

9 Evidence of Forrest

9.1. Certain comments or representations made by Forrest have been reported in earlier chapters, wherever considered most appropriate in our consideration of particular matters falling within the scope of those chapters. In this chapter we summarize Forrest's other evidence on further matters bearing on our consideration of the public interest. These relate to competition, profitability and pricing.

Competition

The Scottish market

9.2. Forrest believed that there were a number of preliminary points to be made as essential background to any consideration of the Scottish rendering market. These related to the position of the renderer, both generally and particularly in Scotland, and to the management philosophy and commitment to capital expenditure of Forrest's ultimate parent, Hillsdown.

9.3. First, the prices obtained by the renderer for his finished products were determined by the international commodities market.

9.4. Secondly, significant capital expenditure by the renderer on compliance with increasingly stringent environmental controls was required at a time when the industry was suffering from overcapacity and its profitability was already constrained. Compliance with these environmental controls also added to the burden of running costs and to the problem of finding capital for reinvestment.

9.5. The renderer in Scotland was affected by each of these problems. In particular, there was chronic overcapacity in the rendering industry in Scotland and a shortage of raw materials for processing. Forrest's maximum capacity was 55 per cent greater than its current throughput and it believed that its two competitors had considerable spare capacity as well.

9.6. As noted in paragraph 5.18, the capital investment provided by Hillsdown had enabled Forrest to continue where other companies had been forced to close, but Forrest was still failing to produce appropriate profits on the capital employed. This illustrated the difficulties faced by the rendering industry.

9.7. Forrest contended, nevertheless, that there was competition throughout Scotland, be it from the generic alternative, landfill; from Dundas Brothers or Dundas Chemical, which together could potentially cover virtually the same geographical areas as Forrest; or potentially from renderers south of the border establishing depots in Scotland, should they consider it commercially worth their while.

9.8. Forrest accepted, however, that there was a degree of natural monopoly in its favour. It believed that it had around a 70 per cent share of red meat waste rendering in Scotland.

New entry

9.9. Given the difficulties currently facing the rendering industry, without mentioning its inherent unattractiveness, new entry seemed to Forrest an unlikely possibility. Forrest did not believe that its reputation or behaviour gave justification for any concern or acted as a barrier to entry. The main difficulties facing any new entrant would be those arising from the overcapacity of the Scottish rendering industry and the limited supplies of raw materials available. This imbalance was made more acute by the financial and regulatory hurdles resulting predominantly from the increasingly stringent environmental controls and also from the tiny second-hand market for processing equipment.

9.10. So far as Hillsdown's poultry waste agreement with PDM was concerned, Hillsdown did not believe that this constituted a barrier to entry or to the growth of existing renderers. Prior to the agreement, the poultry waste from all but one of Hillsdown's poultry companies was already being supplied to PDM. The agreement was also subject to quarterly review by both parties, in spite of PDM's wish for a longer-term agreement, and Hillsdown did not regard itself as committed to the agreement should a more favourable price and service become available elsewhere, for example through a group of poultry renderers putting forward a composite proposal taking account of their respective locations and capacities. Hillsdown itself had in the past considered doing its own poultry rendering and would do so again if its commercial interest would thus be best served.

Competition with PDM

9.11. Hillsdown told us that the fact that Forrest did not currently obtain raw material in England, and Peninsular did not obtain supplies throughout the whole of England and Wales, was not the result of any understanding or agreement reached with PDM. The areas in which Forrest operated were determined by two principal factors, the location of its depots and plant and the location of its raw material suppliers.

9.12. Forrest did not travel further south than Dumfries or Berwickshire owing to the paucity of materials available for purchase in those areas and further south. Indeed Forrest was considering the viability of collecting from Berwickshire because of the minimal amounts available there (some 3 or 4 tonnes per week, all from butchers' shops), though it was possible that the introduction of a small charge might make the collections sufficiently economic to be continued.

9.13. Most of Forrest's suppliers were to be found in the eastern half of Scotland, where its depots enabled it to collect supplies, albeit in small to medium volumes, from as far north as Dornoch, and to consolidate them into economic loads for transporting to Newarthill usually within 12 hours of collection from the abattoir. Greaves, however, which were entirely unavailable in Scotland, were obtained from England and from both the Republic of Ireland and Northern Ireland.

9.14. Forrest pointed out that, because of its experience of the benefits of its collection depots, coupled with the natural affinity that existed between suppliers and any local renderer, it had tried, but so far in vain, to expand into northern England by acquisition:

- In 1987/88 it investigated the purchase of Tyneside Butchers but concluded that the business lacked adequate management and was too far from Motherwell to be managed from there.
- Also in 1987/88 it considered purchasing Blackburn Products Co Ltd but concluded that it was too small and faced serious environmental problems which were compounded by its location in the town centre.
- In early 1988 it wished to purchase Wildriggs, in Penrith. After agreeing the purchase price with its owners, the offer for sale was withdrawn and the business subsequently sold to a pet food manufacturer. [*Details omitted. See note on page iv.*]
- In July 1991 Forrest agreed the price for the acquisition of Wells By-Products, about 25 miles distant from Doncaster. However, the business was sold instead to PDM.

9.15. Nor did Hillsdown have any agreements, formal or informal, with PDM other than the poultry waste agreement already referred to.

9.16. For all these reasons it was Forrest's contention that the fact that it did not currently operate in England resulted from its proper evaluation of a number of commercial and economic factors and not from any agreement or understanding with PDM. If, in Forrest's opinion, it became commercially viable for it to do so, Forrest would expand its operations into England and so increase the availability of raw materials, with the potential benefits to its throughput.

9.17. As regards Peninsular, its major suppliers were located in the South-West and were served by good road networks. Peninsular's suppliers provided it with sufficient raw material to operate at maximum capacity when the plant was running (which it did not do at weekends, for environmental and maintenance reasons), and it had no wish for any greater volumes of raw materials. Peninsular, however, was mindful of the fact that it could at any moment lose any of its supplies to a third party, or through a supplier's withdrawal from the market. Therefore it was constantly in contact with other potential suppliers so that it could replace any lost supplies if need be. Peninsular's relationships with potential suppliers had stood it in good stead following the uprating of its capacity in 1992. Of the abattoirs presently serviced by Peninsular, five remained out of eleven originally captured from PDM.

Profitability

9.18. Forrest denied that its financial results reflected higher charges and lower payments than would have been the case in a more competitive market. On the contrary, its ROCE had been distorted as a result of some exceptional movements, including the approach that had been adopted to the valuation of the property and to capital corporation tax. In reality, after appropriate adjustment, the level of profitability of Forrest did not increase as dramatically as its statutory accounts might suggest.

9.19. Forrest calculated its ROCE for the five years to 1992 as 33.02, 21.91, 28.47, 27.24 and 12.26 per cent respectively. These results, it said, showed a relatively consistent trend from 1988 to 1991, followed by the obvious downturn in 1992 when, *inter alia*, capital employed increased by almost 50 per cent.

9.20. Looking at these returns on what it described as 'management capital employed', rather than capital employed according to the statutory accounts, which in Forrest's case it believed was not particularly meaningful, Hillsdown said that it was none too happy with the trend and would be looking for improvement in 1993. Although it regarded rendering as a medium- rather than a high-risk business, it was one which entailed an enormous and continuing cash requirement, not least to expend on compliance with environmental controls at nil return on capital. Hillsdown therefore considered between 25 and 27 per cent an appropriate rate of return.

9.21. The improvement in its profits in 1990 as compared with 1989, despite the BSE crisis, Forrest commented, was due to the increased throughput arising from its acquisition of Elgin Animal By-Products in April 1990. Forrest indicated, however, that in 1991, when its end-product sales fell by £9.40 per tonne of raw material and its costs increased by £2.35 per tonne, the fact that its profits fell by only £1.11 per tonne reflected the Forrest policy of relating raw material prices to the value of the end product.

9.22. The most important single element in price-setting was the selling price of the renderer's end product. If that price fell, it was inevitable that less must be paid or more must be charged for the raw material needed to manufacture it. This was reasonable and sensible because the renderer had no rationale for carrying on his business unless he could obtain from the abattoir industry what he felt necessary in order to make what he regarded as a reasonable profit. Whilst the creation and sale of animal by-products was not the principal business of the abattoir owner, it was the inevitable consequence of conducting that business. As such, the prices which may be obtained or charged for the by-products were constantly taken into account by the abattoir owner when assessing his profitability and the prices he paid for the animals he purchased. In the UK, in contradistinction to certain other European countries where governmental subsidies may apply, the value of animal waste was necessarily dictated by its value to the renderer bearing in mind what he could get for his finished products, which in turn was governed by international commodities markets. In reality, therefore, the abattoir owner was left with a by-product which may or may not have a value. The issue here was not one of competition but of the structure of the market and people's place in the supply chain.

9.23. Forrest commented further that its total tonnage processed had remained fairly static in the last two years whilst its profitability had declined. This was not what one would expect if the renderer was able to demand what he liked from the abattoir owner. Moreover, end-product sales prices had increased by about £14 per tonne in 1992.

Pricing

9.24. Forrest's formulation of its prices and charges for animal waste has been described in Chapter 6. Essentially, Forrest said, these were determined by reference to its standard yield percentages against market or sales values of the end product, less costs based on an assumed annual throughput of [*] tonnes and a gross profit per tonne ideally of £5 to £10. Prices were revised as often as changes in end-product values required. Around 10 per cent of agreements with suppliers were based on contracts (for a predetermined period) confirmed in writing.

9.25. Before our first hearing with Forrest, we sent it analyses of the pricing data it had supplied at our request covering each of its abattoir suppliers for four categories of waste (fat, bones, SBO and other offal) for May and October 1992. After correcting errors in the data which it had supplied, Forrest explained that in assessing its prices for its individual suppliers it had constant regard to the value of each category of raw material to Forrest in the context of the comparatively high threshold of its continuous process operation (as compared with a batch cooking operation) and the need to obtain sufficient volume of raw materials to enable it to operate profitably. Whilst all volumes were important to Forrest, it might pay less for smaller quantities because of economies of scale and costs of collection.

9.26. Forrest expanded on this point by describing how, realizing that its throughput had fallen below the critical weekly break-even level between March and July 1992 and that it was trading at a loss, it had been obliged to attempt to increase its throughput, if necessary by offering higher prices. These higher prices would then be mitigated by the fact that its fixed costs could be spread over a greater throughput. Hence Forrest approached large-volume suppliers because that materially increased throughput at once, whilst at the same time these volumes were collectable in convenient and therefore economic loads.

9.27. Additional factors which Forrest said accounted for price differentials were size of uplift (collection) and, in particular, whether the supplies of each type of raw material could be collected conveniently and economically; quality differences in the raw materials; the prices offered by other renderers; contracts made at different times or for different periods against the background of a rising or falling market; and the negotiating skills of the individual supplier, or group of suppliers.

9.28. At our first hearing with Forrest we discussed an analysis which Forrest had prepared of the various considerations relevant to the prices offered for raw materials in October 1992 to each of its abattoir suppliers. This analysis showed the volumes of beef fat, bones, SBO and other offal supplied, accompanied by comments relating, for example, to the quality or particular characteristics of the raw material, size of uplift, collection distance or costs and the effect of group price negotiations.

9.29. Forrest stated that the prices that it was prepared to pay were affected by quality differences, which translated into higher or lower yields, such as whether offals included significant amounts of water; whether fat had been hung and dried in the abattoir or simply tossed hot into the waste skip, or was dirty (eg covered in manure); whether bones included fat, or pig heads, or were clean and fresh; and whether SBO had had all the fat removed. These differences in quality affected both processing costs and achievable end-product values and consequently, in turn, Forrest's raw material prices. Forrest thought that the maximum differential arising from quality differences in fat, for a given quantity, would be about £10 to £15 per tonne.

9.30. Forrest presumed that abattoirs would normally be operating in the same basic manner week after week, with no more than minor variances in the value of their raw materials to Forrest as a result. However, Forrest had a Raw Materials Manager who spent about two or three days a week touring abattoirs regularly, particularly the larger ones. In addition, exception reports would normally be received in the first place from Forrest's drivers.

*Figure omitted. See note on page iv.

9.31. The economics of collection varied naturally with both the overall volumes supplied and the size of the individual uplift. On the one hand, an abattoir might supply on a regular and frequent basis raw materials which were collectable in one load, be it of one type of raw material or more. On the other hand, butchers' shops necessitated a 'milk round' picking up variable and irregular quantities of raw materials. Disregarding the latter, the maximum differential arising from collecting different quantities of fat was probably about £40 to £50 per tonne.

9.32. Group prices were applied directly to FMC's three Scottish abattoirs. In addition, some small and remote abattoirs were treated as a group and received prices set to take account of the average weight and collection distance.

9.33. Forrest believed that competition was a further consideration. The negotiating skills of the abattoir owner, however, were a very influential factor given the inherent stability, or lack of desire to switch, between abattoir and renderer. Nevertheless, whilst an abattoir owner had to be very concerned at the service it was receiving before being minded to switch, this did not remove the threat or possibility that he might switch if he considered that it was in his best interests to do so. The strength of the abattoir owner lay in merely being aware of the prices which other abattoir owners were receiving throughout the UK, as indeed he tended to be through frequently talking or meeting with other owners: he did not actually have to switch to take advantage of this situation.

9.34. Further, abattoir owners hardened their negotiating stance in the face of pressure on their margins and became more determined. In the case of one large abattoir with top quality raw material and substantial daily uplifts, Forrest had allowed a temporary 'no-charge' period until January 1993 to help it to re-establish after going into receivership.

9.35. In order of priority, said Forrest, market forces had most bearing on its prices, because if other renderers were offering more favourable rates Forrest would be unable to maintain adequate throughput. This did not mean, however, that there was no limit to what Forrest would be prepared to pay to obtain the volume it needed. For example, in October 1992 Forrest had lost its fat contract with British Beef at Hawick because it would have had to pay £125 or £130 per tonne and this would have resulted in a loss of some £12 per tonne. (Forrest had also lost the offals contract with this abattoir in March 1992.) Whilst Forrest, on occasion, was prepared to bid for raw material at break-even prices where there was an extreme paucity, or abnormally low levels, of raw material supplies, it would not go beyond that, and would go thus far only after taking into account market trends. Exactly how far it would be prepared to go in a given instance would be influenced by the importance of the contract for maintaining Forrest's break-even throughput.

9.36. Forrest said that it had never carried on business with the objective either of removing business from other renderers-other than through the normal competitive process where it needed the throughput and set its prices so as to obtain raw material without incurring losses-or of forcing a competitor out of business, or of deterring potential competitors. As regards the complaints about Biggar, Buchan Meat and ISM, for the reasons explained in paragraph 9.26, Forrest sought raw material from these three suppliers because they offered sufficient volume to ensure Forrest's return to profitability. Although the problem had occurred in the second quarter of 1992, supplies could not be obtained before the third quarter, and thereafter Forrest's throughput increased.

9.37. Forrest stated that it did not set its prices at levels such that the expected additional revenue from the increase in sales was insufficient to cover average costs. It was only too conscious of the level of fixed costs it bore and the importance of a sufficient throughput to enable it to trade profitably. Nevertheless, in difficult circumstances and where there was paucity of raw materials available for purchase, it was prepared to accept a situation where the expected additional revenue covered incremental costs plus only a partial contribution to overheads, because it could otherwise lose a substantial amount of business. Even so, all the prices agreed with Biggar, Buchan Meat and ISM were profitable by up to £10 or £11 for each type of material.

9.38. Commenting on a further analysis that we had carried out which sought to disentangle the effect on prices of competition as against other factors, in particular quantity and quality, Forrest argued that the analysis could not possibly support any conclusion that Forrest practised discriminatory pricing.

9.39. First, Forrest believed that the MMC's approach was fundamentally flawed, not only because it assumed that quality and quantity were the *only* relevant criteria, but also because the effect of adopting broad categories of quality viewed in isolation was to oversimplify the analysis which Forrest undertook when considering the prices it was to offer. The value of raw materials to Forrest was determined by additional variables already described, such as the economics of collecting and processing and the wider range of variability of quality of the raw material. Thus neither quality nor quantity could be viewed in isolation but must be viewed together with the particular features of each individual contract.

9.40. On the basis of these analyses, Forrest produced revised price dispersion ranges for the prices it paid for beef fat, bones, SBO and other offals in October 1992. In each case these showed the ranges not explained by factors other than competition in single figures. In Forrest's view this showed that its approach to pricing was rational and logical and that, contrary to the conclusion reached in the MMC's analysis, it was neither predatory, discriminatory nor otherwise improper.