6 Views of Tomkins

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Introduction

6.1. In this chapter we summarize the evidence put to us by Tomkins in its written submission and at three hearings. To begin with we record its views on jurisdiction. We then summarize Tomkins' reasons for the acquisition and its views on the definition of the market for the supply of flour, competition in the market, vertical integration in the bread-baking sector and the benefits of the merger. We go on to record Tomkins' comments on possible remedies in the event that we found that the merger might be expected to operate against the public interest. The chapter concludes with a summary of the evidence given to us separately by Spillers Milling.

Jurisdiction

6.2. Tomkins told us that the value of gross assets it had taken over on the acquisition of the businesses of Spillers Milling and Fleming Howden from Kerry was £61.6 million. The assets test set out in section 64(1)(*b*) of the Act was therefore not met. Tomkins accepted, however, that the share of supply test under section 64(1)(*a*) of the Act was satisfied, in that as a result of the merger the share of supply of flour in the UK accounted for by RH and Pasta Foods, both subsidiaries of Tomkins, had been increased from some 24 per cent to some 35 per cent.

Reasons for the acquisition

6.3. Tomkins had acquired RH in 1992, since when considerable efficiency savings had been achieved. By 1996, however, it was clear that RH's existing flour mills, which had last benefited from reinvestment in the late 1980s/early 1990s, afforded few opportunities for obtaining further margin improvement and profit growth. There was little scope for profitable organic volume and market share growth in what was a mature market, or for further cost reduction and efficiency savings without major capital expenditure. The business was at the beginning of a new phase of capital investment.

6.4. According to Tomkins, Spillers Milling had been a distant third national force in the UK flour market. Its competitive position in the medium term had been threatened, in Tomkins' view, by inefficiency in its operations, lack of investment in its mills for hard flour production (although there had been some reinvestment at Liverpool and Tilbury) and overdependence on the declining free market. Spillers Milling had been unable to justify a capital investment programme that would have allowed it to close the efficiency gap on Allied Mills and RH and there had been little commitment from Dalgety to support such investment.

6.5. Tomkins considered that the acquisition of Spillers Milling offered a major opportunity. It said that the businesses of Spillers Milling and RH complemented each other to a substantial degree, with the former having strengths in the production of soft flours for cakes, biscuits etc and the latter in the production of hard flour for bread. Tomkins expected to make considerable efficiency savings by rationalizing and integrating the two businesses. The timing of the sale of Spillers Milling had made the acquisition particularly attractive because RH had not yet embarked on its new capital investment programme and would therefore be able to integrate the Spillers Milling business and obtain the synergy benefits as part of that programme.

6.6. Tomkins was planning substantial changes to production and distribution arrangements. These included: [

Details omitted. See note on page iv.

]

6.7. RH had estimated cost savings following the merger (before allowing for expected loss of sales) of some £[✄] in the second year and £[✄] in the third year and onwards, made up as follows.

TABLE 6.1 **Cost savings following the merger**

£ million

	Year 2	*Year 3*
[*Details omitted. See note on page iv.*]		
Total	[✄]	

Source: RH.

6.8. Tomkins told us that it had intended the acquisition of the Spillers Milling business to be additional to, rather than in place of, RH's planned new investment. It believed that the size and asset base of the merged RH/Spillers Milling business would provide further opportunities for substantial cost savings, beyond those set out above. Further cost savings from investment in new capacity and upgrading existing assets ought to be possible as part of a revised or second phase investment programme.

6.9. We asked Tomkins whether the changes it was proposing were likely to suit Spillers Milling's customers. Tomkins said that it was essential to retain customers by ensuring that they were satisfied about quality, service and price. It believed, on the basis of RH's previous experience, that the

changes would be beneficial. For example, moving RH's transport fleet on to contract had resulted in a better service to customers. We also asked whether cost savings would be reflected in lower prices to customers. Tomkins said that its financial appraisal had made allowance for that and it believed that the downward trend in prices would continue as a result of pressure from other millers increasing their efficiency and thus being able to maintain vigorous competition. The cost savings therefore would ultimately be passed on to customers. Tomkins provided us with a projection that suggested a fall in the net selling price of RH's flour of around £[✂] a tonne between 1998 and 2000.

6.10. We questioned Tomkins about its defensive rationale for the acquisition, as set out in an internal document of December 1997 entitled 'Proposal to Acquire the Spillers Milling Group'. The document touched on the opportunity to influence the long-term structure and stability of the UK flour market and stated that the preferred ownership of Spillers Milling must be either RHM or ABF, given RHM's interest in retaining the status quo. It suggested that a management buyout or acquisition by [✂] would be the next best outcome and that the worst would be the sale of Spillers Milling to an international buyer with a different commercial agenda. Tomkins said that we should not read too much into these comments. It had done no more than any sensible business would do in looking at the competitive threats in a market place. It had not had any specific international buyer in mind and the comments about a different commercial agenda were speculative.

6.11. There had been no allowance for such a defensive rationale in the financial analysis that justified the acquisition, which had been based on the synergy opportunities available to Tomkins and potentially to one other player in the market place and were not available elsewhere. Tomkins would not have gone ahead with the acquisition if the financial analysis had not supported it. In the case of any acquisition, it looked for a rate of return on capital investment in excess of the weighted average cost of capital (currently about 9.4 per cent) by the third year. The Tomkins board decision had been based on synergy benefits allowing for price and volume erosion and not on any assumptions as to change in the structure of the market. Tomkins did not deny that it had considered the implications for the market place of Spillers Milling under various scenarios of ownership, but this had not been a key factor in influencing its decision.

Integration of the businesses

6.12. Tomkins said that the planned integration of the RH and Spillers Milling businesses had been put on hold pending the outcome of the MMC's inquiry. Spillers Milling still had its own Managing Director, to whom the six mills reported. A number of changes, outlined in the following paragraphs, had been made, however, in reaction to the current uncertainties.

6.13. The Spillers Milling wheat buying department had lost seven out of ten employees since the business had been put up for sale. RH had used its own employees and recruited new ones to fill the vacancies. Although separate order books for RH and Spillers Milling were being maintained, wheat was being bought for both businesses by the appropriate buyer. For example, an RH buyer was purchasing all imported wheat.

6.14. RH and Spillers Milling were continuing to operate separate sales functions and to maintain separate order and sales ledger books. Before the merger had been referred to the MMC most customers had indicated that they would expect to see a single salesperson once operational and IT issues had been resolved. Four sales staff had left Spillers Milling since the acquisition and those positions were being covered either by other Spillers Milling staff or by RH sales personnel acting as agents for Spillers Milling. At their own request, two national accounts supplied by RH and Spillers Milling were now visited by a single sales person who collected orders for either or both businesses, in each case providing the grades of flour the customer had been receiving before the acquisition. In addition, RH executives had visited some Spillers Milling customers with the Spillers Milling sales staff.

6.15. There had been some changes in responsibilities within the businesses. The site manager at the Spillers Milling plant at Tilbury was now also responsible for the RH mill on an adjacent site. The Operations Director at Spillers Milling had become the RH Planning Director in charge of the integration project whilst the RH Operations Director had taken over responsibility for Spillers Milling operations. The Spillers Milling Personnel Director had retired since the acquisition and a replacement had not been recruited.

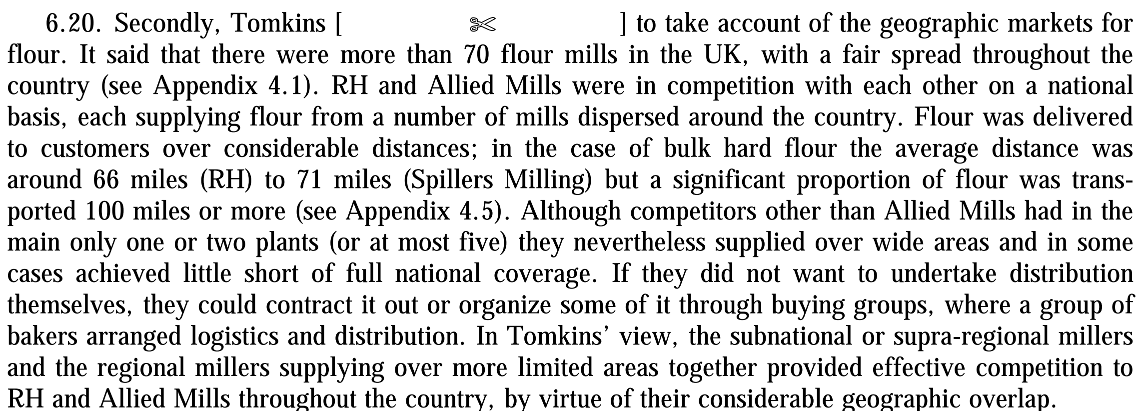
6.16. Steps were being taken to integrate the IT systems of the two businesses. This was necessary in part because the Spillers Milling system was not millennium compliant.

6.17. Tomkins pointed out that the Secretary of State had chosen not to make an Order under section 74 of the Act. This had left Tomkins free, had it so wished, to proceed with the integration of the two businesses but it had taken a conscious decision not to do so. Even if an Order had been made, Tomkins doubted that it would have prevented the changes it had described from taking place.

The market for the supply of flour

6.18. Tomkins provided estimates of post-acquisition shares of UK flour milling capacity and production. These indicated that RH/Spillers Milling had 32.1 per cent of effective capacity, Allied Mills had 27.3 per cent and other millers together had 40.6 per cent. Tomkins suggested that, for several reasons, it was oversimplistic and misleading to view the market only in those terms.

6.19. First, there were different customers and uses for hard and soft flour and no significant demand-side substitutability between hard flours used in breadmaking and soft flours used in other applications. Tomkins suggested that the two types of flour should nevertheless be treated as a single market because of the high degree of supply-side substitutability: some 77 per cent of flour milling capacity in the UK used plant capable of producing both hard and soft flour and even the relatively small number of mills producing only soft flour could, at a cost, convert to hard flour production. RH and Spillers Milling production estimates for the year to April 1998 indicated that RH's share of hard flour supply was some 32 per cent and Spillers Milling's share was just under 10 per cent. Tomkins said that RH was relatively weak in the production of soft flour, with 11 per cent of supply, while Spillers Milling's share was around 13 per cent.



6.20. Secondly, Tomkins [✄] to take account of the geographic markets for flour. It said that there were more than 70 flour mills in the UK, with a fair spread throughout the country (see Appendix 4.1). RH and Allied Mills were in competition with each other on a national basis, each supplying flour from a number of mills dispersed around the country. Flour was delivered to customers over considerable distances; in the case of bulk hard flour the average distance was around 66 miles (RH) to 71 miles (Spillers Milling) but a significant proportion of flour was transported 100 miles or more (see Appendix 4.5). Although competitors other than Allied Mills had in the main only one or two plants (or at most five) they nevertheless supplied over wide areas and in some cases achieved little short of full national coverage. If they did not want to undertake distribution themselves, they could contract it out or organize some of it through buying groups, where a group of bakers arranged logistics and distribution. In Tomkins' view, the subnational or supra-regional millers and the regional millers supplying over more limited areas together provided effective competition to RH and Allied Mills throughout the country, by virtue of their considerable geographic overlap.

6.21. Tomkins said that the choice of flour supplier in any area was not limited to one or two millers in addition to Allied Mills and RH: in every case there were up to eight or more suppliers active in the area. Furthermore, the geographic areas served by regional millers were growing larger as they increased the size of their mills, often concentrating production on new or enlarged mills while closing older or smaller ones. A geographic breakdown of the market based on the location of flour mills was therefore of little significance.

6.22. There was considerable overlap between the delivery areas of different mills, so any one mill might be in competition with mills located at some distance. If a mill lost sales to a competitor to the north, for instance, one natural reaction would be to try to increase sales at the expense of a

competitor to the south. Tomkins said that particular market conditions prevailing in one region would be likely to make their effects felt through a continuous chain of substitution across the country.

6.23. The supra-regional and regional millers were able to compete with RH and Allied Mills as a main supplier for customers whose requirements could be fully met at a location within the area in which they were active. They also competed effectively as an alternative source of supply on a regional basis to national account customers of RH or Allied Mills.

6.24. Thirdly, Tomkins drew a distinction between the integrated and free markets for flour. It pointed out that the milling industry was characterized by a high degree of vertical integration into downstream activities—plant bakeries for the production of bread, and other activities using hard and soft flour. In Tomkins' view, the MMC's economic assessment should disregard sales to integrated customers on the basis that they were not fully open to competition. It added that a miller was unlikely to divert large quantities of flour from an integrated bakery business and would in any event need to find alternative sources of flour for the integrated business. Switching flour from an integrated business to the free market would be attractive only if there were a big price differential. Conversely, RH's free market business was too significant to be put at risk for any short-term benefit that might result from diverting flour to the in-house bakery business. Additionally, the in-house bakery business would have to source flour from the free market at the higher price, so it was unlikely that any advantage would be gained.

6.25. Tomkins maintained, however, that flour millers who currently did not sell in the free market (for example, Marston) would be in a position to do so in future if market conditions were to so dictate. Spare capacity held by integrated millers, as well as any potential they had to expand capacity, was part of the competitive constraint on free market supply.

6.26. Estimates by Tomkins indicated that in the year to April 1998 RH and Spillers Milling together had supplied 40 per cent of the hard flour and 36 per cent of the soft flour sold in the free market. In respect of hard flour, the combined market shares of RH and Spillers Milling in the regions had varied little from the national figure of 40 per cent, with the exception of the north of England, where it was 46 per cent. Tomkins believed that the higher share achieved in the North raised no concerns. High product flows across the UK ensured that conditions in the North could not develop in isolation. Furthermore, RH's relatively high market share reflected the size and significance of one customer in RH's post-merger sales of hard flour in the north of England and Wales. Tomkins commented that RH faced competition from at least four well-established competitors in the North and there had been substantial erosion of Spillers Milling's sales in that region following the acquisition.

6.27. Tomkins did not accept that, in itself, Spillers Milling's strong position in certain segments of the market before the merger was a cause for concern. It said that RH's pre-merger share of supply of biscuit and specialty heat-treated flours was *de minimis* and that the merger had brought about no material change in market structure with regard to those products.

6.28. Tomkins said that its analysis had been intended to demonstrate that there was vigorous competition however the market was considered. It would be possible to segment the market, for example by types of customer or product, in order to analyse how business was developing and how customers were behaving, but this did not necessarily mean that the segments were different markets.

Competition in the supply of flour

6.29. Tomkins told us that RH was and would continue to be subject to competitive pressures from a number of sources, discussed below. It commented that the competitive pressures manifested themselves in ways that were typical of an industry characterized by maturity and static demand, overcapacity and product homogeneity: a continuing drive to keep costs down to competitive levels; falling prices as competitors sought additional sales to maintain capacity loading, and as customers with a policy of multiple sourcing played one supplier off against another; prices that lagged behind the rate of inflation as efficiency gains were eroded; and modest profitability.

6.30. With regard to the effects of the merger, Tomkins said that Spillers Milling had not been an effective competitor under Dalgety's ownership, for the reasons summarized in paragraph 6.4. As Dalgety had chosen to sell to Kerry, the alternative scenario to the merger that the MMC should consider was Spillers Milling under Kerry's ownership. Tomkins pointed out that flour milling was a non-strategic business for Kerry and that there could be no certainty that it would have been able or willing to make the investment in Spillers Milling that it needed in order to be an effective competitor.

Competitors

Allied Mills

6.31. Tomkins told us that Allied Mills, part of ABF, currently operated flour mills located throughout the UK with an aggregate installed capacity of some 28,597 tonnes a week (when adjusted for the planned closure of Burscough) or 1.5 million tonnes a year of hard and soft flour, giving it 27.3 per cent of national installed capacity. It produced hard and soft flour for internal consumption and for sale to the free market. It competed directly with RH (and the supra-regionals and regionals) throughout the UK.

6.32. Over recent years, ABF had undertaken a £100 million investment programme, involving the construction of a new state-of-the-art dual-purpose flour mill (Coronet Mill) in Manchester, the construction of a new speciality mill at Corby and extensive remodelling of three other mills (Rochford, Tilbury and Liverpool Seaforth). In turn, three mills were scheduled for closure. At the time the investment programme was announced ABF and Allied Mills had stated that the investment programme was intended to bring down costs and improve efficiency in a highly competitive industry.

6.33. Tomkins commented that Allied Mills was vertically integrated into plant baking through ABF's ownership of Allied Bakeries, one of the two largest plant bakeries in the UK and market leader in the premium white bread market. ABF also owned Speedibake, which manufactured frozen and ambient long-life part-baked products, as well as Burtons Biscuits Ltd and Westmill Foods.

6.34. We suggested to Tomkins that there was a close similarity of interest between itself and ABF that might result in very limited competition. Tomkins did not accept this view. It said that milling was a core business for ABF, which was directing its strategy towards food ingredients businesses. Allied Mills was a large, well-managed business with considerable resources. It gave every indication that it would continue to be pro-active and aggressive in the market place and Tomkins regarded it as a powerful competitor.

Supra-regional and regional millers

6.35. Tomkins provided details of 24 millers it regarded as leading supra-regional and regional competitors to RH. This analysis included details of product range, brands, technical resources, vertical integration links and investment history. It drew our attention to a number of factors, outlined in the following paragraphs, as demonstrating that these companies, individually and collectively, represented an active and dynamic force in the market place.

6.36. Tomkins said that the companies concerned were not necessarily small or lacking in financial resources: Smiths was a subsidiary of Northern Foods; Marston was owned by Amylum UK, which was in turn owned by Tate & Lyle; Meneba was the largest Dutch flour miller, with some 80 per cent of production in the Netherlands; Heygates, though privately owned, was part of a group with other activities and substantial resources; and Kerry, as the most recent entrant through its acquisition of the former Spillers Milling mills at Gainsborough and Birstwith, also had substantial resources.

6.37. These competitors included a number of new and effective entrants to the market place, such as Finedon, which over a few years had grown a substantial business supplying the free market plant bakeries, Meneba (which entered the UK market by acquisition in 1997), Marston and Kerry itself. Tomkins recognized that the flour milling industry was not a natural target for substantial new entry,

given that demand was relatively static and existing businesses were generally efficient. The incentive to enter would be considerably greater for companies that were already operating upstream or downstream in the market. Additional capacity was, however, most likely to come from incremental expansion by existing millers. Finedon and Whitworth had recently expanded capacity and Smiths was currently doing so.

6.38. Tomkins submitted evidence that the supra-regional and regional companies were prepared to invest in rationalizing or modernizing their production, including by capacity expansion. Smiths, for example, had announced that it was building a new mill at Worksop and planning to close two others, and Amylum, Finedon and Whitworth had increased the capacity of their mills.

6.39. Tomkins believed there was no reason why the supra-regional and regional millers should not continue to compete on cost against the national players. It pointed out that they suffered no disadvantage in wheat purchasing, which was 70 per cent of total costs. Furthermore, a number of these suppliers had achieved about 1,500 to 2,000 tonnes a week milling capacity, which was regarded as the optimal scale in new plant construction, with their existing scale of operation. Tomkins commented that the supra-regional and regional millers were able to avoid or reduce some of the costs borne by the national suppliers in R&D and in compliance costs associated with the Food Safety Act. Nor did they all need to develop and supply a full range of products. Some of them also had the advantage of plant that had been wholly or largely depreciated, whilst remaining serviceable. Finally, in so far as the businesses were family owned, they would not necessarily be required to meet the same financial targets as the larger, publicly owned businesses like RH, nor would they have to compete for funding with other investment opportunities.

6.40. Several of the competitors were present in downstream businesses: for example, Carrs, Heygates, Smiths and Timms had interests in plant bakeries and Kerry, Marston, Smiths and Whitworth in businesses using soft flour. Tomkins commented that this downstream activity underlined those companies' long-term commitment to the industry.

6.41. Tomkins maintained that the supra-regional and regional millers, like all others, were under pressure to maintain or increase sales volumes and capacity loading, because of the effect on profitability. In a market where demand was static, sales volumes had to be defended, if necessary by making concessions on price.

6.42. Large customers such as plant bakers tended to buy flour from several sources. Tomkins suggested that in many such cases a supra-regional or regional competitor could have established preferred supplier status, perhaps because it did not compete directly with the customer in a downstream business. Customers who wanted to maintain multiple sources of supply and to avoid undue dependence on Allied Mills or RH might be expected to support these competitors. Tomkins believed that if its major customers ever thought the market place was uncompetitive they would sponsor milling capacity to ensure that there was sufficient competition. In other cases suppliers could rely on the loyalty of local craft bakers or other customers built up over many years. Service levels were significant to those relationships and regional suppliers had an advantage over the nationals in that respect.

Actual and potential imports of flour

6.43. Tomkins said that the behaviour of leading suppliers to the UK market was constrained by the threat of competition from imported flour on a large scale. The volume of imports was currently relatively small because the UK milling industry was highly efficient and because the transport costs, which Tomkins estimated at between £20 and £50 a tonne depending on distance, were quite high. There was, however, substantial surplus flour milling capacity in Continental Europe and producers therefore had a considerable incentive to sell into the UK market if they could do so profitably. Tomkins suggested that the transport costs could relatively easily be overcome by any combination of low domestic wheat and processing costs, coupled with a favourable exchange rate. The Channel Tunnel had eased access.

6.44. Even the import of relatively small quantities of flour was liable to have a destabilizing effect because incumbent suppliers would be reluctant to damage the profitability of their businesses by losing sales volume in a market where demand was essentially static. Tomkins suggested that there would be what it termed an echo effect in the market place as a batch of imported material was offered to several potential purchasers.

6.45. Imports of flour in 1997 were reported at just over 51,000 tonnes (just over 1 per cent of UK demand) and came mainly from Ireland, northern France and northern Germany. This was in fact double the amount imported in 1996. Tomkins believed this growth had been due in part to large UK flour buyers widening their supply options in order to put more pressure on the UK millers. It told us that whilst some 25 per cent of imports tended to be of specialist grades of flour for particular applications such as French breads, the remaining 75 per cent was of standard bakers' flour. In Tomkins' view these facts demonstrated that there were opportunities for substantially higher imports should market conditions in the UK warrant them. Tomkins said that there were no technical constraints on foreign millers' ability to supply the UK market. They all had access to the appropriate varieties of wheat and their mills were capable of producing the grades of flour required by UK customers.

Countervailing power of customers

6.46. Tomkins said that long-term contracts were not common in the flour milling industry. Flour was essentially a commodity product and it was relatively easy for a customer to switch from one supplier to another. Customers had a wide choice and used this to secure favourable prices. RH was therefore unable to exercise market power since its customers were not dependent on it for their flour supplies.

Bread bakers

6.47. Tomkins said that the market for bread (including morning goods) accounted for almost 64 per cent of total UK flour consumption and for almost all hard flour consumption. Production units were traditionally classified as plant bakeries, in-store bakeries and high street craft bakeries.

6.48. Plant bakeries had been established for many years. They baked and supplied wrapped bread and pre-wrapped morning goods and rolls. Many of them were vertically linked with flour milling businesses but others such as Warburtons and Roberts were large and successful independent businesses. The largest plant bakeries were big users of flour, well able to exert buyer power. Tomkins provided figures indicating that the eight major plant bakeries other than British Bakeries and Allied Bakeries bought flour from at least two millers and in some cases from as many as five or six.

6.49. Tomkins said that in practice the independent plant bakers changed their patterns of supply to meet strategic objectives or to exert price pressure on existing suppliers. Typically, flour suppliers were asked to retender every few months. Plant bakers had a strong incentive to optimize their flour buying, since flour accounted for approximately 27 per cent of the retail value of the standard white loaf. It was easy for plant bakers to switch suppliers because the flours used were essentially homogeneous. Tomkins added that in recent years, all plant bakers had been under intense price pressure from their major customers, the grocery multiples (principally the leading supermarket groups), and those pressures had been passed back up the chain to the millers.

6.50. Tomkins calculated that the grocery multiples (including in-store bakeries) had a total share of 74 per cent of the retail bread market. It commented that bread had been heavily discounted by the grocery multiples in recent years as part of the price wars between multiple retailers. In consequence, the retail sales value of bread through outlets other than high street craft bakeries had continued to fall over the past five years. This decline in value had been reflected in prices for bread flour.

6.51. The leading grocery multiples were also able to exercise countervailing power on flour suppliers by virtue of their position as operators of in-store bakeries, which were estimated to account for some 20 per cent by value of the total bread market. Tomkins told us that in-store bakeries always

bought flour from two or more different sources and were in a strong position in their dealings with millers, in respect of both price and quality of product.

6.52. Tomkins said that the traditional high street craft bakery sector was in long-term decline. It had suffered from the bread price wars initiated by the grocery multiples and the incursions of in-store bakeries. Some craft bakers had formed co-operatives and joint purchasing organizations to increase their buying power. Tomkins maintained that the craft bakers benefited from countervailing power exercised elsewhere, because millers would seek to maintain relativity between prices charged to craft bakers and those charged to the in-store bakeries in particular, so as to encourage the continued existence of the small craft sector. It said that in fact the price of standard white flour fell in line with price reductions to in-store bakeries. Tomkins also drew attention to the retail bakery chains, the largest of which, Greggs, with over 1,000 shops, was well able to exercise effective purchasing power. Tomkins said that there was a ripple effect in the market. Price pressure exerted successfully in one part of the market meant that suppliers would concentrate their selling efforts in other parts, which would lead to price reductions there also: a price adjustment to one customer or in one market sector would lead to adjustments for other customers in order for the miller to retain their business in the face of price competition from other suppliers.

Other customers

6.53. Leaving aside starch production (which Tomkins told us was vertically integrated) the major customers were cake, biscuit, chapatti and other food manufacturers. These tended to be large companies with considerable countervailing power and included several of the major food groups such as McVities (United Biscuits) whose purchases from RH exceeded those of the large plant bakeries. Customers had the power to ensure that they were supplied on competitive terms, and the choice of a considerable number of other suppliers of cake biscuit, chapatti and specialty heat-treated flours. Furthermore, many of these manufacturers sold a high proportion of their products to the grocery multiples, who were the largest buyers of food products containing flour and whose exercise of purchasing power might be reflected indirectly through additional price pressure on the flour miller. Tomkins told us that from over 5,000 customers in the UK, 80 accounted for 75 per cent of all flour sales. It said that this represented a significant concentration of buyer power.

Evidence of effective competition

6.54. Tomkins said that various features pointed to the continued effectiveness of competition in the flour milling industry. First, the major competitors in the industry were continuously driving to achieve competitive cost advantages, and were prepared to invest heavily to do so: for example, Allied Mills' recent £100 million investment programme (see paragraph 6.32), Smiths' £10 million investment programme and Whitworth's and Finedon's current expansion programmes. There was no apparent reason why the supra-regional and regional competitors might not achieve cost levels that enabled them to go on competing effectively.

6.55. Secondly, there was continuous competition for customers, which was driven by the impact that any change in volume and capacity loading had on millers' profitability. All participants in the industry—national suppliers, supra-regional and regional players, even wholesalers reselling flour bought in bulk at wholesale prices—were engaged in competition that had benefited customers in terms of keen prices and high service levels. Tomkins provided recent examples of cases where RH had been required to react to competitive price pressure in order to retain or gain business.

6.56. Tomkins commented that the uncertainty surrounding the merger had provided a window of opportunity for other millers to win customers from Spillers Milling and RH. Volume losses since the acquisition had been greater than Tomkins expected, although it was confident of recovering some lost business.

6.57. Thirdly, Tomkins said that customers themselves took the initiative over prices. A number of them tracked wheat prices, which changed daily, and had a good understanding of the millers' costs of production and margins. They were quick to renegotiate prices to obtain the benefit of any lower wheat prices, effectively putting the miller's price on to a cost plus basis.

6.58. Fourthly, competitive pressures had led to steady erosion (in real terms) in RH's net selling prices for flour of about [✄] per cent over a ten-year period, as a result of which its gross margins had fallen. Margins had been stabilized in recent years only because operating costs had been reduced. Tomkins said that the benefit of those efficiency gains continued to be eroded by competition and was not retained by RH.

6.59. Fifthly, Tomkins told us that profitability in the flour milling industry continued to be relatively modest, for both RH and its competitors.

Price setting in the industry

6.60. We invited Tomkins to comment on concerns put to us that, as a result of the merger, it would be in a position to exercise price leadership. Tomkins said that the concept of price leadership was irrelevant in a commodity market experiencing deflation, which had prevailed over the previous two or three years and was thought likely to continue. Flour buyers, particularly the grocery multiples, had been leading the negotiations with millers and had been driving prices down.

6.61. We also asked Tomkins to comment on a reference in its 1998/99 Strategic Plan to Spillers Milling having been a catalyst for much of the previous price erosion. Tomkins said that it believed Spillers Milling had been losing sales volume, partly because of uncertainty about its future, and had therefore adjusted prices to try to recover and retain its customer base.

6.62. The Strategic Plan had also identified the restoration of market price discipline as a key task for Tomkins in 1998/99. Tomkins told us that this reflected its assumption of £[✄] of price erosion in the first year following the merger, because of volume loss in a period of market instability. It expected the market to have settled down by the second year and that it would have recovered some lost volume.

6.63. Tomkins maintained that the evidence available led to the conclusion that the market for the supply of flour was competitive and that RH would continue to be subject to effective competitive constraints.

Vertical integration

6.64. RH was vertically integrated into plant baking through British Bakeries and also into retail bakery through Three Cooks, which operated some 300 retail bakery outlets in England. Tomkins said that British Bakeries obtained most of its flour from RH without seeking competitive tenders. Changing the transfer price charged by RH to British Bakeries would have a neutral effect on Tomkins' overall profitability. (RH bought some, mainly specialist, flour from other millers to supply to RHM's other baking operations.) Spillers Milling had been vertically integrated into the breadmaking sector until 1992, since when it had been predominantly a supplier to the free trade in both bread and other flour. It had, however, remained vertically integrated in soft flour until completion of the sale to Tomkins in March 1998.

6.65. Tomkins said that any concerns about vertical integration needed to be set in context. It estimated that over the year to April 1998 supplies of hard flour to the free trade averaged some 28,614 tonnes a week, of which supplies from Spillers Milling accounted for some 5,052 tonnes a week, or around 18 per cent, and were less than the supplies to the free market from either Allied Mills or RH. Spillers Milling, therefore, had not been overwhelmingly the supplier of choice to the free trade.

6.66. The general concern over vertical integration was that free-trade plant bakers would be increasingly dependent on supplies from an integrated miller that might be tempted to favour its own downstream activities at their expense. Tomkins argued that that concern was misplaced. For one thing, its substantial sales of hard flour in the free market were too important to risk losing by artificially favouring its own integrated business. That had been so in the past and would be more so in the future. Furthermore, RH currently set prices to British Bakeries and Three Cooks on an arm's length basis, where transfer prices were benchmarked against a basket of free-trade market prices on a quarterly basis. Tomkins submitted that there could be no reasonable expectation that this policy would in future be abandoned in favour of one designed artificially to benefit the downstream businesses. Indeed, given that RH operated as a separate profit centre, the incentive was to maintain the arm's length relationship. The free-trade business acquired along with Spillers Milling would give RH even less of an incentive to favour its downstream businesses. The Spillers Milling business and assets had been acquired for a substantial price, and RH could not rationally embark on a course designed to alienate customers, lose demand and leave its newly acquired assets under-used.

6.67. Tomkins said that, in any event, RH was not in a position to exploit its free-trade customers to the benefit of its integrated operations. The free-trade plant baker could move business away from RH to one of several competitors, which would always include one or more independent suppliers to the free trade that were not vertically integrated. These included Bowmans, Bradshaws, Meneba and Nelstrops in the north of England and Finedon, Marriages and Meneba in the South. However, given that other integrated flour millers were already present in the market for supply to the free trade, and that customers purchased substantial tonnage from them with apparent satisfaction, there appeared no reason to limit the choice of alternative suppliers to non-integrated millers. There was no evidence that customers suffered any disadvantage through being supplied by integrated millers. A large number of customers chose to buy at least some of their flour from such millers although independent millers were available as an alternative.

6.68. In Tomkins' view there could be no rational incentive for RH to divert, say, 100 tonnes of flour away from the independents to British Bakeries. The independents would simply obtain supplies elsewhere, but even if they did not, British Bakeries would not gain all the bread business represented by that amount of flour. As independent plant bakers tended to buy flour from more than one miller, a customer would not need to switch all its flour buying to another source in adjusting or replacing the proportion currently supplied by RH. Tomkins commented that, because the milling industry was so capital intensive, the competitive pressures were such that the mere threat of changing supplier or reducing volumes was a sufficient competitive constraint.

6.69. Tomkins told us that Spillers Milling had lost business since the acquisition, as customers altered their buying patterns. Some business had been won back, but at the beginning of July sales were still around [✂] tonnes a week below the pre-acquisition level. Most of the loss had been in respect of hard flour volume in the north of England, with business going to Allied Mills, Meneba, Bradshaws, Nelstrops, Finedon, Whitworth and Kerry. Two grocery multiples had switched to other suppliers and one had made it clear that it was not prepared for the merged entity to have such a high share of its business.

6.70. Tomkins maintained that real power lay with the grocery multiples rather than the millers or the plant bakers. It said that the grocery trade had an interest in preserving a number of independent players in the plant bakery sector. Were there to be any threat to the structure of the plant baking market or to the position of the independents within that market, the grocery multiples were in a position to intervene, for example by rebalancing their purchases of plant bread away from British Bakeries and towards the threatened independents.

6.71. Whilst many of the points made in relation to independent plant bakers applied with equal validity to high street craft and other bakers, Tomkins suggested that it was also relevant that for most purposes the latter operated in a separate part of the market. It drew attention to the Key Note 1997 Market Report on Bread Bakers which noted that the in-store bakeries were more of a threat to craft bakers than plant bakeries. The report said that this was because of perceived differences in consumption and purchasing patterns between in-store bakery and plant-baked products. In general, the former were bought for immediate consumption the same day—perhaps as a 'treat purchase'—while wrapped

products were bought for later consumption and/or for more mundane occasions. Tomkins argued that, to the extent that craft bakeries and plant bakeries were not directly in competition, RH's vertical integration into plant baking had no material effect on the position of craft bakers, whether before or after the merger. Nor was RH's ownership of the Three Cooks chain of retail bakeries relevant: it was simply *de minimis* in the context of the whole.

6.72. Commenting on its recent acquisitions of the bakery groups Golden West and Le Pain Croustillant, Tomkins said that they reflected its desire to position itself in growth markets rather than being completely exposed to the declining part of the market (wrapped sliced bread). The businesses had not been acquired primarily to provide more outlets for RH's flour. It currently supplied them with only small quantities and had no immediate plans to change their existing arrangements with other suppliers.

6.73. We put to Tomkins concerns that had been expressed to us about a possible conflict of interest between RH's involvement in R&D and its supply of flour to independent bakers who were competitors of its downstream bakery businesses. It had been suggested that the independent bakers would be reluctant to discuss the development of new products with RH and that the loss of Spillers Milling's independent R&D facilities had, therefore, left them at a disadvantage. Tomkins said that these concerns reflected lack of experience of the way RH worked. It accepted that it needed to gain the trust of new customers. RH had had long experience of maintaining customer confidentiality and recognized that it would be commercial suicide to do otherwise. It had always operated a system of Chinese walls to ensure that information about, for example, product development by customers was not passed to its vertically integrated businesses (or vice versa). Tomkins assured us that there would be no change in this policy as a result of the merger, and indeed no commercial incentive for change.

6.74. Management changes within RH in 1996 had resulted in its former Managing Director being appointed to run British Bakeries while at the same time the Technical and Planning Director of British Bakeries became Managing Director of RH. Tomkins said that this had made no difference to the policy of confidentiality.

6.75. Tomkins believed that, for the reasons it had identified, any concerns based on the vertical integration aspects of the acquisition were misplaced.

Benefits of the merger

6.76. Tomkins maintained that the merger would result in a number of benefits to the public interest. It drew attention to its long-term commitment to the flour milling industry. It also intended to improve the efficiency of the Spillers Milling business and reduce its unit costs. As indicated in paragraph 6.9, the countervailing power of flour buyers and the falling price of flour in real terms suggested that these cost savings would be competed away to the ultimate benefit of customers.

6.77. Tomkins said that it had no plans to reduce the quality or variety of products it would supply following the merger. RH owned advanced R&D facilities that enabled it to work with customers in designing flours to meet their needs. These facilities would also be available to the customers of Spillers Milling.

Remedies

6.78. We asked Tomkins to consider a number of possible remedies that might be applied in the event of our concluding that the merger might be expected to operate against the public interest.

6.79. We first suggested behavioural undertakings to continue to observe Chinese walls between milling and baking activities. Tomkins said that it would not reject proposals for behavioural undertakings that were apt and proportionate to remedy particular public interest detriments that might be identified as resulting from the merger. However, the particular remedy that we had suggested was

misconceived. If there were any real concerns about RH leaking confidential information obtained from free-trade customers, they would have surfaced before the merger. RH had done business with free-trade customers for a number of years and no problems had arisen over its receiving confidential information about those customers. If a customer had particular concerns about confidentiality, the situation could be clarified by contract or exchange of letters, and on occasion this had happened. It would be wholly contrary to RH's own commercial interests to risk its reputation and goodwill by disclosing confidential information. The proposed remedy was therefore unnecessary since the market already demanded the assurance of Chinese walls.

6.80. We invited Tomkins to comment on a suggestion that a limitation might be placed on its further acquisition of flour milling or baking capacity or on its share of either market. Tomkins believed that such a remedy would be flawed because it would not address detriments arising out of the merger under investigation but only future mergers or market developments and would undermine the system of merger control in the UK. In its view, any imposed limitation on Tomkins' share of the milling or baking market would be perversely anti-competitive.

6.81. Commenting on partial divestment as a possible remedy, Tomkins said that, although it considered there were no public interest concerns requiring remedy, it recognized that the divestment of certain of the mills acquired would be feasible. However, it believed that further and more detailed analysis would be needed, in the light of the nature and extent of any public interest detriment identified, before a view could be taken on whether any particular divestment would be apt and proportionate.

6.82. Tomkins did not accept a suggestion that the two or three most profitable mills should be divested. That would leave it with the least profitable assets while the purchaser would gain a valuable asset on the cheap. It suggested instead that rather than profitability, the criterion should be that any mill divested should have a reasonable remaining economic life in its present state or with limited additional expenditure on maintenance and asset replacement.

6.83. It would not be possible for divested plants or businesses to be accompanied by an endowed customer base. The industry was not characterized by long-term contractual arrangements. Flour was for the most part an unbranded commodity product, so that buyers had free choice of supply at all times. Tomkins told us that customer loyalty often tended to be to a supplier rather than a source of supply, so that in the event of the sale of a plant the customer might choose to remain with the vendor. Tomkins believed that it would be impractical and undesirable to seek to restrict RH's ability to compete for customers for a limited period of time in the event of disposal of mills. RH would continue to operate as a national supplier of a complete range of flours. It would thus inevitably be in competition with the divested mills. In Tomkins' view it would be contrary to the public interest to prevent customers from benefiting from this competition and choice. More particularly, multi-sourcing was a particular feature of the industry, so that before the merger nearly 25 per cent of Spillers Milling's customers, accounting for some 57 per cent of its sales, were also customers of RH. It would not be practical to seek to prevent RH from continuing its business with customers with whom it had an independent and free-standing relationship. Tomkins raised the option of a limited divestment of capacity together with contractual arrangements for the new owner to supply some of the flour requirements of Tomkins' in-house customers, assuming that acceptable commercial terms could be negotiated. This would provide a baseload of volume to the mill or mills in question and therefore make the assets to be divested potentially more attractive to a prospective purchaser.

6.84. We suggested to Tomkins that partial divestment might prove inadequate for a number of reasons, including the concern of some customers to maintain choice of national suppliers; the desirability that the mills divested should be of sufficient scale to allow rationalization of production into larger mills; the desirability of maintaining a company with a diverse range of products and skills; and concerns about the implication of the merger for soft flour (in which Spillers Milling had a strong market position) as well as hard flour.

6.85. Tomkins did not believe there was a need for another national supplier since there was plenty of choice and competition in the market with two national players and a number of large supra-regional millers that also supplied nationwide. In addition, many national account customers bought some flour from regional millers.

6.86. In Tomkins' view the suggestion that the business divested should be of a scale to permit rationalization seemed wrong in principle, given that before the merger there was no realistic prospect of the rationalization of the Spillers Milling business by either Dalgety or Kerry. The pre-merger situation was the baseline against which any remedies should be measured; it followed that ordering solutions by reference to a purchaser's ability or desire to rationalize and reinvest would take into account considerations that were not relevant to the decision. There were also numerous practical questions as to whether a purchaser could be found and to what extent rationalization would be possible or necessary, depending on which and how many mills were to be divested, and the nature and scale of the pre-existing business of the purchaser.

6.87. Tomkins said that it was not necessary to divest a large number of plants in order to maintain a company with a wide range of products and skills. It provided evidence that regional or supra-regional millers, some operating with a single plant, had a diverse product range and an extensive portfolio of skills. A buyer already in the industry could be expected to have all or most of the necessary products and skills.

6.88. Tomkins did not see any special or additional feature arising in relation to soft flour, since all mills were capable of producing soft flours and it was possible to install equipment for heat treatment where required, or to arrange for toll-processing.

6.89. As an alternative remedy, we suggested to Tomkins a more general requirement to divest sufficient capacity to reduce RH's market share to what it was before the merger. Tomkins said that RH's pre-merger market share, whether measured on capacity, production or sales in the free market, was below 25 per cent. Given that it did not occupy a position of scale monopoly (much less of dominance) the remedy would be disproportionate and excessive. Such a divestment would be financially burdensome to Tomkins, given that it had paid the full price for Spillers Milling and would now be in the position of a forced seller, a detriment that would not be offset by its freedom to choose the assets to be sold.

6.90. We invited Tomkins to consider the potential remedy of divestment of Spillers Milling in its entirety as a going concern to a purchaser approved by the Secretary of State. We suggested that the business should be disposed of no later than within six months of the date of publication of our report.

6.91. Tomkins believed that such a remedy would be excessive and disproportionate in the light of RH's pre-merger position (see paragraph 6.89). It also pointed out that a full 'going concern' divestment would not be possible since the old Spillers Milling business prior to disposal by Dalgety could not be reconstituted. Kerry had retained the Gainsborough mill and other assets, the R&D facility had been sold to another party and Tomkins was only entitled to use the [*Details omitted. See note on page iv.*]. Tomkins said that since the purchase, and pending the outcome of the MMC's inquiry, there had been some further deterioration in the business acquired because of factors beyond its control.

6.92. The rump of Spillers Milling would not be attractive on a stand-alone basis to a purchaser and there would be no certainty that one would be found. Any purchase price offered would reflect the factors mentioned in paragraph 6.91 and also the impossibility of guaranteeing the transfer of the customer base. The sale to a single purchaser would almost certainly be at a knock-down price involving Tomkins in a very substantial loss. [*Details omitted. See note on page iv.*]

6.93. We put to Tomkins the proposal that if there had been any weakening of Spillers Milling since the merger any divestment should include other pre-existing RH capacity to ensure that the business divested was of equal viability to that acquired in order to remedy any adverse effects of the merger.

6.94. Tomkins said that it had made no attempt to integrate the Spillers Milling business (see paragraphs 6.12 to 6.16). Such weakening of its competitive position as had occurred had been outside Tomkins' control, resulting in particular from competitive incursions and customer pressure. It argued that where a specific statutory power existed and had not been exercised (see paragraph 6.17) it would be wholly inappropriate for the MMC, *ex post facto* and at Tomkins' expense, to seek to impose remedies which were predicated on the statutory power having been exercised. Furthermore, in Tomkins' view it could not be right to require the divestment of capacity and assets that it owned before the acquisition of Spillers Milling.

Spillers Milling

6.95. Spillers Milling gave separate evidence in which it told us that its business had suffered from the concentration of the free market and loss of sales volume to other millers in a highly competitive and largely price-driven market place. Recent loss of business from large customers had had a serious effect on a business the size of Spillers Milling that had a high level of fixed overheads. It had been considering buying another small milling business in order to recover lost volume but Dalgety would not fund a purchase. In general, Spillers Milling had suffered from lack of investment. The milling equipment in some plants had been replaced, but the infrastructure of buildings and the ergonomics of the operation had not been addressed. The Tilbury mill, for example, needed additional warehousing, and the Cambridge mill needed significant investment in order to reduce labour costs.

6.96. Spillers Milling said that the business, as a coherent entity, had been weakened by Kerry's retention of the Gainsborough mill. That mill had accounted for about 18 per cent of Spillers Milling's volume throughput and had shared appropriately the burden of the business's total overheads. Furthermore, as a dual-purpose mill that was well positioned geographically it had been significant in helping Spillers Milling to balance its portfolio of products. In particular, it had produced some small but profitable lines which had had to be bought in following its loss. The business as a whole had also been weakened by the sale of the R&D facility to DuPont and the departure of some key staff.

6.97. Spillers Milling was being maintained for the time being as a separate business from RH. Customers expected, however, that the two businesses would be unified and some had said that they would change supplier because the total volume of flour they bought from a single source would then be too large. Spillers Milling said that it was quite easy for a customer to move large volumes of business: it could be done within a month. A number of large customers had already moved business away from RH/Spillers Milling, and Spillers Milling knew of none that had switched from itself to RH since the merger.

6.98. In Spillers Milling's view, the merger offered the opportunity of synergies and rationalization. It believed that Tomkins had the resources to invest in the business. It did not consider that any major conflict of interest issue arose from RH being vertically integrated downstream. The ease with which any dissatisfied customer could switch to another supplier would be a constraint on RH.

6.99. In the event of our concluding that the merger might be expected to operate against the public interest, Spillers Milling did not believe that the six mills acquired by RH could be divested as a separate stand-alone entity. The business had been weakened as described in paragraph 6.96. [*Details omitted. See note on page iv.*] In principle, divestment of some of the mills would be feasible since each was an independent unit, but a large proportion of business was contracted to Spillers Milling rather than to an individual mill. It would not be possible to compel customers to give their business to the new owner of a mill. If the mills were split up between a number of different

buyers, it would be difficult to ensure that the current levels of quality, service and technical support were maintained and this again could result in loss of customers.

D P B KINGSMILL *(Chairman)*

H G C ALDOUS

G F OWEN

A ROBINSON

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P A BOYS *(Secretary)*

29 July 1998