

Completed acquisition by Lactalis McLelland Limited of Lubborn Cheese Limited

ME/4163/09

The OFT's decision on reference under section 22(2)(a) given on 6 August 2009. Full text of decision published 25 August 2009.

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**Please note that the square brackets indicate figures or text which have been deleted or replaced in ranges at the request of the parties or third parties for reasons of commercial confidentiality.**

**PARTIES**

1. **Lactalis McLelland Limited (Lactalis)** is part of a global dairy group owned by B.S.A. International, S.A. It employs 38,000 people and owns 127 industrial sites worldwide. Lactalis supplies a range of 'hard' and 'soft' cheeses to the UK including Président, the 'Seriously' brand, Orkney Cheddar, Salakis, Galbani, Societe and Dolcelatte. Lactalis also supplies own-label cheeses to supermarkets.
2. **Lubborn Cheese Limited (Lubborn)** is a producer of soft cheese in the UK, mostly of Somerset-branded produce out of its creamery in Somerset. Its range encompasses Somerset Brie, Organic Somerset Brie, Somerset Camembert, Somerset Goats Cheese, Somerset Rustic, Channel Islands Brie and 'Capricorn' Goats Cheese. Turnover for the year ended 31 March 2008 was £11.6 million.

**TRANSACTION**

3. On 3 June 2009, PricewaterhouseCoopers LLP (PwC) were appointed receivers and managers of Dairy Farmers of Britain (DFoB). The shares in

Lubborn were held by a DFoB subsidiary, Dairy Farmers of Britain Processing Limited (DFoBP).

4. On 6 June 2009, following a bidding process, Lactalis and DfoBP, through PWC, completed the acquisition by Lactalis of Lubborn. The transaction consisted of the sale of the entire issue capital of Lubborn for the sum of [ ].
5. The OFT's statutory deadline under section 24 of the Act for deciding whether to refer the merger to the Competition Commission is 5 October 2009. The OFT's administrative target date to announce its decision is 14 August 2009.

## **JURISDICTION**

6. As a result of this transaction Lactalis and Lubborn have ceased to be distinct. The parties overlap in the supply of soft cheese in the UK. Their combined share of supply is above 25 per cent and therefore 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.

## **COUNTERFACTUAL**

7. Paragraph 3.24 of the OFT's Substantive Assessment Guidance<sup>1</sup> states:

'In most cases, the best guide to the appropriate counterfactual will be prevailing conditions of competition. However, the OFT may need to take into account likely and imminent changes in the structure of competition in order to reflect as accurately as possible the nature of rivalry without the merger.'

8. An example of the likely and imminent changes that the OFT may need to have regard to is whether the target company is a 'failing firm'.
9. The OFT's position on how it will assess an exiting (including failing) firm defence was recently articulated in the 'Restatement of OFT's position

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<sup>1</sup> *Mergers Substantive Assessment Guidance* (OFT 506). See also, para 4.23 of *Draft Merger Assessment Guidelines*, a joint publication of the Competition Commission and the Office of Fair Trading (Draft Joint Merger Assessment Guidelines).

regarding acquisitions of 'failing firms'.<sup>2</sup> The OFT confirmed in that restatement that it will only clear a transaction based on 'failing firm' claims where it has sufficient compelling evidence that the following conditions are met:

- absent the merger, the target business would have inevitably exited with no serious prospect of re-organization, and
- there was no realistic and substantially less anti-competitive alternative to the merger.

#### Inevitable exit

10. Lactalis submits that Lubborn would have exited the market and that this should be taken into account for the purposes of the counterfactual. In particular, Lactalis noted that DFoB was in receivership and the sale of Lubborn was part of the wider divestment of DFoB's businesses. In this respect, Lactalis argued that there was no reasonable prospect of Lubborn surviving without being acquired by a third party. In particular, it was argued that without the acquisition by Lactalis, the farmers who previously supplied cows' milk to Lubborn but had not been paid by DFoB would have found other outlets for their milk, or that they would have gone out of business, leaving Lubborn without cows' milk for the production of cheese. In addition, Lactalis argued that Lubborn was not a stand-alone business, in that it depended on DFoB for the supply of cows' milk and other essential elements of its business, including sales and marketing and the management of key sales accounts, HR services and IT services.

#### No less anti-competitive alternative

11. Lactalis provided some evidence to support its argument that there was no other buyer, whose acquisition of Lubborn would produce a substantially better outcome for competition than the merger under consideration.
12. The OFT also received evidence from PwC regarding information on the bidding process and the alternative bidders considered by PwC.
13. However, since the OFT concludes (see below) that the merger does not give rise to a realistic prospect of a substantial lessening of competition

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<sup>2</sup> Published on 18 December 2008. See also para 4.27ff of the *Draft Joint Merger Assessment Guidelines*.

against pre-merger conditions of competition, there is no need for the OFT to reach any conclusion regarding the failing firm defence put forward by Lactalis. To the extent that it were in fact inevitable that Lubborn would have exited the market and been acquired by a third party, the OFT's testing of the merger against pre-merger conditions of competition provides a reasonable proxy for such a situation in any event.

## **MARKET DEFINITION**

14. The parties overlap in the manufacture and supply of Brie, Camembert and Goats cheese. These cheeses fall within the broader category of 'soft' cheeses which also includes feta, mascarpone, mozzarella and other continental origin cheeses. The vast majority of the parties' sales are to the supermarkets, as branded and/or supermarket own-label products, however, they also supply grocery wholesales and specialist cheese suppliers.
15. Brie is a soft-ripened cows milk cheese named after the French region where it originated, although it has not been granted 'protected designation of origin'(PDO) status. Accordingly, Brie types are manufactured not only in France, but also in North America, Germany, Poland and Great Britain. Brie is characterised by a smooth, edible white downy rind, and a creamy, rich buttery interior.
16. Camembert is also a soft-ripened cows milk cheese, often compared to Brie, but with a more earthy and nutty taste. As in the case of Brie, Camembert originated in France (Normandy) but is manufactured throughout the world.
17. Goats cheese is made from Goats milk. It is manufactured throughout the world and is sold in various forms, including soft, semi-hard and hard. Lubborn's Goats cheeses are all of the soft variety.

## **Product scope**

18. With regards to the product scope, the OFT considered a number of factors including whether British origin soft cheese is in the same market as imported (Continental) soft cheese, whether Brie, Camembert and Goats cheese are in the same market, whether branded soft cheese products are in the same market as private-label soft cheese products, and finally whether the different distribution channels represent separate markets.

## British vs. Continental soft cheeses

### Parties' views

19. In its submission to the OFT, Lactalis argued that the British soft cheeses (of the type supplied by Lubborn) are in a separate market from Continental (imported) soft cheese (such as those supplied by Lactalis) and therefore there was no overlap between the parties. Lactalis claimed that although British soft cheese may take the style, form and name of French soft cheese, such as Brie and Camembert, consumers do not view British and French soft cheese as substitutes for each other.
20. In particular, according to Lactalis:
  - research [ ] into shopper preferences between [ ] showed that a group of customers would not transfer from [ ] Somerset Brie to [ ] French Brie. However, in the same document [ ] mentions the challenge of winning market share from French Brie
  - other research [ ] shows that there was greater awareness and association of French-origin Brie and Camembert than British-origin Brie and Camembert. Furthermore, [ ] do not consider or mention competition from British soft cheese, including [ ]
  - the price of British soft cheese is consistently higher than the price of Continental own label soft cheese, not only because Lubborn faces higher production costs than those faced by Continental soft cheese producers, but principally, according to Lactalis, because the market positioning of British soft cheeses gives them a price premium<sup>3</sup>
  - pricing data show that variations in the share of total sales of British Brie and Camembert are not related in any way to price differences between the British and Continental soft cheeses, and
  - on the basis of a comparison of the production costs faced by Lubborn in the production of British Brie with those faced by French manufacturers, Lactalis concluded that - given the combination of the relative price of raw milk in Britain and France and production efficiencies achieved in France (as a result of greater volumes) - Lubborn could not supply sufficient volumes of British (own-label) Brie to take the place of Continental (own-label) Brie.

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<sup>3</sup> [ ].

21. Finally, Lactalis argued that British soft cheese suppliers would readily and swiftly switch supply in response to a price increase in Lubborn cheese by Lactalis, as the technology and machinery required to produce any soft cheese is similar and this makes such switch unproblematic.

#### The OFT's investigation/evidence

22. The OFT has sought to analyse a range of evidence to evaluate whether British soft cheese and French soft cheese (and specifically the areas of overlap, Brie and Camembert) belong to the same product market, including price correlations, demand elasticities, evidence from third parties and the impact of promotions.

##### (i) Price correlations

23. The OFT's price correlation analysis based on the data supplied by the parties reveals that the prices of Somerset Brie and Camembert are either weakly or even negatively related to the prices of branded<sup>4</sup> and own label French Brie and Camembert. The validity of the results for Somerset Brie is, however, questionable given that there were only 9 data points for this compared to 40 for all the others. However, the general results for Somerset Camembert are similar to that for Brie.
24. The OFT is conscious of the shortcomings of using price correlations for the purpose of defining relevant markets. In particular, even if the prices of two products are highly and positively correlated, this does not necessarily imply that they are in the same relevant market, as the correlation may be spurious or due to both products using a common input (for example, raw milk in this case) or common trends, such as strong seasonality in sales (say, at Christmas). As a result, while noting that, on the basis of these figures, there is no (or even negative) correlation between Somerset and French origin Brie and Camembert cheeses in this case, the OFT attaches limited weight to this evidence taken in isolation.

##### (ii) Demand elasticities and critical loss analysis

25. The OFT has estimated demand elasticities using three years worth of 4-weekly data on the volume and value sold of Brie and Camembert, aggregated by TNS from supermarkets' scanner data. The OFT has used its

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<sup>4</sup> Brands include Président (Lactalis), Coeur de Lion and Le Rustique (both Bongrain).

estimated elasticities in a 'critical loss' implementation of the SSNIP test for market definition.

26. The OFT has estimated demand elasticities by modelling consumers' choice of Brie and Camembert in two stages: the first stage being the choice between Brie and Camembert, and the second being the choice between French branded, French private-label and Somerset.<sup>5</sup> The following analysis refers only to Somerset Camembert, there were insufficient data points to carry out the same analysis for Brie.
27. For Somerset Camembert, the OFT obtained an own-price elasticity of demand of around -3, which implied that a price increase of 5 per cent would lead to a reduction in the quantity demanded by around 15 per cent.
28. Whether a loss of 15 per cent in sales would render unprofitable such a 5 per cent increase in price by a hypothetical monopolist depends on the incremental profitability of lost sales. (If a 15 per cent loss in sales were unprofitable, then the market appears wider than only Somerset Camembert. If it were not, then the market appears no wider than Somerset Camembert.)
29. Lactalis provided figures showing the profit margin for Somerset Camembert was around [ ] per cent. With a profit margin of [ ] per cent, the critical loss in sales needed to render unprofitable a 5 per cent price increase by a hypothetical monopolist of Somerset Camembert would be around [ ] per cent.<sup>6</sup> On the basis of the OFT's estimated demand elasticity for Somerset Camembert of around -3, the actual loss in sales following a

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<sup>5</sup> In the econometric specification at the top level, the dependent variable is the quantity demanded of Brie and Camembert (in natural logarithms, or 'logs'), and the independent variables are price indices and total expenditure for the two cheeses (again in logs), plus a time trend, and yearly and monthly dummies. At the bottom level we estimate an Almost Ideal Demand System (AIDS), where the expenditure shares of French branded, French private-label and Somerset Camembert are regressed on price indices of the different types of Camembert and total expenditure for this segment (in logs), plus a time trend, and yearly and monthly dummies. (For details of the AIDS model see Angus Deaton and John Muellbauer (1980), 'An Almost Ideal Demand System', *American Economic Review*, 70, pp. 312-336.) The two-stage model we used in this case has been applied in a variety of mergers involving differentiated products, for example, beer and ready-to-eat cereals. See, for example, Jerry Hausman, Gregory Leonard and J. Douglas Zona (1994), 'Competitive Analysis with Differentiated Products', *Annales d'Economie et de Statistique*, 34, pp. 159-180, and, Daniel L. Rubinfeld (2000), 'Market Definition with Differentiated Products: The Post-Nabisco Cereal Merger', *Antitrust Law Journal*, 68, pp. 163-182.

<sup>6</sup> The formula for the 'critical loss' is  $s/(s+m)$  where  $s$  is the price increase and  $m$  is the profit margin. For a price increase of 5 per cent (that is 0.05) and a profit margin of [ ] per cent (that is [ ]), the critical loss is therefore around [ ] per cent (that is  $0.05/[ ]$ ).

5 per cent price increase by a hypothetical monopolist appears to be around [ ] per cent<sup>7</sup>. As this exceeds the critical loss (though not by much), the hypothetical monopolist's 5 per cent price increase appears unprofitable, implying that the relevant product market may be wider than Somerset Camembert.

30. However, Lactalis submitted that the accounting basis of the margins calculated by Lubborn was significantly different to its own accounting basis. In particular, Lubborn's profit margin did not allow for a number of direct costs of sales such as overheads and distribution that Lubborn attributed to its parent company DFoB. On Lactalis' basis, the profit margin for Somerset Camembert may be significantly lower than [ ] per cent (that is [ ], in percentage terms).<sup>8</sup> Were this the case, the critical loss in sales needed to render unprofitable the hypothetical monopolist's 5 per cent price increase would be significantly higher—such that the 'actual loss' of [ ] per cent would no longer exceed it, implying that the relevant market would be no wider than only Somerset Camembert. Consequently, given the uncertainty about profit margins, it is hard for the OFT to reach a conclusion on market definition on the basis of this critical loss analysis.

(iii) Third parties' views

31. Views from third parties were mixed on whether British and French soft cheeses, in general, belong in the same market. Although the provenance of the cheese appears important, supermarkets' views differed on whether consumers would switch between British and Continental origin soft cheeses in response to a small but significant and non-transitory increase in the price (SSNIP). In particular, two supermarkets believed that consumers would switch, while two others stated that—while they consider British and French soft cheese to be in the same market—consumers may not switch in response to a SSNIP because of the importance of the provenance. A fifth supermarket was firmly of the view that these products

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<sup>7</sup> In critical loss analysis, it is usual to estimate the actual loss from the elasticity of residual demand facing the merger firms as this is taken to be a good measure of the elasticity of demand facing a hypothetical monopolist of the narrowest candidate market. In this case, however, there is no overlap between the merger firms in the narrowest candidate market, as only Lubborn produces Somerset Camembert (and is a virtual monopolist in it). Consequently, in this case the elasticity of total demand for Somerset Camembert is the appropriate basis on which to estimate the actual loss.

<sup>8</sup> Indeed, on the basis of the OFT's estimated elasticity of demand for Somerset Camembert of -3, profit margins might be expected to be no higher than [ ] per cent and not [ ] per cent (as there is an inverse relationship between profit margins and the elasticity of demand).

were in separate markets and consumers would not switch in response to a SSNIP.

(iv) Impact of promotions

32. The OFT also assessed the way British and French soft cheese was promoted by supermarkets, in particular whether promotions are run at the same time or at different times and their impact on sales of other goods.
33. In examining the timing of promotions, the OFT considered that if promotions are run concurrently, then this may be because supermarkets do not view the products as substitutes. (It would not appear to make much commercial sense to simultaneously reduce the price of two products that are substitutes for each other, as this would leave their relative price unchanged and not encourage consumers to switch from one to the other.) Conversely, if promotions are not run concurrently, then this might suggest that supermarkets consider that consumers may view the products as substitutes and so may be induced to switch from one to the other.
34. Data provided by Lactalis in this regard was mixed but two supermarkets said that they would not consider promoting British and French soft cheeses at the same time as they saw some switching during promotions. Data provided by two other supermarkets also showed that promotions on these products are not run at the same time. This could suggest that these products may be considered by supermarkets to be substitutes and so possibly be part of the same market.
35. The second issue is whether promotions have an effect on the sales of other products. It is worth noting that even if consumers do switch, often the price impact of a typical supermarket promotion such as 'buy one, get one free' or 'three for the price of two' is much greater than that which the SSNIP test traditionally considers for the purposes of market definition. In spite of this, an absence of switching could still indicate that British and French soft cheeses are in separate markets.
36. The OFT's analysis of the impact of promotions on sales of British and French Brie and Camembert in two supermarkets revealed some evidence that some promotions of Somerset Camembert affected sales of French Camembert (Président) and vice versa. Conversely, the analysis showed that promotion of branded French Brie primarily affected sales of retailers' own-label Continental soft cheese rather than Somerset Brie.

## Conclusion

37. The evidence on whether British soft cheese and French soft cheese are in the same product market is mixed. Without prejudice to the precise market definition, the OFT has therefore examined whether British and French origin Brie, Camembert and Goats cheeses should be considered separately or, in the case of Brie and Camembert, together. Since these are the areas of overlap between the parties, if there is no realistic prospect of a substantial lessening of competition on this market then no concerns should arise in the market for all soft cheese in the UK.

### **Brie, Camembert and Goats cheese**

38. Third party views were clear that Brie and Camembert can be considered as a separate market to other soft cheese. In particular no retail customer considered that consumers would switch in response to a SSNIP on both Brie and Camembert.

39. However, third parties views were mixed on whether Brie and Camembert could be considered to be part of the same market or whether separate markets exist for Brie and for Camembert. Some competitors told the OFT that they consider Brie and Camembert to be in separate markets and that customers would not switch in response to a SSNIP. However, supermarkets told the OFT that Brie and Camembert are part of a single market and that consumers would switch between the two in response to a SSNIP<sup>9</sup>.

40. Regarding Goats cheese, most third parties told the OFT that they considered soft Goats cheese to be a separate market from other soft cheese. In particular, the rationale for purchase is for health reasons - as Goats cheese is easier to digest - and taste. Because of this they did not believe customers would switch to other soft cheeses in response to a SSNIP. Indeed one customer pointed to the fact that despite price inflation over the past few years - the result of weakening sterling (against the Euro) and the increase in goat milk prices - sales of Goats cheese had continued to rise.

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<sup>9</sup> With the exception of one supermarket which told the OFT that while it considered there to be a single market for Brie and Camembert, it did not believe that consumers would switch between the two in response to a SSNIP.

## **Retailer (own) label and branded soft cheese**

41. Soft cheese manufacturers (including the parties) sell their output both as proprietary brands (for example, Lactalis' Président, Bongrain's Coeur de Lion, and Lubborn's Capricorn) and through retailers' own labels. The OFT considered whether these two supply routes were part of the same market.
42. In doing so the OFT distinguished between:
- the upstream level of the supply chain, that is the procurement of soft cheese by large retailers and others (for example wholesalers and specialist retailers) and
  - the downstream level of the supply chain, that is the sale of soft cheese to final consumers.
43. In particular, it may be the case that even if branded products and private labels do not compete at the downstream (consumer) level, retailers nonetheless view them as 'substitutes for shelf space' at the upstream level.
44. In Friesland Foods/Campina<sup>10</sup> the European Commission noted that the procurement of branded products follows a different procedure than the one for private label products. However, despite these differences in procurement procedures, the Commission decided that, in that case, for a number of dairy products (for example fresh and long-life milk, and Dutch cheese) private labels were in the same relevant market as branded products at the upstream level.<sup>11</sup>
45. In this case the OFT followed the same approach as the Commission in examining whether private labels and manufacturers' brands of soft cheese are in the same relevant market at the upstream level.
46. On balance, the evidence before the OFT suggested that:
- the same suppliers supply both branded and own-label products

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<sup>10</sup> Case No. COMP/M.5046 – Friesland Foods / Campina, 17 December 2008.

<sup>11</sup> See section 7.1.1.2 of the Commission's decision in Friesland Foods / Campina for an assessment of these criteria in the case of basic fresh dairy products, for example, fresh milk. The Commission, however, conducted a detailed assessment for each dairy product. For example, it found that private labels and branded products were in separate markets at the upstream level in the case of fresh flavoured dairy drinks.

- Lactalis did not differentiate in its UK sales figures between branded and own-label sales<sup>12</sup>
- over 80 per cent of soft cheese sold in the UK is sold by supermarkets, of which 80 per cent is sold as own-label
- almost all ([ ]) of Lubborns' soft cheese (Brie and Camembert) is sold as retailer own label, and
- third parties did not think that a distinction between branded and own-label was appropriate.

47. On this basis, the OFT considered that branded and own-label soft cheese appear to be part of the same product market.<sup>13</sup>

### **Distribution channels**

48. The OFT received very little evidence from third parties regarding whether different distribution channels for soft cheese (to grocery retailers, wholesalers and specialist suppliers) represent separate product markets. As mentioned above, the vast majority of sales of soft cheese are made through supermarkets. However, all the main suppliers are common to each distribution channel.

49. Therefore, the OFT concludes that the appropriate frame of reference in this case is to consider all distribution channels within the same frame of reference.

### **Geographic scope**

50. Lactalis argued that from a geographic perspective, the scope of the product markets identified above is national. While the OFT notes that there are significant imports of soft cheeses into the UK the importance of British soft cheese is relevant to the UK only. It appears, therefore, that competitive conditions in the UK are different to those in wider Europe.

51. Therefore the OFT considers the appropriate geographic frame of reference for this merger to be the UK.

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<sup>12</sup> Lactalis said that this was because a supermarket may sell a branded product on its delicatessen counter as own-label cheese or may re-package branded cheese in an own-label selection pack.

<sup>13</sup> This is consistent with previous OFT decisions, in particular its decision in the anticipated merger between First Milk Limited and Milk Link Limited, 12 December 2007 (at paragraph 17).

## **Conclusion on frame of reference**

52. Based on the evidence provided by Lactalis and third parties, and on its own analysis, on a cautious basis the OFT considers that the appropriate frame of reference for this merger is:

- the supply of Brie and Camembert to all customers in the UK, regardless of provenance, branding or distribution channel, and
- the supply of soft Goats cheese to all customers in the UK, regardless of provenance, branding or distribution channel.

## **COMPETITIVE ASSESSMENT**

### **UNILATERAL EFFECTS**

#### **Market shares**

53. Treating British origin and Continental origin Brie and Camembert as a single market, the parties will have share of supply of [40-50] per cent with an increment of [20-30] per cent. For Goats cheese, the parties' combined market share will be [40-50] per cent with an increment of [10-20] per cent. The OFT considers that these market shares are high enough to give rise to prima facie concerns over unilateral effects.

54. If treating Brie and Camembert as distinct UK markets, the parties' combined share would be [50-60] per cent with an increment of [20-30] per cent for Brie, which is high enough to give rise to prima facie concerns over unilateral effects and [20-30] per cent with an increment of [10-20] per cent for Camembert, which is not high enough to rise to prima facie concerns over unilateral effects

#### **Closeness of Competition**

55. Given that the combined shares of supply (for Camembert, Brie and Camembert combined and Goats cheese) are at levels which might give rise to competition concerns, the OFT has considered evidence on the closeness of competition between the parties. Based on the evidence provided by Lactalis and third parties and on its own investigation, the OFT

concludes that Lactalis and Lubborn are not close competitors in the supply of Brie, Camembert and Goats cheese in the UK.

#### Brie and Camembert

56. Lactalis argued that the parties did not operate in the same market and so did not compete (as described above). However, even if the OFT did consider the products to be in the same market, Lactalis argued that they were not close competitors, as Lactalis' main competitors were Bongrain and Eurilait, while Lubborn's closest competitor was Cornish Country Larder (CCL). In particular, own label cheese, which accounts for an estimated 80 per cent of all cheese sold in this sector ([ ] per cent of Lubborn's cheese), is labelled with the provenance of the cheese and most retailers would seek to provide both a continental-origin own-label and British-origin own-label offering. Lactalis supplies (retail) customers with French own-label Brie and Camembert whereas Lubborn supplies customers with Somerset Brie and/or Camembert.
57. Evidence provided by Lactalis shows that customers do not view branded French Brie to be a close substitute to British Brie (most of which is sold as retailer own-label), with own-label French Brie considered a closer substitute to British Brie. This is consistent with the (albeit limited) pricing information that the OFT has, indicating that branded French Brie is priced higher than own-label British Brie, which in turn is priced higher than French own-label Brie.
58. Lactalis' evidence shows that branded French Camembert (such as Président and Le Rustique) is considered to be premium whereas British Camembert is not. However, this is at odds with the pricing information provided to the OFT which suggests that Lubborn's Somerset Camembert is priced higher than both branded and own-label French Camembert. This is also at odds with the OFT's estimated demand elasticities (discussed in paragraphs 25–30), which suggest that branded French Camembert and Somerset Camembert are close substitutes: in particular, the diversion ratio (defined as the ratio of the cross-price elasticity of demand to the own-price elasticity of demand) from Somerset Camembert to branded French Camembert is 70 per cent, and from branded French Camembert to Somerset Camembert is 53 per cent. These are far higher than the diversion ratios from Somerset Camembert and branded French Camembert to either own-label French Camembert or Brie.

59. Set against this, internal documents from Lubborn suggest that sales of 'premium' products (such as Lubborn cheese) have been lost to value products as consumers adjust spending during a severe economic downturn. This could suggest consumer switching has more to do with income effects rather than substitution effects.
60. Furthermore, all retail customers apart from one stated that they consider Lubborn and Lactalis to be competing only to a limited extent due to the different provenance of their cheese. In particular, third parties provided evidence of instances of actual or proposed switching from Lubborn and from Lactalis soft cheese, which indicated that any switching was not between the parties. For example, supermarkets told the OFT that if they were to switch from Lactalis, they would switch to Bongrain, Eurilait or other continental cheese suppliers. In particular, one customer said that it had switched from Lactalis branded soft cheese to [ ] to achieve a better price. Similarly, third parties provided evidence to the OFT that if they were to switch away from Lubborn, it would be to CCL. In particular, internal documents and third parties provided examples where such switching has already happened.<sup>14</sup>

#### Goats Cheese

61. As mentioned above, if French and British soft Goats cheese formed part of the same market, the merging parties would have a market share of about [40-50] per cent with an increment of almost [10-20] per cent.
62. As with the evidence and the arguments analysed above for Brie and Camembert, the merging parties are not considered close competitors by any of the retail customers in the supply of soft Goats cheese, and there was only one competitor that raised any concerns about this market (addressed below).

#### Conclusion

63. If British origin and Continental origin soft cheeses (including Brie, Camembert and Goats cheeses) are considered as separate markets then there is no overlap between the parties and, consequently, no horizontal competition concerns. However, there is some evidence that British and

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<sup>14</sup> For instance, at Christmas 2001, one competitor started supplying one supermarket [ ]. Further, in November 2008, Lubborn was asked by one customer to provide a bid to replace Cornish Organic Brie (CCL). Finally in April 2009, one customer decided to de-list Somerset Brie (Lubborn) in favour of Cornish Brie (CCL) because [ ].

Continental origin soft cheeses may be substitutes. However, even if considering one market for all soft cheese (that is British and Continental), or separate markets for all Brie, all Camembert and all Goats cheese, the majority of retail customers consider the parties to be competing with one another only to a limited extent. Therefore, the OFT concludes that, considering all the evidence, the merger does not give rise to a realistic prospect of a substantial lessening of competition in the supply of British and Continental origin Brie, Camembert and Goats cheese in the UK.

## **COORDINATED EFFECTS**

64. The OFT notes that the dairy sector is subject of a current investigation by the OFT under the Competition Act 1998. In the present case, the OFT received no concerns from any third party regarding the possibility of coordinated effects resulting from the merger.
65. However, the OFT has considered each of the three conditions that might indicate the potential for coordinated effects and referred to in the Draft Joint Merger Guidelines.<sup>15</sup> Taking each of these conditions in turn, the OFT concluded that none was satisfied. In summary, for the reasons set out below, the evidence before the OFT does not support the idea that the merger will 'tip' the market towards coordination.

### **Firms need to be able to reach and monitor the terms of coordination**

66. Lactalis submits that there is not a sufficient degree of market transparency or interaction between competitors that could facilitate the terms of coordination being reached and monitored. Whilst retail price information is available, there is no transparency over wholesale prices that would enable competitors to align their behaviour. In addition, Lactalis submitted that it was unable to identify precisely what proportion of its sales to retailers are actually sold as own-label products (see paragraph 46 above), nor its rivals' precise production capacities. Furthermore, there are no written contracts with supermarkets and so supply agreements could be short-term.
67. Finally, there is no interaction between competitors that would facilitate the emergence of a coordinated price. Whilst there are some vertical relationships, there are no significant structural links between competitors. Indeed, as shown in internal documents, Lactalis spends [ ] in analysing

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<sup>15</sup> Paragraphs 4.115-4.132.

how best to compete with Bongrain and Bel in particular, as does Lubborn with regard to competing with its main competitor, CCL.

#### **Coordination needs to be internally sustainable among the coordinating group**

68. Lactalis submitted that it competes aggressively for business with Bongrain and Bel in particular, both for branded and own-label supplies of continental cheeses to the supermarkets. This is consistent with the views expressed by customers. The acquisition of Lubborn enables Lactalis to offer a British soft cheese to its customers but could not, in itself, create or strengthen the possibility that the competitors would now find it profitable to coordinate their competitive behaviour.

#### **Coordination needs to be externally sustainable**

69. Lactalis submitted that even if the first two conditions were satisfied, the conditions of competition in any 'soft cheese' market are not conducive to tacit coordination in order to sustain any such behaviour.

70. As the Draft Joint OFT and CC Merger Assessment Guidelines state, 'Coordination will be sustained only if the outside competitive constraints on the firms involved in the coordination are relatively limited'. Lactalis argued that coordination was unlikely to be externally sustainable given the buyer power of the supermarkets. In particular, as the overwhelming majority of the ultimate customers of soft cheese suppliers are supermarkets (accounting for 80 per cent of total sales and most of these sales were of retailer own label brands) buyer power would be sufficient to prevent coordination.

#### **Conclusion**

71. Therefore, based on the evidence provided by Lactalis and the lack of third party concerns, particularly from customers, the OFT does not believe that the merger can be expected to give rise to coordinated effects.

#### **CONGLOMERATE EFFECTS**

72. In light of the possibility that British and Continental soft cheeses are not in the same market, the OFT investigated the possibility of the merger giving rise to conglomerate effects. Conglomerate effects do not arise from the loss of direct (horizontal) competition between parties (which would be examined as a part of unilateral or coordinated effects analysis), nor

between firms that are vertically related in some way (that is are active at different stages of a supply chain). Instead, conglomerate effects may arise in mergers of firms in different markets that are not vertically related— either because the products they produce are complements or are unrelated.

73. Generally, in competition terms, conglomerate mergers are often benign (if they involve unrelated products) or even efficiency-enhancing (if they involve complements). However, in certain circumstances, a conglomerate merger of complementary products can result in the merged entity foreclosing rivals (through tying and bundling or through 'portfolio effects').<sup>16</sup> The OFT only regards foreclosure as anti-competitive where it results in a substantial lessening of competition in the foreclosed market(s), not merely where it disadvantages one or a few competitors.
74. The third party concerns that the OFT received in this case that might be said to relate to potential conglomerate effects were that, following the merger:
- Lactalis would be able to tie or bundle sales of British and French Brie/Camembert which could lead to a diminished overall product offering by raising prices or reducing quality, and
  - Lactalis as a whole would have a large portfolio of speciality cheeses in the UK.

#### **Tying and bundling**

75. The OFT has examined whether, following the merger, Lactalis would have the ability and incentive to foreclose rivals through tying/bundling British and Continental Brie/Camembert.

#### **(i) Ability to foreclose**

76. The ability to foreclose depends on the following cumulative conditions:
- Lactalis acquiring, as a result of the merger, market power in at least one product market which customers view as being particularly important

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<sup>16</sup> See chapter 6 of the OFT's *Mergers - substantive assessment guidance* (OFT516) and, for a more recent statement, the Draft Joint Merger Assessment Guidelines, paragraph 4.152ff.

- the products to be tied/bundled being supplied to mostly the same customer base, and
- Lactalis being able to credibly commit to a strategy of tying/bundling.<sup>17</sup>

#### Market power

77. Estimated market shares suggest that Lubborn may possess market power. In particular, the parties estimated that Lubborn has a market share of approximately [90-100] per cent for British Brie and Camembert although almost all of this is sold as retailer own-label. However, the merger itself does not add to this share of supply. While some customers stated that Somerset Brie is a 'must stock' brand others commented that Lubborn's products were not 'must stock' and there were alternative sources of British Brie and Camembert, namely Cornish Brie from CCL. In addition, some customers told the OFT that they would consider de-listing Lubborn cheese if Lactalis sought to increase prices.
78. Market shares may indicate that Lactalis may have some market power in relation to French Brie and Camembert with a market share of [20-30] per cent but, again, the merger does not add to this. Some customers have mentioned that they consider Lactalis' Président Brie to be 'must stock', based on the volume of sales. However, another customer said it had switched between Président and [ ] brands to achieve a better price. Finally some customers told the OFT that they could switch away from Lactalis to alternative providers of French cheese if Lactalis increased prices or attempted to tie/bundle sales.
79. Based on the evidence provided, the OFT does not believe that the merger would confer on Lactalis additional market power to enable it to leverage that power into another market. In particular, the OFT concludes that the parties do not have 'must stock' brands, and customers have the ability to switch to alternative soft cheese suppliers.

#### The same customer base

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<sup>17</sup> See the *Draft Joint Merger Assessment Guidelines*, paragraphs 4.152–4.167.

80. In many instances, the primary customers for Lactalis products are the same as for Lubborn products. These customers are large multiple supermarkets, smaller supermarkets customers, catering/foodservice operators and wholesalers.
81. There is some evidence that some customers negotiate for product lines across the board. In particular, one competitor stated that they supplied one customer with all their Brie/Camembert requirements, including purchasing Somerset Brie from Lubborn to provide the full range, and this is part of the basis on which they won the business. Several other supermarkets, however, deal with multiple suppliers for their requirements of Brie and Camembert.

#### Credible commitment

82. Lactalis submitted that it would risk losing share of own-label production in response to any attempt at tying or bundling products which disadvantaged its supermarket customers. Lactalis submitted that supermarkets can easily and swiftly react to any attempted tying or bundling - by Lactalis of Lubborn branded cheese with its other branded cheese - by de-listing either those cheeses (all of which have alternatives available) or other branded and/or own label cheeses it supplies.
83. One third party mentioned that Lactalis, whether able to or not, had not engaged in tying or bundling to date, and did not think that the merger would change this. Other supermarkets did not express concerns that Lactalis would be able to tie/bundle their products and that they would oppose such moves if it was not in the interests of consumers.

#### (ii) Incentive to foreclose

84. The incentive to foreclose depends on whether tying/bundling is profit enhancing as a result of the merger. This depends on whether the gains from foreclosure in the affected market(s) outweigh any costs of foreclosure (including lost sales) in the markets for the tying/bundling products with market power.
85. One possible way for tying or bundling to be profit enhancing is if such behaviour effectively forecloses a rival brand which is constraining the price

of the brand that is being tied/bundled. For example, this could be foreclosure of rival French Brie suppliers if Président Brie is the brand tied to sales of Lubborn's Somerset Brie. Once the rival constraining brand has been foreclosed, Lactalis may be able to raise the price of the tied brand (in this example, Président Brie).

86. However, on the basis of the evidence in this case it seems clear that the potential incentives to foreclose are not present. In particular:

- the competing brands (in Brie and Camembert) that Lactalis would need to foreclose from the market are all international brands that will continue to be manufactured and so could readily re-enter the UK even if excluded on a short term basis, and
- most of the sales (over 80 per cent) of the Continental origin Brie and Camembert sold in the UK is sold as supermarket own label brands and these accounts can be switched easily by retailers.

87. Therefore, there seems little incentive for Lactalis to seek to foreclose since the proportion of the market (that for 'branded' continental origin Brie and/or Camembert) that might be subject to foreclosure is only a small part of the overall market for soft cheeses. Moreover, it would be relatively easy for retailers to circumvent Lactalis and switch to other continental brands (either for branded or own label products).

## Conclusion

88. The OFT does not believe that the proposed merger creates or strengthens the ability and incentive for Lactalis to foreclose others by tying or bundling. In particular, views from third parties show that Lactalis would not have the ability and incentive to tie/bundle post merger.

## Portfolio effects

89. The second conglomerate effects theory of harm that the OFT examined in this case was portfolio effects. These may arise if customers value variety (a 'portfolio') rather than only one or a few products. In such situations a

conglomerate merger may give the merged firm a product range advantage that can lead to increased market power for its portfolio of products.<sup>18</sup>

90. In principle, there are a range of customers for whom this theory of harm may apply: wholesalers, contractual catering/foodservice customers and large supermarket operators.

91. As with its assessment of tying/bundling above, the OFT has focused its examination on whether Lactalis would have the ability and the incentive post merger to foreclose competitors, and whether any likely foreclosure would represent a substantial lessening of competition in that market(s).

(i) Ability to foreclose

92. The ability to foreclose depends on:

- there being substantial fixed costs associated with providing the variety that customers value, and
- few, if any, other firms being capable of matching the merged firm's portfolio.

93. There would appear to be substantial fixed costs in providing customers with a portfolio of cheese products. In particular, to be able to offer full range of cheese within a segment, for example Brie, a company would need to be able to offer at least French own label, French branded and British Brie. No other company has been able to offer this portfolio until now, with the exception of one competitor in their contract with one supermarket.

94. However, most customers, with the exception of one supermarket, already multi-source their supplies of Brie and Camembert (see paragraph 81 above) and additionally were not strongly in favour of product bundles and portfolios. Moreover, large retailers did not consider the parties' products are 'must stock' items or when they did, this was qualified by an ability to de-list or move to an alternative brand. Therefore, the OFT does not believe that customers value sufficiently the wider range being provided by one supplier such that Lactalis will be placed in a particularly advantageous position.

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<sup>18</sup> *Draft Joint Merger Assessment Guidelines*, paragraph 4.156.

(ii) Incentive to foreclose

95. The incentive to foreclose will depend on whether leveraging strong Lactalis brands to sell additional (weaker) products is profit enhancing, given that if a substantial proportion of customers strongly prefer to buy some of the portfolio of products in isolation then sales of these might fall.
96. The incentives to foreclose for a portfolio effects theory of harm are, in this case, the same as for the tying and bundling theory of harm (see above).

Conclusion

97. The OFT has considered the possibility of the merger giving rise to a substantial lessening of competition through portfolio effects but concluded that the merger does not materially alter the market structure or increase the ability of Lactalis to foreclose through portfolio effects. Therefore, the OFT has not found it necessary to conclude on the parties' incentive to do so post merger.
98. The OFT notes, however, that Lactalis will not be uniquely placed to offer customers a wide range of Brie cheeses. Furthermore, OFT questioning of third parties has revealed that, although a range of products is valued by customers, they do not value the ability to acquire their range of products from any one supplier (either directly or indirectly) sufficiently highly to suggest that foreclosure would be successful. Customers told the OFT that they could de-list a particular brand including Somerset Brie and Président Brie if they could achieve a better price or were unable to agree terms.

**BARRIERS TO ENTRY AND EXPANSION**

99. Evidence by competitors suggests that the barriers to entry in the market of soft cheese are relatively high. In particular, significant capital investment was required and it was suggested that supermarket buyer power made entry unattractive to potential new entrants. No new entry has taken place in the last five years and no third party anticipated any new entry in the next two years. However, since the OFT concludes that this merger does not give rise to any competition concerns, it is not necessary to conclude on the issue of barriers to entry.

## **BUYER POWER**

100. During the OFT's investigation, there have been a number of references made to the presence of buyer power in this market. However, given the lack of close competition between the parties, conclusion on this issue is not necessary to determine the outcome of this case.

## **THIRD PARTY VIEWS**

101. The OFT received comments and views from a number of third parties, including competitors and customers. These are referred to above as appropriate but the OFT notes that the majority of third parties did not raise any concerns regarding the merger (with the exception of concerns raised by two competitors over conglomerate effects, which are discussed above).

## **ASSESSMENT**

102. The transaction concerns the acquisition by Lactalis of Lubborn, both suppliers of soft cheese (Brie, Camembert, Goats cheese) to supermarkets, wholesalers and food services customers in the UK. Pre-merger Lactalis supplied Continental soft cheese and Lubborn supplied British soft cheese in the UK.

103. The OFT examined whether British origin soft cheese is in the same market as Continental (imported) soft cheese, and whether Brie, Camembert and Goats cheese are in the same product market.

104. According to Lactalis, Continental and British soft cheeses were in separate markets and so there was no horizontal overlap as a result of the merger. However, third parties' views were mixed. The OFT's critical loss analysis was inconclusive and the evidence on promotions was also mixed, with some evidence pointing to separate markets and some evidence pointing to British and Continental soft cheese belonging to the same market.

105. Without prejudice to the precise market definition, the OFT has examined the merger on both scenarios, namely considering British and Continental cheese separately and together, and has concluded that in either case there is no realistic prospect that the merger may be expected to result in a substantial lessening of competition in the supply of soft cheese in the UK.

106. Taking British soft cheese to be in the same market as Continental soft cheese, the parties' combined market share for Brie and Camembert is over [40-50] per cent with an increment of over [20-30] per cent. For Goats cheese, the parties' combined market share is [40-50] per cent with an increment of over [10-20] per cent. If Brie and Camembert are in separate markets, the parties' combined market share for Brie would be over [50-60] per cent with an increment of over [20-30] per cent and just under [20-30] per cent with an increment of [10-20] per cent for Camembert. Most of these shares are high enough to raise prima facie competition concerns.
107. The OFT considered the closeness of competition between the parties under all these different frames of reference. Based on the evidence provided by the parties and third parties, and on its own analysis, the OFT concluded that Lactalis and Lubborn are not close competitors in the supply of Brie and/or Camembert in the UK.
108. All customers, apart from one, stated that they considered Lubborn and Lactalis to be competing only to a limited extent due to the different provenance of their cheese. In particular, they provided evidence of switching or proposed switching away from Lubborn or Lactalis soft cheese indicating that the merging parties are not considered each other's closest competitors. Supermarkets told the OFT that if they were to switch from Lactalis, they would switch to Bongrain or Eurilait amongst others. In addition, third parties provided evidence to the OFT that if they were to switch away from Lubborn, it would be to CCL and submitted examples where such switching had already happened.
109. Similarly, based on the evidence provided by Lactalis and third parties and the lack of any third party concerns, the OFT concluded that the parties were not close competitors pre-merger in the supply of soft Goats cheese in the UK.
110. Furthermore, the OFT received no concerns from any third party regarding the possibility of coordinated effects resulting from the merger. However, the OFT has considered the three conditions referred to in the Draft Joint OFT and CC Merger Assessment Guidelines and concluded that none of the conditions was satisfied.

111. Following third party concerns and in light of the possibility that British and Continental soft cheese are not in the same market, the OFT investigated the likelihood of a substantial lessening of competition arising as a result of the merger from conglomerate effects - either as a result of tying and bundling or as a result of portfolio effects.
112. The OFT has carefully considered the arguments made by Lactalis and third parties in this case. The OFT considers that the merger does not create or strengthen the ability of Lactalis to foreclose others by tying or bundling. In particular, views from the majority of supermarkets show that the merged entity would not have the ability to tie/bundle as its products were not 'must stock' or at least there were a number of alternative products. The OFT also concluded that the proposed transaction does not create or strengthen the incentive to undertake tying or bundling. Particularly, the OFT notes that it seems unlikely that such a tying/bundling strategy would foreclose other soft cheese suppliers as they are not wholly reliant on UK supermarket sales and Lactalis would be vulnerable to the risk of supermarkets delisting other Lactalis branded products and/or switching own label accounts.
113. Finally, the OFT has carefully considered the possibility of the merger giving rise to portfolio effects and concluded that there was no such realistic prospect.
114. Consequently, the OFT does not believe 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.

## **DECISION**

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