competition law. Rather, the transaction should be assessed, in the context of current and foreseeable market conditions, in light of the significance of the constraints posed by the merging parties on one another, as well as constraints exercised on the merged entity by other actual and potential market participants post-merger.

Shares of supply

29. In terms of fresh milk supply in Great Britain Wiseman has a share of supply of approximately [10-20] per cent; the increment resulting from the transaction is around [0-5] per cent.¹⁷ Competition concerns do not arise at this level.
30. Within Scotland, Wiseman will supply around [50-60] per cent of fresh milk to all customers; the increment resulting from the transaction is around [0-10] per cent.¹⁸
31. Wiseman's share of supply to the middle ground segment on a Scotland-wide basis is estimated by the parties to be around [50-60] per cent; the increment is around [0-10] per cent. After Wiseman, the largest suppliers to the middle ground on a Scotland-wide basis are Graham's Dairies (around [10-20] per cent) and Claymore/Arla (around [0-10] per cent); other processors active in this segment are Quothquan ([0-10] per cent), Mitchells ([0-10] per cent), Bonally ([0-10] per cent) and Allarburn ([0-10] per cent).¹⁹ On this basis, the post-merger HHI is in excess of 4000, indicating that the sector is highly concentrated; the increase

¹⁷ Source: Wiseman.

¹⁸ Source: Wiseman. Wiseman's share of supply in the Scottish market has declined following the loss of the contract to supply Morrisons; Wiseman will stop supplying Morrisons in October 2005.

¹⁹ Source: Wiseman estimates.

exceeds 400, indicating that the merger may give rise to competition concerns.²⁰

32. However, as noted above, the focus of SMD's activities, and hence the area of overlap, is in respect of supply to middle ground customers (particularly smaller middle ground customers) in the Greater Glasgow (or Scottish Central Belt) area. Share of supply figures are not available on this basis, although production volumes of processors in the Greater Glasgow area are considered below.

Susceptibility of the market to coordination

33. Coordinated effects could take the form of tacit (or express) collusion on pricing (by way of price leadership or otherwise), customer allocation and/or geographic market sharing. Tacit collusion may arise in circumstances where market participants have the incentive and ability to align their behaviour in the market. In this context, the relevant question is whether the merger may be expected to give rise to concerns relating to coordinated effects or exacerbate existing concerns.
34. There are a number of features of the Scottish milk market that could facilitate coordination. Firstly, the product is homogenous; this may facilitate reaching terms of coordination because product differentiation or quality issues will not complicate collusion. Secondly, there is price transparency upstream (raw milk) and downstream (retail price), which narrows the spectrum of uncertainty as to wholesale pricing bands. The practice by processors of announcing wholesale headline price increases could act as a focal point for coordination. The OFT has been made aware that all of the major players (including Wiseman, SMD and Graham's) sent out letters to customers seeking similar increases in fresh milk prices within a few days of each other in February 2005. Alternatively, the 'benchmark' retail prices, for which established middle-ground differentials exist (see paragraph 19, above), could also act as such a reference point.
35. In the Scottish Milk Report the CC concluded, as one might expect, that price competition has a significant impact on the profitability of processors, which may provide an incentive to coordinate.
36. For tacit collusion to be successful, firms must have the ability to sustain the coordinated behaviour over time. In this sector, the perception that consumers in Scotland have a preference for Scottish milk indicates that the possibility of bringing fresh milk from the North of England may be limited; in respect of supply to (smaller) middle ground customers, additional transportation costs may also be

²⁰ The Herfindahl-Hirschman Index (HHI) measures market concentration by summing the squares of the market shares of all the firms engaged in the market. The increase in HHI (the delta) can be calculated by subtracting the market's pre-transaction HHI from the expected post-transaction HHI. See further Mergers: Substantive assessment guidance, paragraph 4.3.

prohibitive. Barriers to entry are relatively high and [...], indicates that we should take a cautious view of any potential disruption by way of new entry/expansion (see further below). In addition, there is stable demand for an essential good, which may aid sustainability of coordination due to relative price-insensitivity of retail customers and consumers, and facilitate monitoring of deviation by 'cheating' suppliers.

37. Moreover, there is little risk of disruptive customer responses due to a lack of customer sophistication and buyer power across the bulk of the middle ground customer base (with the exception, perhaps, of the largest middle-ground customers); smaller customers may be more concerned about their position relative to competing retail outlets, which will not be an issue if their closest competitors are also paying higher prices.
38. Finally, a successful tacit collusion strategy depends on the ability of firms to detect and punish any deviation. In this sector supply arrangements are fluid and there are no specific switching costs, therefore rapid price cuts could act as a punishment mechanism. In addition, all processors have spare capacity so they are capable of retaliating; however, as noted below, the ability to deploy spare capacity depends on access to sufficient volumes of competitively priced raw milk. Furthermore, there is some evidence that some processors may keep accurate records of customers won and lost, which may facilitate detection.
39. Allegations of collusion involving a merging party have been made to the OFT in the course of this investigation. Moreover, the OFT's Cartels Branch has received allegations of collusion between a number of competitors in the Scottish milk sector and, having reached a view that there are reasonable grounds to suspect an infringement of the Competition Act Chapter I prohibition, is continuing its investigation into those allegations; in particular the OFT has carried out a number of inspection visits. Although the cartel allegations are, as yet, unproven and should therefore be treated with caution, the OFT believes that it would be unreasonable to ignore them entirely given the stage this investigation has reached. In our opinion the allegations and the OFT Chapter I investigation form part of a larger matrix of factors relating to coordination that may be taken into account in assessing the weight we attach to particular arguments and evidence.
40. Wiseman's position results in an entirely asymmetric supply structure. Symmetries of market share and/or costs are not, however, conditions precedent to every possible form of coordination. In the Scottish Pride Report, the CC concluded that Wiseman's market power would not be weakened by the fringe, finding that it was likely that Wiseman's rivals would be passive in response to price rises rather than target the customers of the merged entity.²¹ In these circumstances a

²¹ See Scottish Pride Report, paragraph 2.88.

plausible coordination theory in this case would be that rivals follow Wiseman as the coordination 'leader'. The matrix of factors outlined above suggests that it may be profit-maximising for Wiseman's rivals to follow 'passively' in the wake of higher prices that Wiseman's market power permits it to set, rather than actively to undercut Wiseman substantially. This could affect price competition both between the small processors and between the small processors and Wiseman. For Wiseman's rivals, it may also be commercially most sensible not actively to target Wiseman's customers at all, for fear of retaliation.

Facilitating more perfect, durable or complete coordination via the merger

41. As noted above, the issue is not simply whether the sector might currently be characterised as being conducive to coordination, but whether the merger materially affects the status quo by heightening coordination. One way of considering this issue is to ask whether there is a realistic prospect that the merger makes coordination more perfect, more durable, or more complete.
42. Clearly, the reduction in the number of suppliers in a concentrated market can itself facilitate coordination (or help stabilise existing coordination). However, it is arguable that SMD's presence is so insignificant that its removal as an independent force has no material impact on prices and coordination at processor level. Conversely, in terms of supply to middle ground customers in the geographic area of overlap, the following table indicates that SMD is a close third behind Quothquan as Wiseman's largest rival apart from Graham's (by production volume). Switching data submitted by the parties indicates that SMD is Wiseman's closest competitor after Graham's. The table also illustrates that along with Quothquan, SMD is one of only two significant 'smaller fringe' players.²²

²² Switching data provided by the parties indicates that volumes have been lost to/won from all of the processors listed, indicating that all of those listed compete for customers in at least part of the region of overlap.

Table 1: Rivals to Wiseman based in the Greater Glasgow/Central Belt area

Processor	Estimated Production (mlpa)	Percentages (rounded)	Distance to SMD site (miles)
Graham's Dairies	[50-60]	[60-70]%	35
Quothquan	[10-20]	[10-20]%	39
SMD	[]	[10-20]%	-
Bonally ²³	[0-10]	[0-10]%	45
Ballantyne	[0-10]	[0-10]%	4
J Pollock & Sons	[0-10]	[0-10]%	23
J Steel & Sons	[0-10]	[0-10]%	8
Total	[]	100%	-
Wiseman	[]*		

Source: Wiseman; individual processors

* Volume applied by Wiseman to the middle ground; includes volume produced by plant in Aberdeen.

43. In view of the significance of SMD in the segment in question, it is not unrealistic to conclude that SMD competed vigorously against the other smaller processors for non-Wiseman customers. In other words, in a leader-follower context, 'fringe' vs. 'fringe' competition may be more intense than a fringe player targeting the market leader (see above). Therefore, the constraint that SMD exercises on the smaller processors (and vice versa) absent the merger may be significant. This constraint will be eliminated once SMD's customers are brought within the 'fold' of the market leader, Wiseman. In these circumstances, the effect of the transfer of SMD customers to Wiseman and the relaxation of the competitive constraint placed on the smaller processors means coordination may be more perfect, durable or complete following the merger. The question whether this effect may be counteracted by the threat of new entry is considered below.

Unilateral effects

44. The OFT has ascertained that the processors active in the geographic area of overlap have spare capacity, and therefore that they could in theory compete for SMD's customers post-merger. If we assume that the market is not conducive to tacit coordination, it appears that the theoretical ability to increase capacity may,

²³ Bonally's current production may be higher.

in practice, be hindered, firstly, by the processors' reluctance to compete for customers of the leading supplier and, secondly, by what they perceive to be a lack of access to sufficient volumes of competitively priced raw milk. Third party views provide some support for these factors, both of which appear to inhibit expansion by rivals to offset the loss of competition between the merging parties (see further paragraph 47, below).

45. Moreover, in view of the statements [], imminent new entry may not act as a pricing constraint on the merged entity (see below).
46. In these circumstances, Wiseman may find it profitable to increase (or maintain) the price of fresh milk to middle ground customers (in particular, but not limited to, former SMD customers) to a level that is higher than it would be absent the merger (see Counterfactual above).

Barriers to entry and expansion

47. Most of the small processors listed above stated that they were not operating at full capacity. However, the majority of the smaller processors listed in Table 1 were concerned by the transaction. Stated reasons for their lack of incentive and/or perceived inability to expand included: (i) Wiseman's commercial practices which make it difficult to compete; (ii) allegations of collusion between Wiseman and Graham's; and (iii) alleged higher raw milk costs as compared to Wiseman who, according to the respondents, may be supplied by First Milk on preferential terms.
48. According to the parties, smaller middle ground customers also have the option of using wholesalers (including Bottled Milk Buyers (BMBs) such as Yester Farm Dairies and Craig Dairies, and cash & carry stores). Some of the customers contacted by us in this inquiry agreed that this may be a realistic option; the possibility was also noted in the Arla/Express Report. However, wholesalers and BMBs do not represent additional volume since they have to source their requirements from processors; therefore their presence in the market depends on them being able to obtain competitively priced fresh milk.
49. Compared to the national multiples, barriers to entry are lower in respect of supply to the middle ground. The parties estimate that the cost of establishing a new depot capable of supplying 20 mlpa to middle ground customers would be about £500,000. However, it may be difficult for a new entrant in a mature market to build a book of customers such as to make the business profitable. Given that Wiseman is paying approximately £900,000 for the SMD business, the cost of de novo entry may be considerably higher than £500,000.

Entry/expansion by Arla

50. Arla has announced that it will open a processing plant at Lockerbie, Dumfriesshire, some 74 miles from Glasgow. This plant will have an initial capacity of [] million litres per annum (mlpa) and is expected to come on-stream this year. []. In Arla's opinion the new plant may also be too far away to supply middle ground customers in the region in which SMD operates.
51. We note that this position appears to conflict with public statements made by Arla's Chairman in October 2004 to the effect that the Lockerbie plant will enable Arla to improve service to all of its customers, particularly those in the middle ground small shop and foodservice sectors.²⁴ When the OFT put this statement to Arla they explained that Claymore already served some national account business in Scotland that might be categorised as middle ground. In this regard, Lockerbie will provide greater coverage than previously []. However, Claymore does not serve the independent middle ground in Greater Glasgow and the Lockerbie plant []. It should also be noted that none of the customers contacted by us in this case expressed a view that supply by Arla from Lockerbie would be an option in the future.
52. Given the relationship between Arla and Wiseman, the threat of expansion in the middle ground segment by Arla could in theory make any post-merger price increases unprofitable. Arla could also represent a credible disruptive force as to coordination in supply to Scottish middle-ground customers in the relevant area. However, while we are particularly sensitive to the commercial incentive for rivals to frustrate the merger approval process of their competitors, [], we are unable to conclude with sufficient certainty that entry by Arla will be suitably timely, likely and sufficient to serve the relevant middle ground customer base potentially affected by this merger so as to resolve the competition concerns identified above. (Further investigation may lead to a different conclusion, however.)

Customer switching and buyer power

53. When selecting a fresh milk supplier, customers consider that price and service are important, as is the quality of milk. Switching is possible because usually there are no formal contracts and no penalties are incurred when a customer switches supplier. While there is evidence of some switching to the processors listed in Table 1, the number of Wiseman customers who have switched to a small processor is low relative to the total volume of fresh milk supplied by Wiseman.

²⁴ Chairman's statement dated 30 November 2004 accompanying the announcement of Arla Foods' preliminary results for the 18 months ended 30 September 2004.

54. The CC noted in the Arla/Express Report that the smaller middle ground customers have less buyer power, but they are more flexible in terms of being able to switch to small dairies, wholesale suppliers or cash & carry stores. In this context it should be noted that a number of smaller middle ground customers were concerned that what slight bargaining power they had would be eroded by the reduction in the number of processors.

Third party views

55. The Scottish Executive (SEERAD) did not express concerns in relation to the transaction; neither did the National Farmers Union.
56. Concerns expressed by customers and competitors have been referenced in the relevant sections of the competitive assessment. In general we note the level of concern was significant and, in particular, that a number of processors and customers who were unconcerned at the time of the First Milk/Wiseman merger investigation, were concerned about Wiseman's acquisition of SMD.

VERTICAL ISSUES

57. As a result of the transaction, First Milk will no longer wholly own a company active in milk processing. However, First Milk potentially stands to benefit from Wiseman's increased share of the supply of the fresh milk market through its 15 per cent shareholding in Wiseman. In our view the change brought about by this transaction does not materially affect our analysis of vertical competition issues as outlined in the First Milk/Wiseman decision, because First Milk's incentives to favour Wiseman will not materially increase with the addition of customers accounting for only [] mtpa. To the extent that the merger increases the volume of raw milk that Wiseman requires, it might be expected to acquire such supplies from First Milk. For First Milk this simply replaces the volumes that would otherwise have gone to SMD. It is difficult to see that the merger itself significantly changes First Milk's incentives.
58. However, as noted above, a number of small processors have raised concerns in the context of this inquiry that First Milk may be supplying raw milk to Wiseman at prices lower than those charged to other processors; this, they say, makes it increasingly difficult for them to compete with Wiseman on a level playing field.

ASSESSMENT

59. The merger would result in a combined share of supply of fresh milk to middle ground customers in Scotland of approximately [60-70] per cent (Wiseman [50-60] per cent, SMD [0-10] per cent). The next largest competitors are significantly

smaller than the merged entity (Graham's: [10-20] per cent, Claymore/Arla: [0-10] per cent). We do not have accurate shares of supply for the region of overlap, but since this is SMD's main area of operation, the increment may be more significant than the increment in respect of all of Scotland.

60. Having considered all the evidence, we conclude that there is a realistic prospect that the conditions for coordination are present, and that the elimination of SMD, one of the principal smaller suppliers to the middle-ground customers in the Glasgow Area/Central Belt area, will lead to coordination being more perfect, durable or complete than it would be absent the merger. Smaller rival processors may lack the incentive, if not the ability, to compete with the leading supplier in a market in which the players may be able to tacitly coordinate their activities along leader-follower lines; a perceived lack of access to additional raw milk supplies may also impair their ability to expand production to fill their plants. In particular, we are unable to conclude with the requisite degree of certainty that smaller processors would have both the ability and the incentive to compete for the SMD customers that would transfer to Wiseman as a result of the transaction, and smaller middle ground customers in the region of overlap generally.
61. Even in the absence of any coordination, the merger may permit Wiseman unilaterally to profitably increase the price of fresh milk to middle ground customers (in particular, but not limited to, former SMD customers) to a level higher than absent the merger.
62. Moreover, while we are particularly sensitive to the commercial incentive for rivals to frustrate the merger approval process of their competitors, we are unable to resolve the question of whether or not Arla will compete for middle ground customers in the Greater Glasgow area and/or the Central Belt of Scotland to a degree sufficient to alleviate all competition concerns.
63. 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.
64. As noted above, for the purpose of the Undertakings the relevant test against which an acquisition should be assessed is whether the acquisition is unlikely to give rise to higher wholesale prices than otherwise would be the case. The Undertakings are intended to create an additional safeguard to protect the market for the wholesale supply of fresh processed milk to customers in Scotland other than national supermarket groups (i.e. middle ground customers). In our view, this safeguard was intended to operate in addition to the jurisdictional and substantive tests prescribed by the merger control provisions of the relevant legislation. In light of our decision under section 33(1) of the Act, the issue of consent under

the Undertakings will be reconsidered by us following the CC's investigation and report.

DECISION

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