

## **Gut-room contracts**

8.1. PDM's general explanation of its trading activities and business policy is set out in Chapter 7. This chapter is concerned with matters which, in the course of our inquiry, arose in relation to gut-room contracts. They include PDM's interest in securing gut-room contracts, complaints received about the company's practice in competing for such contracts, PDM's response to the complaints, and assurances by PDM as to its practice in estimating and bidding for such contracts and in operating gut-rooms.

8.2. Background information on the practices in abattoirs as to the sorting and separate disposal of by-products, including items separated out in gut-rooms, is given in paragraphs 2.12 to 2.15. In past years, while many abattoir owners traditionally operated 'gut-rooms' for the removal of some parts of the abdominal mass from slaughtered animals, they often did not attempt to separate certain body cavity fats from the residual offal. Thus, the offal supplied to renderers often included the more valuable body cavity fats and the overall price paid by renderers took into account the presence of the higher quality material.

### **Gut-room contractors**

8.3. PDM told us that in more recent years, a number of abattoirs had begun to contract out the operation of their gut-rooms to specialist companies. These contractors separated out some of the materials from the abdominal mass and disposed of them separately, eg the pancreas to the insulin industry, tripes for human consumption or pet food, and runners for the manufacture of sausage casings. They also dealt separately with kull fat (or 'caul' or 'best' fat), flushed gut (or 'second-grade fat') and residual offal. PDM added that, until recently, gut-room operators also tended to leave the abattoir owner to dispose of the residue of offal remaining from the abdominal mass after the more valuable parts had been removed, but that as the residual offal now had a value, the contractors were disposing of it themselves.

### **The development of PDM's interest in obtaining gut-room contracts**

8.4. PDM told us that it was in these circumstances that it had become interested in obtaining gut-room contracts. It regarded the existing gut-room contractor companies as essentially its competitors in the business of collecting animal waste materials. They had secured to themselves control of the supply of waste materials which previously would have been sold to renderers such as PDM by the abattoir owners as part of a single contract including not only the 'middles' (best fat, second grade fat and offal) but also body fat, suet, bones and blood. PDM made no complaint of this development, showing as it did the existence of a demand for specialist gut-room services. For the protection of its own business, however, PDM had been obliged to offer similar gut-room services in competition with the other contractors.

8.5. As regards the efficiency with which materials were separated in the course of gut-room operations, PDM felt that, where it was the contractor, its practices and results compared well with those of abattoirs conducting their own gut-rooms and of specialist gut-room contractors. If a slaughterhouse which had its own gut-room was temporarily short-staffed in its principal departments, the abattoir's management might well withdraw an employee from the gut-room to work in the slaughtering area as being, in the management's view, more important. This would immediately downgrade the gut-room material. If PDM was running the gut-room, the prime responsibility of its employees posted there was to stay there and look after the gut-room material, so that the quality of the materials taken away would be higher than when other contractors were doing the work. For instance, the company would extract a larger proportion of the available fats as first-grade and a smaller proportion as second-grade, and hence would achieve a higher value than would otherwise be the case. More generally, PDM said it would maximise the separation and sale of the better quality material for particular uses. However, the effect would be to reduce the quality of the residual material for rendering.

8.6. PDM told us that there were some abattoirs which operated their own gut-rooms and did a first-class job. Such abattoirs separated everything out and handled the material very much to suit the renderer. This was because the renderer negotiated with the abattoir owner directly not only on price but on how the material would be received. PDM considered that a gut-room contractor which was not itself a renderer had an advantage (a disadvantage from the renderers' point of view) in that it handled the material exactly as it liked. If it was not in its interest to present the second-grade fat in the form that the renderer would like, the renderer had a difficult problem in ensuring that such fat was received in the state appropriate for the production of high-grade tallow.

8.7. However, PDM also told us that it had at first been reluctant to quote for gut-rooms thinking that while a gut-room contractor such as Imperial Meat (see paragraph 8.12) was there as a specialist, this avoided the need for PDM to take on people to do the same job. When abattoir owners started to compare prices being received under existing gut-room contracts with what PDM could pay, they asked PDM to quote and PDM decided to do so. If successful, it would be sure of receiving the fat in the way that it wanted it for processing. PDM said that the most important consideration for it was that, otherwise, the company would, in the long term, probably lose that material and also the rest of the material from the abattoir, not just the fats from the gut-room. A gut-room operator was able to talk to the abattoir owner on a day-to-day basis about the other materials available to the trade which do not normally go through the gut-room. PDM would probably lose the direct contact and ability to negotiate with the abattoir owners, which it valued highly.

8.8. In further explanation of the considerations which had led it to make offers for gut-room contracts, PDM told us that its recent experiences with gut-room contractors had led the company to re-examine the belief that (without having made any detailed inquiry) it had previously held that such contractors did have specialist skills in the separation of various categories of material comprised in the abdominal mass of animals. By separating and flushing the gut (which was then classed and sold as second-grade fat), contractors in recent

years had deprived the residual offal of any substantial value. Where the gut was not properly flushed, as had often proved to be the case, PDM found that it was receiving poor quality, low yielding second-grade fat on the one hand and low-value (or even worthless) offal on the other.

8.9. PDM acknowledged that it was a relative newcomer in the business of operating gut-rooms. It was not in PDM's view a business at which as yet it was particularly efficient. However, having recently made a closer examination of gut-room operations, the company was confident that, by the application of appropriate measures of control, costing and marketing, it could and would bring its gut-room operations to a much higher level of efficiency.

### **Markets for gut-room products**

8.10. PDM gave us its view of the market opportunities for gut-room products. 97 per cent by weight of the materials coming from gut-room operations went either to rendering or to the pet food industry. There were large market opportunities on the pet food side. PDM estimated that some 6,000 tonnes of raw material were used in the United Kingdom every week by the pet food industry, only 3,500 tonnes of this being manufactured from United Kingdom-produced materials.

8.11. Apart from the pet food market, the outlets for cattle tripe, pig pancreas, the cattle reed (rennet bag, used in cheese manufacturing) and a small market for runners (already fully supplied), PDM was not aware of any other market (except rendering) that it was or would be particularly involved in as a consequence of engaging in gut-room operations.

### **Complaints about PDM**

8.12. PDM's alleged activities and pricing policy in respect of gut-room contracts were, at different stages of the inquiry, the subject of separate complaints to the Commission from two companies each of which told us that, as a gut-room contractor, it felt itself subject to direct competition or other commercial pressures from PDM. The companies are Specialpack Ltd (operating mainly in the Midlands and West Yorkshire) and Imperial Meat Company Ltd (operating mainly in the south). Each company felt that PDM, as the dominant renderer and purchaser of materials for rendering, did, or was able to, use its influence with abattoir owners in ways which did or might damage the contractor's interests.

### **Specialpack Ltd**

8.13. In July 1983, Specialpack told us of its beliefs that a certain aspect of PDM's market position was detrimental to the rendering trade. Specialpack said that PDM was predominant in rendering soft green offal, and was the only major processor of blood. That being so, abattoirs might be concerned that, if they supplied some of their animal by-products to other collectors, they would risk refusal by PDM to collect their soft offal and blood.

8.14. PDM stated to us that it had never told or suggested to any abattoir owner that if it did not receive the better-quality waste material, it would not collect at all.

8.15. Specialpack also criticised PDM's conduct affecting Specialpack itself. It told us that over a period of years from 1976 it had enjoyed satisfactory business arrangements with PDM which had collected most of its fats and waste. There followed a period when PDM declined to pay Specialpack what, in the latter's opinion, were adequate prices for fats. Where offal was concerned, at certain times PDM made a charge for, or made no payment for, collection of the material from abattoir gut-rooms. Specialpack told us that it objected to this charge, particularly as it had supported PDM during a price war when Specialpack had not pressed for an increase in the price of waste supplied to PDM.

8.16. Specialpack told us that its dissatisfaction had come to a head in late 1981 and that in October that year it had arranged to supply to another renderer (who was then willing to pay more than PDM) material previously supplied to PDM. PDM had expressed concern to Specialpack and had attempted unsuccessfully to win back the company and, with it, the material. Specialpack also alleged that, subsequently, PDM approached a number of Specialpack's abattoir suppliers and, in an attempt to recover the material from the suppliers, offered them prices which were higher than those which Specialpack as a contractor regarded as realistic.

8.17. As regards Specialpack's complaint, PDM told us that Specialpack provided a specialist collection service as gut-room contractors to a number of abattoirs most of which had previously been direct suppliers of material to PDM. PDM's impression was that Specialpack had, during a price war in 1977-78, received offers of higher prices from another company and that (as Specialpack did not then threaten to take its materials away from PDM) it probably took the view that the higher prices offered were likely to be short-lived. PDM confirmed that, after the price war, it had treated Specialpack in the same way as its other suppliers, as regards both payment and charges for material. Specialpack had continued to supply to PDM the kull fat, flushed gut and offal from the thirteen or so abattoirs in which it controlled the gut-rooms. PDM had felt some concern about the quality of the material which it was receiving from Specialpack and this was one of the reasons why its trading relationship with Specialpack deteriorated in 1981. Notwithstanding its complaints about quality, PDM told us it did not wish to lose the material which it had been receiving from Specialpack.

8.18. Following Specialpack's termination in October 1981 of its arrangement with PDM, the latter did try to get Specialpack to refrain from changing renderers. It also approached the abattoirs where Specialpack was controlling the gut-room, but was not successful in the bids which it made to the abattoir owners for their gut-room contracts. It had, however, since then successfully competed with Specialpack for certain additional gut-room contracts which Specialpack was seeking.

### **Imperial Meat Company Ltd**

8.19. In December 1983 Imperial Meat, the second contracting company named in paragraph 8.12, put the point to us that fear of retaliation by PDM could prevent an abattoir which had been selling PDM a 'rich' offal containing

fat—for which PDM paid little or perhaps nothing—from employing the services of a gut-room contractor. If a contractor was operating the gut-room and separating out the by-products, PDM—although reluctant to pay a higher price for better-quality material—would have to buy separated fat from the contractor. This also meant that PDM would have to deal with a third party rather than just the abattoir owner. To prevent such a situation arising, PDM might threaten to charge the abattoir for removal of the remaining offal and blood or threaten to refuse to collect it.

8.20. Imperial Meat also alleged that PDM's aggressive buying policy deterred other renderers from quoting for fat which the company had previously been supplying to PDM because such renderers feared that PDM would retaliate by offering their existing fat suppliers unrealistically high prices.

8.21. PDM's response to the suggestion that it would not collect only low-grade material was that it had never on any occasion told or suggested to any abattoir owner that, if it did not receive the better-quality waste material, it would not collect at all. PDM supplied us with a list of over 100 slaughterhouses from which it collected only low-grade waste material. It said that subject to price PDM was always prepared to collect waste material of whatever quality provided it was worth its while doing so. The anxiety of an abattoir owner who might be considering selling the higher-grade material to a separate renderer could only, in PDM's view, concern the price which PDM or some other renderer would be prepared to pay for the remaining, solely low-grade, material. As to the allegation that PDM's buying policy deterred other renderers from quoting for fat which the gut-room contractor had previously been supplying to PDM, the company stated that no renderer liked to lose material and if material were lost a renderer would seek to replace it. PDM did not agree with the implication that by protecting its supplies of raw material, the company was somehow indulging in an anti-competitive practice.

8.22. PDM also denied that it had paid 'little or nothing' for the residual or waste offal which remained after extraction of higher value items by a gut-room contractor. The company had paid the market price with regard to the composition of the material. When the flushed gut or 'second-grade fat' had been left as part of the residual offal, prices paid for the offal had reflected that fact.

8.23. Imperial Meat also told us of its apprehension that PDM's gut-room division would use its position to make offers to operate gut-rooms at rates in excess of realistic market prices in order to eliminate competition.

8.24. In response, PDM denied that it had ever offered unreasonably high prices in order to secure gut-room contracts in competition with others.

8.25. At a later date Imperial Meat complained to us that PDM or a PDM subsidiary had approached a number of abattoir owners, whose gut-rooms Imperial Meat was operating under contract, with offers to undertake the operation of such gut-rooms, and to displace Imperial Meat. The prices allegedly offered by PDM were higher than those being paid to the abattoirs by Imperial Meat, which reported that (none of the offers having been accepted) PDM made further offers to some of the abattoir owners at rates which Imperial

Meat considered, on the basis of certain calculations which it submitted to us, to be uneconomically high and to constitute predatory pricing. None of the abattoirs concerned had at the time of our inquiry accepted the higher offers but Imperial Meat told us it had felt obliged to raise its own prices to the abattoir owners in order to retain the business.

8.26. Imperial Meat told us of certain action it had taken in early August 1984:

- (1) It had started to man the gut-room of a large abattoir in the North-West, further north than it had operated before, in an area where PDM was in a strong market position. Residual offal from this abattoir had been going to a firm which (although Imperial Meat did not know it when it took on the contract) was a subsidiary of PDM. Imperial Meat had not threatened to stop supplying the waste to PDM but its value was lower because Imperial Meat was now separating out and selling intestinal fat which had previously been included in the offal skip. PDM had expressed annoyance to Imperial Meat over the loss of this fat.
- (2) Imperial Meat had found purchasers in the North for some of the fat that it had previously been supplying regularly to PDM, at higher prices than PDM had been paying. The fact that Imperial Meat had to deliver the material to northern customers, whereas PDM had collected it, meant that Imperial Meat incurred transport costs on this business.

8.27. We took up Imperial Meat's complaint with PDM which told us that it wrote in summer 1984 to some 60 abattoirs (including some where Imperial Meat operated the gut-room) expressing the intention of expanding its gut-room service and offering to discuss the matter further should it be of interest to the addressee. The letters did not include price offers but in those cases where the recipient abattoir owner was prepared to discuss PDM's proposals, offers were made to pay £3 per unit (exclusive of tripe) for cattle and 20p and 10p respectively for sheep and pigs. In certain cases, PDM had made further offers at prices comparable to prices mentioned to us by Imperial Meat. Agreement had been reached by PDM with a few abattoir owners but by January 1985 these did not include any where Imperial Meat operated the gut-room.

8.28. In explaining the background to its decision to make these offers, PDM said there had been repeated differences between PDM and Imperial Meat about the quality of the second-grade fat. PDM said that Imperial Meat, having been shown the condition of some fat received from it at Silvertown, had spent some time improving the quality but the quality subsequently deteriorated again. PDM said that eventually Imperial Meat went to other renderers and asked them to quote for the fat which until then Imperial Meat had supplied to PDM. PDM's information was that Imperial Meat then introduced renderers' agents to the abattoirs to quote for the offal and the bones.

8.29. PDM told us that the loss of the Specialpack business in 1981 had caused PDM to look at going into gut-rooms itself. The loss in 1984 of the Imperial Meat material had meant that PDM saw no alternative but to make a positive effort to compete for gut-room contracts. This had led PDM to offer higher prices than Imperial Meat or indeed PDM itself was already paying for

its existing gut-rooms. (A list of gut-rooms operated by PDM companies in January 1985 is at paragraph 5.21.)

8.30. PDM told us that the loss of a substantial weekly tonnage of material from two particular abattoirs had been damaging. The gut-rooms of these abattoirs were operated by Imperial Meat which had diverted to other customers material it had previously supplied to PDM. PDM had subsequently made higher offers to these abattoirs for their gut-room contracts, but unsuccessfully.

### **Estimates of likely profitability of gut-room operations**

8.31. In the light of the facts that PDM had made more than one offer and that the price offered had increased so rapidly, we asked PDM to supply us with detailed estimates of the expected sales and costs of the gut-rooms of the two abattoirs mentioned above. PDM provided information about the kill rates and the yield of fat formerly received (through Imperial Meat) from the two gut-rooms. In PDM's submission, if those two gut-rooms were taken together, and if the results of rendering the materials deriving from them were also taken into account, the figures demonstrated that PDM would operate those gut-rooms profitably if it took over from Imperial Meat and paid the abattoir owners the highest prices it had offered them. PDM said that, although the percentage of gross margin on the value of most of the material handled by the gut-room contractor was quite small, an integrated renderer was able to offer prices such as those mentioned whereas a gut-room contractor, if he was not also a renderer, probably hoped for a higher margin.

8.32. On the basis of the information supplied to us by PDM, including its own cost estimates (which we adjusted so as to include a reasonable allocation to those gut-rooms of overhead and other costs incurred centrally by PDM), we formed the opinion that, had their offers been successful, PDM would—at the highest prices which it acknowledged offering for the contracts—have incurred losses in operating each gut-room.

8.33. It also emerged that it was not PDM's practice, before making price offers for gut-room contracts, to make any comprehensive and realistic estimate of the likelihood of operating the gut-rooms in question profitably at the prices offered.

### **Assurances by PDM**

8.34. We invited PDM to give us its response to the proposition that the company should only bid for a gut-room contract on the basis of a reasonable expectation that operation of the gut-room would be profitable and to our view that the profitability or otherwise of operating a gut-room should be judged by treating the gut-room as a stand-alone profit centre.

8.35. PDM told us it was prepared to undertake that its activities in gut-rooms would be determined by the same economic factors as those which governed the activities of gut-room contractors who did not have a rendering operation. Subsequently PDM said that, in order to implement the undertaking which it had given about its existing and future activities in gut-rooms, it

proposed to establish the gut-room side of its business as a separate division of the PDM group in the same way as its pet food activities were organised. The rendering and pet food divisions would pay to the gut-room division the appropriate market prices for the materials available from the gut-rooms. There would be no cross-subsidisation. A full charge would be made to the division in respect of its proper share of all head office and other administrative costs. In this way PDM would be able to conduct its gut-rooms as 'stand-alone' operations and its policy towards the bidding for, estimating for, and evaluating the results of its gut-room contracts would be determined accordingly.

8.36. Our conclusions on the issues relating to PDM's pricing policy and practice in bidding for gut-room contracts are set out in Chapter 9.