Friesland Foods/Campina: a merger between two Dutch dairy cooperatives approved with a set of comprehensive remedies

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Introduction

The Friesland Foods/Campina case (M.5046), which concerned a full legal merger between the two leading Dutch dairy producers, covered the entire production chain of dairy products starting from raw milk and including everyday consumer products such as milk, cheese, butter or cream, as well as intermediate products used in the food industry such as emulsions, and lactose, an ingredient employed in the pharmaceutical industry.

The transaction not only involved a large number of affected markets, but also had vertical aspects since both cooperatives, Friesland Foods and Campina, are obliged to buy all the raw milk produced by their member-farmers and the member-farmers have to sell their entire production to the cooperatives. Given the fact that Friesland Foods and Campina have a combined market share of [70-80%] on the market for the procurement of raw milk in the Netherlands and similar shares on several markets for dairy products, the Commission was only able to clear the case, on 17 December 2008, subject to commitments which take into account not only the position of the parties on different dairy product markets, but also the need for access to the raw milk market as a necessary condition for the effectiveness and viability of divestments — leading to a comprehensive set of conditions and obligations.

The Commission’s in-depth investigation used the usual investigative techniques such as questionnaires addressed to market participants and telephone interviews. In addition the Commission’s Chief Economist Team conducted an intensive analysis of the parties’ internal pricing data as well as scanner data covering several product categories in the fresh dairy segment. This data (time series of volumes and values) was used as the basis for a set of econometric calculations to supplement the traditional analysis with respect to closeness of competition and product market definition.

The parties and the transaction

Friesland Foods and Campina, the two largest dairy cooperatives in the Netherlands, both collect raw milk and process it into consumer and industrial dairy products. Campina had in 2007 6 885 member-farmers and activities in fresh dairy products, cheese, butter, fresh and long-life flavoured drinks, and emulsions in various countries in Europe, North and South America and Asia. Friesland Foods counted 9 417 members (2007) with sales of consumer dairy products in Europe, the Middle East, Asia and Africa as well as sales of dairy ingredients for professional and industrial customers worldwide.

The transaction involved a full legal merger between the two cooperatives, leading to the establishment of a single cooperative, FrieslandCampina.

Friesland Foods and Campina are vertically integrated in the purchase of raw milk from member-farmers and sales of downstream dairy products processed from this raw milk. However, as both companies are cooperatives, this vertical integration is atypical in the sense that the link between a cooperative and its member is stronger than a mere economic relationship and also because conditions of supply are more stringent for both parties.

First, member-farmers are the owners of their cooperatives. Consequently, they are involved in the governance of the cooperative through various representative bodies. Elected farmers appoint the Board of the cooperative (the decision–making body) and have the right to approve or veto certain decisions of the Board.

With respect to conditions of supply, member-farmers are obliged to deliver all their raw milk to the cooperatives while the latter are in turn obliged to buy 100% of members’ production, irrespective of market conditions. The result of this reciprocal obligation is that there is a continuous flow of raw milk from farmers to dairy plants. This system remains in place after the merger.

All member-farmers of the new cooperative FrieslandCampina receive a base price for their supplies, namely the guaranteed milk price, which consists of a weighted average of the raw milk price paid by dairy companies in Denmark, Germany, Belgium and the Netherlands (excluding the parties). In addition to the guaranteed price, they also receive a share of the overall profits of the cooperative. This so-called “performance payment” equals 25% of the net profits, while 75% of these profits are added to the reserves of the company, either directly (60%) or through the issuance of bonds to members (15%).
On top of the milk price, farmers are granted member bonds and member certificates, which are financing instruments awarded to member-farmers on the basis of the quantity of milk delivered by them in a given year. The compensation or interest rate payable on such instruments for financing the company is independent of the quantities of milk that such investors deliver to the company. Therefore, members are remunerated for financing the company through annual interest on bonds. They also have the option of cashing the value of these bonds upon termination.

It follows that part of the remuneration paid to farmers (the performance payment and, less directly, member bonds) depends on the business results of the new entity in the downstream dairy markets where it is active. This method of determination of the milk price creates a strong link between the downstream markets for processed dairy products and the price paid to farmers by cooperatives for raw material, which therefore cannot be compared to a "normal" market price that would be solely influenced by raw milk supply and demand factors.

Furthermore, in that kind of cooperative structure, member-farmers have limited incentives to leave the cooperative. First, the supply arrangements give them security of outlets, which is critical for a perishable product such as raw milk produced on a daily basis. Secondly, farmers who have invested in the cooperative can only get back the value of their past investment in the cooperative if they stay as members, since they lose their entitlement to the profits of the cooperative upon termination of their membership. This structure limits farmers’ incentives to leave the merged entity and, by extension, influences the decisions of independent farmers or members of competing cooperatives. This can be expected to have an impact on access to raw milk for competitors.

The dairy sector

The dairy sector comprises a series of interrelated product markets, reflecting the wide variety of milk-based end products. The typical business model for dairy companies, notably dairy cooperatives, is to process the raw milk collected from farmers into a wide variety of higher-value added dairy products. The common raw material — raw milk — means that prices of dairy products follow similar trends.

Raw milk consists of several nutritional components: fat, proteins, lactose (milk sugar) and minerals. For some dairy products, only the non-fat components (such as proteins and lactose) are used. Other products, notably butter and cream, are made from the milk fat. Many key products such as cheese and drinking milk contain a mix of fat and non-fat components. Some products — in particular cream, buttermilk and whey — are, in essence, by-products resulting from the production of the primary dairy products such as drinking milk and cheese. The diagram below shows how the fat and non-fat components of raw milk can be used for different applications.

**Figure 1: The different applications of milk’s components. ©Trevor Smith, dairy industry consultant**

<table>
<thead>
<tr>
<th>FRESH COWS’ MILK</th>
<th>SEPARATION</th>
<th>RECOMBINATION</th>
<th>ADDRENNET</th>
<th>COMPRESSION</th>
</tr>
</thead>
<tbody>
<tr>
<td>SKIM (1)</td>
<td>FAT</td>
<td>STANDARDISED MILK (2)</td>
<td>CURD</td>
<td>WHIT</td>
</tr>
<tr>
<td>CRÉME</td>
<td>SKIM (1)</td>
<td>SKIMMED MILK POWDER (SMP)</td>
<td>CHEESE</td>
<td>LACTOSE</td>
</tr>
<tr>
<td>BUTTER</td>
<td>BUTTERMILK POWDER</td>
<td>CASEIN</td>
<td>CHEESE</td>
<td>Whey Protein Concentrate (WPC)</td>
</tr>
<tr>
<td>BUTTERMILK Powder</td>
<td>CASEIN</td>
<td>INTERMEDIATE PRODUCT</td>
<td>INTERMEDIATE PRODUCT</td>
<td>INTERMEDIATE PRODUCT</td>
</tr>
</tbody>
</table>

(1) SKIM = protein + other solids (lactose, minerals) + water
(2) STANDARDISED MILK = of a fat content adjusted by the addition of skim or cream
Competitive effects of the merger

The activities of Friesland Foods and Campina overlap in many dairy product markets, starting with the procurement of raw milk, the entire range of fresh dairy products (milk, yoghurt, buttermilk, custard, porridge, desserts, quark, flavoured drinks), cheese, butter, cream, long-life milk, coffee whiteners, long-life dairy drinks, emulsions and lactose.

A thorough investigation of the structure and the functioning of the dairy markets concerned by the merger was carried out. As a result, it was found that the merger, in its initial form, would have led to a significant impediment of effective competition in the markets for the procurement of raw milk, fresh basic dairy products (i.e. fresh milk, fresh buttermilk and plain yoghurt), cheese, value added yoghurt and quark (sometimes also called curd cheese), fresh flavoured dairy drinks, long-life dairy drinks and fresh custard and porridge. (1)

The competition concerns on the long-life dairy drinks market were solved through brand divestitures, and the remedies for fresh dairy products and cheese involved “classical” business/plant divestitures. The focus in the next paragraphs is on the markets for raw milk procurement, for which the remedy package represents a number of innovations.

Procurement of raw milk

At the level of product market definition, a distinction was made in this case between procurement of conventional raw milk and procurement of organic raw milk. As no competition concerns were identified in the latter case, the assessment focused on procurement of conventional raw milk.

The notifying parties, whose activities overlap only in the Netherlands, argued that procurement of conventional raw milk is sub-national in scope and fully coincides with the working area of the parties (Friesland Foods collects raw milk in the eastern and northern parts of the Netherlands whereas Campina collects raw milk in the southern and western parts of the Netherlands). The Commission’s market investigation found, however, that the relevant market is national in scope. First, costs of procurement of raw milk are influenced by a number of factors besides distance, such as the size of the processing or production plants located in the area (large processing plants can benefit from economies of scale) and the size of the farms from which raw milk is sourced. Secondly, the parties’ competitors collect conventional raw milk in areas which extend, in general, beyond the respective working areas of Friesland Foods and Campina and cover a substantial part of the Netherlands. Thirdly, competitors in the raw milk procurement market do not necessarily take the price paid out by Friesland Foods or Campina to their farmers as a benchmark to set their own purchase prices, and other cooperatives pay the same price to their farmers for raw milk, irrespective of the region where these farmers are located.

On the national market for the procurement of raw milk, the merged entity holds a very high market share, amounting to [70-80%]. Coupled with the fact that on the supply side, farmers supplying raw milk are highly fragmented, this provides a strong indication that the merged entity holds a dominant position in the procurement market for conventional raw milk. These market shares have been particularly stable in the past.

The Commission found that, because of the cooperative structure of the parties, their very strong position on the procurement market would not give them market power and the ability to reduce milk procurement prices, leading to lower output both of raw milk and in the downstream markets and thus harming consumer welfare. The new cooperative retains the current commitment to purchase the milk from its members post-merger. It is thus likely that the merged entity will have neither the ability nor the incentive to reduce the price paid for raw milk purchased from its members, leading to a reduction in input purchases and a consequent reduction of output and increased prices further downstream.

However, the new entity would without the proposed commitments have had the ability and the incentive to leverage its strong position in the procurement market for raw milk to foreclose existing or potential downstream rivals, by limiting or raising the costs of their access to raw milk. The following elements are relevant in this respect.

First, the market investigation showed that the merger would have significantly impeded competition in some national downstream markets for dairy products processed from raw milk, for instance fresh dairy products and cheese. As a result, the merged entity would have been able to exercise market power on these markets. The reduction of effective competition in these markets would have enabled the parties to charge higher prices, and secure higher margins, in the fresh dairy products and cheese markets. This would have led to an increase in the overall profits of the merged entity.

The increase in profits linked to downstream market power could have been redistributed to farmers, by means of higher pay-out prices, since part of the

(1) In contrast, no competition concerns were found in markets such as long-life milk, organic fresh basic dairy products, bulk and packet butter, liquid and spray cream, liquid coffee whiteners, SDEs, food grade lactose, pharmaceutical and DPI lactose.
price paid to farmers for raw milk is directly linked to the profits of the new entity in downstream markets. If the parties were to pay higher prices for raw milk to farmers than their competitors while offering the same kind of cooperative solution to which Dutch farmers are attached (stability of income, commitment to collect all the raw milk produced, long-standing relationships), it is likely that more farmers would apply to join the new entity. Any increase in the pay-out price for raw milk would also make members of the post-merger entity less likely to switch to other purchasers of raw milk. Through both means, the merged entity’s position on the market for procurement of raw milk would therefore have been further reinforced.

With regard to the downstream markets, the market investigation showed that alternative suppliers on the Dutch fresh dairy product and cheese markets need access to Dutch raw milk on a large scale. In a situation where the merged entity would have had the possibility of increasing its already very large farmer base, these competitors would find it more difficult to gain access to Dutch raw milk. The transaction would therefore have further reduced their ability to compete effectively in their respective Dutch downstream dairy markets by raising barriers to entry or expansion and would have strengthened the market power of the notifying parties in these markets.

In summary, the merger brought together the two main purchasers of raw milk in the Netherlands, which control roughly [70-80%] of the market. The market power that they would have had post-merger on downstream markets would have enabled them to generate additional profits and therefore pay higher prices to farmers. Consequently, the merged entity would have been in a position to attract more farmers and maintain and/or strengthen its farmer base. This situation would have increased barriers to entry and/or to expansion on the primary downstream markets for fresh dairy products and cheese where Dutch raw milk is needed to compete effectively.

**Fresh dairy products**

For fresh dairy products, the market investigation in this case led to the definition of numerous product markets.

The notion of fresh dairy products includes fresh basic dairy products (i.e. fresh milk, fresh buttermilk and plain yoghurt), value added yoghurt and quark, fresh flavoured dairy drinks, fresh custard and porridge. Fresh basic dairy products can be divided into organic and non-organic, and within each of these categories separate product markets for fresh milk, fresh buttermilk and plain yoghurt can be distinguished. It was concluded that in these markets, private label and branded products belong to the same product market upstream. A possible distinction, with regard to the distribution channel, between retail/Out of Home (“OOH”), is left open for non-organic fresh basic dairy, while in organic fresh basic dairy OOH and retail belong to the same market. The upstream market for (organic and non-organic) fresh milk, fresh buttermilk and plain yoghurt was considered national in scope.

For value added yoghurt and quark, separate markets are defined according to distribution channels. A separation into value added yoghurt on the one hand and quark on the other, and a separation into health/indulgence as well as into private label and branded products was left open as such a distinction did not affect the competitive assessment. The relevant geographic market is national in scope for the upstream market in the supply of value added yoghurt and quark to OOH wholesalers and wider than national for the upstream market in the supply of value added yoghurt and quark to retailers.

There are also separate relevant product markets for health-related fresh flavoured dairy drinks and non-health related fresh flavoured dairy drinks, which can be further separated into the supply of branded and private label products and according to the distribution channel (retail/OOH). As the merger did not lead to an impediment of effective competition in the market for health-related fresh flavoured dairy drinks and the private label market was not affected, the competitive assessment focused on the branded non-health related market for fresh flavoured dairy drinks. The upstream market for non-health related fresh flavoured dairy drinks is national in scope.

Separate product markets also exist for fresh custard, porridge and portion pack desserts. For custard a separation between private label and branded products is left open. Whether the market has to be further separated according to the distribution channel was also left open as such a distinction did not affect the competitive assessment. The markets for custard and porridge were considered national in scope.

The market investigation found that the transaction as proposed in its initial form would have significantly impeded effective competition as a result of the creation of a dominant position on the markets for non-organic fresh milk, fresh buttermilk and plain yoghurt in the Netherlands, regardless of a further segmentation of these markets according to distribution channels. This conclusion was based, inter alia, on the parties’ high combined market share, on the fact that they were regarded as each other’s closest competitor, on the difficulty for customers to switch to alternative suppliers and on the difficulty for competitors to expand production in the event of a price increase.
Similarly, the notified concentration would have significantly impeded effective competition on the market for value added yoghurt and quark in the Netherlands supplied to the OOH segment and on the market for branded non-health fresh flavoured dairy drinks in the Netherlands, separated according to the distribution channel into retail and OOH.

In the markets for fresh desserts, the notified concentration would have significantly impeded effective competition on the market for fresh custard in the Netherlands and the market for porridge in the Netherlands, regardless of whether these markets need to be further segmented according to the distribution channel. As in the other markets described above, the conclusion was based, inter alia, on the parties’ market position, on the fact that they were regarded as the closest competitors and that it was thus difficult for customers to switch to alternative suppliers.

Cheese

The cheese supply chain in the Netherlands has many specific features. The market investigation revealed that Dutch-type cheese (i.e. Gouda, Maasdam, Edam and varieties) needs to be distinguished at the level of product market definition from other hard/semi-hard cheeses such as Emmenthal, Tilsit, etc. Dutch-type cheese is sold in the Netherlands either to specialised cheese wholesalers, who are active at an intermediate level between production and downstream distribution channels, or retailers and other downstream channels. Dutch-type cheese can be either mature cheese (i.e. naturally matured cheese) or rindless cheese (i.e. cheese that is wrapped in a plastic foil when it is young and does not mature any further); mature cheese is often bought by specialised cheese wholesalers at the age of 15 days for the purpose of further ripening before it is sold to downstream distribution channels in the Netherlands. The market investigation led to a delineation of separate product markets for the sale of Dutch-type cheese to specialised cheese wholesalers on the one hand and to supermarkets and other modern types of retail on the other hand. Any further subdivision of the Dutch-type cheese market was left open as such a distinction was not material for the competitive assessment.

With respect to the relevant geographic market, the markets for the sale of Dutch-type cheese to specialised cheese wholesalers and modern types of retail (including all narrower segmentations except for rindless cheese) are national in scope while the markets for the sale of rindless Dutch-type cheese (including all narrower segmentations) to specialised cheese wholesalers and modern types of retail are wider than national and include at least the Netherlands and Germany.

The market investigation found that the transaction in its initial form would have significantly impeded effective competition on the markets for the sale of Dutch-type cheese to specialised cheese wholesalers (including narrower segmentations into mature, Gouda and 15 day-old cheese) and to modern types of retail (including narrower segmentations into mature and Gouda cheese) in the Netherlands.

As regards sales to specialised cheese wholesalers, this assessment is based, inter alia, on the high market shares of the parties, the closeness of competition between the parties, the limited abilities of specialised cheese wholesalers to switch to alternative domestic or foreign suppliers, the limited prospects for entry and expansion in the near future and the fact that all countervailing factors put forward by the parties (e.g. decreased demand and increase in re-imports/sales of cheese originally destined for exports in the event of price increases, alleged dependence on wholesalers’ storage and ripening capacity) were found to be insufficient to prevent the merging parties from increasing prices.

Similarly, the assessment of the market for sales to modern types of retail is based, inter alia, on the high market shares of the parties, the closeness of competition between the parties, the limited degree of competition between the parties and specialised cheese wholesalers, the limited possibilities of modern types of retail to switch to alternative domestic or foreign suppliers, the limited prospects for entry and expansion in the near future and the fact that all countervailing factors put forward by the parties (e.g. buyer power, increase in re-imports/sales of cheese originally destined for exports and increased use of rindless cheese in the event of price increases) were found to be insufficient to prevent the merging parties from increasing prices.

Remedies

In order to remove the competition concerns described above, Friesland Foods and Campina committed to divest/grant:

- The entire fresh dairy business of Friesland Foods situated in Nijkerk (the Netherlands), covering the products fresh milk, fresh buttermilk, plain yoghurt, value added yoghurts and quark, fresh custard, porridge, fresh flavoured dairy drinks, fresh cream and organic fresh basic dairy products;
- An exclusive, renewable five-year licence to use the Friesche Vlag brand name in the Netherlands for the current Friesland Foods Fresh product portfolio, followed by a black-out period;
- The ownership of Campina’s Melkunie brand and the ownership of all Friesche Vlag sub-
brand names and all brands that are specific to the products of Friesland Foods Fresh (with the exception of the Friesche Vlag brand itself); and

- Campina’s Dutch-type cheese production facility at Bleskensgraaf (the Netherlands) and the carve-out of a sales team and other employees for R&D, planning and logistics and general support from the sales organisation of the merged entity.

As explained above, the merger would in its initial form also have led to a significant impediment of effective competition in the market for procurement of conventional raw milk by bringing together the two main purchasers of raw milk in the Netherlands, given the market power that they would have on downstream markets. These competition concerns in the market for procurement of conventional raw milk had therefore to be solved through commitments in the downstream markets and had to include access to raw milk for the divested businesses on a lasting basis. The parties have provided a set of commitments with respect to access to raw milk to eliminate the significant impediments of effective competition identified in the downstream and the upstream markets. In addition to transitional supply agreements for the buyers of the divestment businesses in fresh dairy products and cheese, the remedy package included the setting up of a “Milk Fund” and incentives for farmers to leave the merged entity.

The Dutch Milk Fund (“DMF”)

The parties will grant drawing rights for a maximum volume of 1.2 billion kg of raw milk to plants of dairy companies in the Netherlands that produce fresh basic dairy products, Dutch-type mature cheese or one of these products in combination with other dairy products. These drawing rights will be guaranteed by an independent non-profit organisation DMF (in the form of a “stichting” or foundation under Dutch law) which will act as a mediator between FrieslandCampina and potential users of these drawing rights.

The volume of 1.2 billion kg will first cover the maximum capacity of both plants of the divested businesses and the remaining volume will allow purchasers of the divestment businesses to expand their business during the period of functioning of the DMF. It should also enable alternative players to source raw milk on competitive conditions to support further growth, thereby further contributing to the restoration of effective competition in the downstream markets for fresh basic dairy products and cheese in the Netherlands.

The price for raw milk will correspond to the guaranteed price that the merged entity will offer to its member-farmers minus 1% for the first five years from the date on which this remedy becomes effective (which corresponds to the date when the DMF becomes operational) and thereafter will correspond to the guaranteed milk price without reduction.

Both divestment businesses will have preferential drawing rights up to the volume representing the total production capacity of those businesses. This arrangement was considered necessary to ensure that these divestment businesses will be able to compete with the parties on a lasting basis.

The DMF will remain in operation until the volume of raw milk to be made available by FrieslandCampina through the DMF has been reduced to zero following the application of the incentive to leave described below. The volume of raw milk available under the DMF commitment will be reduced every year by the volume of raw milk for which applications have been made under the incentives to leave scheme. Therefore the DMF will remain in place until newcomers in the downstream markets have been able to constitute their own supply platform.

Incentive to leave

The parties have also undertaken to reduce the exit barriers for members of the merged entity by granting to existing members of FrieslandCampina in the Netherlands a financial incentive to leave FrieslandCampina (the “Start Up Payment”) and to enter into a supply arrangement of any kind with a certain minimum duration with a buyer of raw milk in the Netherlands. The amount of the Start Up Payment is 5 EUR per 100 kg raw milk delivered in the year immediately preceding the year in which the application for the Start Up Payment is made. Any member of FrieslandCampina may apply for the Start Up Payment provided it becomes a supplier to any buyer of raw milk in the Netherlands for a period of three years. Whenever a member terminates his membership with FrieslandCampina, the raw milk volume for which the Start Up Payment has been paid is withdrawn from the volume to be made available by FrieslandCampina through the DMF.

These incentives should provide access for the purchasers of the fresh dairy and cheese divestment businesses to the original sources of milk (farmers). These purchasers should be in a position to contact members of the cooperative societies and to offer alternative terms and conditions. This commitment provides for a more structural solution which enables the purchasers of the divestment businesses to secure their own supply base.

Members that have exited FrieslandCampina may rejoin FrieslandCampina as a member. However, if
a member re-accedes to FrieslandCampina within three years from the date he ceases supplying raw milk to FrieslandCampina or definitely stops supplying raw milk altogether, he will have to repay the exit fee on a pro rata basis. This specific arrangement, which gives the farmer the opportunity to rejoin as a member should he decide to apply for the scheme, is essential to secure the success of the incentives to leave scheme. Otherwise, the prospect of not being able to return will function as an additional deterrent to leave and make the incentives less attractive.

**Conclusion**

In view of these substantial remedies offered by the parties, which are designed to keep the markets at issue competitive and to ensure that consumers will not be harmed by the merger, the Commission was able to approve this significant concentration in the Dutch dairy sector. The Commission’s decision is conditional upon full compliance with the commitments.