

Completed acquisition by Milk Link Limited, First Milk Limited and Dairy Farmers of Britain Limited of assets of United Milk Limited, namely the Westbury Milk processing plant

The OFT's decision on reference under section 22(1) given on 26 February 2004

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## **PARTIES**

1. **Milk Link** is a farmers' cooperative active mainly in the south west of England. **Dairy Farmers of Britain** is a farmers' cooperative active mainly in the west of England and Wales. **First Milk** is a Farmers Cooperative active mainly in Wales, the west of England and Scotland. **United Milk** was a small farmers' cooperative who owned the Westbury plant. United Milk entered into receivership on 19 August 2003. **Westbury Dairies Limited (WDL)** is the joint venture company (JV) set up by Dairy Farmers of Britain, Milk Link and First Milk to acquire and operate the Westbury plant. The turnover of the acquired business accounted for less than £70 million for the financial year ended 31 March 2003.

## **TRANSACTION**

2. The parties acquired joint control of United Milks' processing plant at Westbury on 28 October 2003. The transaction was notified on 15 December 2003 and the administrative deadline expired on 12 February 2004. The statutory deadline will expire on 27 February 2004.

## **JURISDICTION**

3. The acquisition is treated as one overall transaction because the parties are regarded as associated persons within the meaning of section 127(4) (d) of the Enterprise Act 2002. The parties overlap in the procurement of raw milk and raw milk processing and the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. A relevant merger situation has been created.

## **RELEVANT MARKET**

### **Product market**

4. The parties overlap in the procurement of raw milk and are also active in raw milk processing.

5. The parties are farmers' cooperatives, their primary activity is to procure raw milk from their members, collect it and transport it to processors for conversion into dairy products such as: liquid milk, cheese, butter, cream or Skimmed Milk Powder (SMP). Cooperative members generally receive a lower milk price per litre than independents. However, they receive an additional annual payment (called the 13<sup>th</sup> payment) from their cooperative, dependent on the profits made over the course of the year.
6. The Westbury plant processes raw milk into SMP, cream and butter. These products are sold directly to food processors for further use in ready meals, chocolate, bakery products, desserts etc. Third party responses indicate that these 'commodity dairy products' are a sink for excess milk production since they fetch the lowest price and are generally regarded as an inefficient use of milk supplies.

#### *Demand-side substitutes*

7. Dairies and other milk processors can not substitute other products for raw cows' milk for the vast majority of their products.
8. Similarly, SMP, cream and butter exhibit limited demand substitutability. Customer responses indicate that only a minority of factories can use liquid skimmed milk instead of SMP and butter-oil instead of butter.

#### *Supply-side Substitutes*

9. Dairy farming requires specific buildings, equipment and knowledge on the part of the farmer. As a result it is unlikely that farmers of other agricultural produce would switch into dairy farming given the current rates of return achievable in raw milk production. Third party responses indicate that mixed farmers could increase milk production by diverting more land to milk production, however, they account for less than 10 per cent of all dairy farmers.
10. At the processor level, third party responses also indicate that switching into 'sink' dairy products, of the type produced by Westbury, from other dairy products like liquid milk would be difficult due to the high capital costs involved and difficulties in gaining a secure supply of 'surplus milk' at viable prices.
11. Due to the limited demand and supply side substitutability in raw milk and milk processing it is considered that the most appropriate frames of reference are for the supply of raw cows' milk and the supply of SMP, cream and butter respectively.

#### **Geographic market**

12. This transaction impacts upon the procurement of raw milk and the processing of milk products such as SMP, cream and butter. Given that raw milk needs to be transported to the processor within 24 hours there may be regional aspects to competition. However, third parties estimate that a delivery range of around 100 miles is viable and, as there are no clear geographic breaks, a chain of substitution within England, Scotland and Wales is likely to operate.

13. No competition concerns appear to be raised on either a national or regional basis within Great Britain so the geographic frame of reference for raw milk can be left open.
14. The frames of reference for SMP, cream and butter are likely to be at least EU wide if not global. These products are far less perishable than raw milk and are regularly traded across national borders. Many of the customers of WDL for these products are either export agents or located abroad and third party comments indicate that SMP is imported from as far away as New Zealand.

## **HORIZONTAL ISSUES**

### **Shares of Supply**

15. The parties' main business activity is raw milk procurement. United Milk had supply contracts with a number of independent farmers from whom it procured around 220 million litres per annum (mlpa). These contracts have been carried over to WDL.
16. The parties estimate that their respective shares of the procurement of raw milk in Great Britain will increase only marginally. None of the parties will have a share above 15-25 per cent and none will see an increment above 1 per cent as a result of the merger. Only if the shares of the parties are taken together, they would account for about 45-55 per cent, with WDL accounting for between 1-5 per cent. Horizontal issues will therefore only arise if the parties were to coordinate; any potential for coordination between the parties to the JV will be considered below.
17. The parties are, albeit to a limited extent, also active in raw milk processing. WDL and the parties to the JV would together account for about 5-15 per cent of raw milk processing in Great Britain.
18. Regarding the downstream markets for processed products (SMP, cream and butter) third parties confirmed that there are many suppliers in the UK, Europe and Worldwide. WDL will face competitive constraint from overseas producers of milk products. It is therefore most unlikely that there will be any horizontal issues in the supply of SMP, cream or butter.

### **Barriers to entry and expansion**

19. Raw milk production requires specific plant, buildings, technical knowledge and land in an area with a suitable climate. Third party responses from farmers indicate that new entry, or entry into milk production by farmers of other crops, would be unlikely as these entry costs are high relative to the returns that could be achieved.
20. The level of production is largely exogenous to the farmer and follows a fixed annual cycle, with a spring flush from April to July where raw milk output increases significantly. Farmers can make small adjustments to their annual output of raw milk through changes in feed type and herd size; however they are constrained largely by the availability of land, buildings and the capacity of their on-site milking equipment.

21. Third party responses indicate that a new milk processing plant would cost approximately £50 million to build and take 3 years to come on stream. Entry into 'sink' processing, i.e. the production of SMP, butter and cream is difficult, as the failure of United Milk demonstrates, since these processors need to acquire cheaper supplies of raw milk in order to remain viable.

### **Buyer power**

22. Raw milk must be sold and processed within 24 hours. This places the onus upon the co-ops to find markets for their raw milk since they are committed to buying the milk produced by their members. Downstream buyers, particularly the large processors, are therefore at an advantage when negotiating supply contracts and can exert at least a degree of buyer power.

## **VERTICAL ISSUES**

### **Potential Foreclosure to independent farmers**

23. The possibility of this transaction leading to foreclosure, in terms of independent farmers supplying raw milk to Westbury, is considered to be low. Third party farmers and processors contacted indicate that there is a circa 100 mile delivery range over which raw milk deliveries and collections are viable. Independent farmers are also aided by the fact that it is the processors who are responsible for collecting raw milk in the absence of cooperative membership. Responses from farmers showed that they had a choice of potential purchasers for their milk, not just Westbury. There are a large number of smaller plants in the vicinity of the Westbury plant and larger plants within this radius include Dairy Crest Severnside, Glanbia Taw Valley, ACC Portsmouth and the large liquid milk plants around London.
24. The potential for foreclosure also needs to be considered in the light of the relevant counterfactual. United Milk was in receivership, and although the receivers attempted to contact a range of potential buyers, the WDL JV was the only bid. The counterfactual of United Milk remaining as a viable, independent processor is therefore unrealistic since absent the merger it appears that the Westbury plant would have been closed.

### **Coordinated effects**

25. Some third parties, whilst unconcerned about this transaction and welcoming the continued operation of the Westbury plant, expressed some concern that the joint venture may potentially lead to coordination between the three large cooperatives. This could potentially take two forms, either through the use of the WDL joint venture to engage in joint selling or marketing in the supply of raw milk; or through the use of the Westbury plant to process excessive volumes of milk, so as to withhold raw milk from the market, and so drive up prices.
26. However, for the reasons discussed below there is little likelihood of this transaction leading to coordinated effects of either type.
27. Regarding the former theoretical scenario, that the parties may use WDL to foster wider collusion in the sale of raw milk, our investigation found no evidence that

this was likely to be the case.

28. There will be no increment in the information available to the parties as the raw milk sector is already highly transparent with price lists published regularly. There also remains a competitive fringe of independents, accounting for approximately 45-55 per cent of raw milk supply who may be able to disrupt coordination. Furthermore due to the factors discussed above, any coordination may also be likely to be disrupted by buyer power.
29. There is no credible punishment mechanism that could be used to maintain any coordinated outcome. The supply of raw milk is relatively fixed so the parties can not increase production to 'punish' any deviations; therefore the incentive to cheat and switch back to supplying higher priced customers is likely to be high.
30. Regarding the latter theoretical scenario; whereby the parties channel additional (as opposed to the excess in the spring flush) supplies of raw milk through Westbury. In addition to the factors listed above, this strategy is likely to be highly damaging to the commercial performance of parties. This strategy would result in a reduction in the effective milk price received by farmer members, since raw milk for processing as SMP receives the lowest price. It would also result in reduced profits from milk processing, since prices for intervention products like SMP and butter are set to fall significantly as a result of reform to the EU Common Agricultural Policy. This in turn would necessitate a reduction in the 13<sup>th</sup> payment and increase the likelihood that farmer members could be tempted away by higher direct supply prices or would give the parties an incentive to cheat on any collusive arrangement, especially given the absence of a credible punishment mechanism.
31. Furthermore the activities of WDL are relatively small in relation to the overall activities of the parties in raw milk supply and relatively small in relation to the raw milk sector as a whole. So not only would it appear to be commercially damaging to process excessive amounts of milk through Westbury, there may also be a question as to whether the parties would be able to process enough milk to materially affect prices.
32. Withholding raw milk from the market would, therefore, not appear be a viable strategy and is unlikely to be sustainable in the long run.

### **THIRD PARTY VIEWS**

33. Third parties contacted expressed the view that the continued operation of the Westbury plant was important for the efficient operation of the raw milk market. Some processors, although not concerned about this transaction, noted that they would be concerned if this JV were to lead to or facilitate wider coordination between the parties in the supply of raw milk.

### **ASSESSMENT**

34. The acquisition of the Westbury Plant by the parties resulted in an increment of between 1-5 per cent in the procurement of raw milk and none of the parties has

a share of supply above 15-25 per cent as a result of the transaction. The parties jointly account for about 5-15 per cent of raw milk processing in Great Britain. The downstream markets for SMP, cream and butter are at least EU-wide in scope and no horizontal issues are raised.

35. With regard to possible foreclosure effects, responses from farmers confirmed that there remains a choice of potential purchasers of raw milk. Potential coordination between the parties to the JV appears to be an improbable outcome of this transaction, given that there is buyer power downstream, no credible punishment mechanism and withholding raw milk from the market would be damaging to the cooperatives.
36. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within the UK.

## **DECISION**

37. This merger will therefore **not be referred** to the Competition Commission under section 22(1) of the Act.