No. CT-91/1

THE COMPETITION TRIBUNAL [redacted]

IN THE MATTER of an application by the Director of Investigation and Research for orders pursuant to section 92 of the Competition Act R.S.C. 1985, c. C-34, as amended;

AND IN THE MATTER of the acquisition by Hillsdown Holdings (Canada) Limited of 56% of the common shares of Canada Packers Inc.

B E T W E E N:

THE DIRECTOR OF INVESTIGATION AND RESEARCH

Applicant,

- and -

HILLSDOWN HOLDINGS (CANADA) LIMITED,
MAPLE LEAF MILLS LIMITED,
CANADA PACKERS INC. and
ONTARIO RENDERING COMPANY LIMITED

Respondents

REPLY AFFIDAVIT OF JOHN R. GROENEWEGEN

I, John R. Groenewegen, of the City of Guelph, in the Province of Ontario, MAKE OATH AND SAY:

1. I have been retained by Maple Leaf Foods Inc. (formerly Canada Packers Inc.) to comment and advise on the Ontario rendering industry and to address issues relating to the competition of the rendering of red meat by-product material. My background and qualifications are described in my earlier affidavit, which was filed by the Respondents on August 2, 1991.

[redacted]

2. Attached hereto as Exhibit "A" to this my affidavit is a true copy of my reply to the rebuttal affidavits of Thomas W. Ross and David D. Smith, filed by the Applicant on August 23, 1991.

Sworn before me at the)
City of Guelph in the)
Province of Ontario)
this 6th day of September 1991.)

John R. Groenewegen

A. Svoboda
A Commissioner, etc.

9700D/10-11

[redacted]

This is Exhibit "A" to the

Reply Affidavit of John R. Groenewegen,

Sworn before me on the 6th day

of September, 1991

A. Svoboda

A Commissioner, etc.

DR. JOHN R. GROENEWEGEN

9700D/12

REPLY OF JOHN R. GROENEWEGEN

I BACKGROUND

1. I am a Principal with Deloitte & Touche Management Consultants and am responsible for the Economics and Policy Analysis Group in the Guelph office. I received a Ph.D. in Agricultural and Applied Economics from the University of Minnesota in 1980. The purpose of this reply is to address arguments made by David Smith and Thomas Ross in their rebuttal affidavits.

II THE GEOGRAPHIC NATURE OF THE MARKET

2. Dr. Smith (paragraph 18) and Professor Ross (paragraph 5) of their respective rebuttal affidavits refer to Dr. Bisplinghoff's evidence to suggest the relevant geographic market for the pick-up of red meat materials is Southern Ontario. As shown in Table 6.1 of my affidavit, sworn on August 2, 1991, renderers would be willing to transport inedible beef raw materials a considerable distance to obtain desired end product characteristics. [redacted] This distance includes many rendering locations outside of Ontario. This example demonstrates the size of the geographic market for renderable material. The attached Figure 1 shows the relationship between the purchase price and the distance a renderer will travel for a given marginal value of beef material to the renderer. Information provided to me by Maple Leaf Foods of Coture establishing accounts in Toronto and transferring this material to Montreal supports this statement.

III THE TRANSPORTATION ADVANTAGE TO CERTAIN RENDERERS

3. The "outside limit" of a price decrease (for raw material supplies) due to the merger is based on the cost advantage a particular renderer has to service major accounts. For example, in the first half of 1991, the rendering credits to a beef slaughterer were [redacted] (after transport costs), based on Table 7.1 in my original affidavit. To the renderer, the landed cost includes transportation charges of [redacted] (based on data provided by Maple Leaf Foods). Assuming this was Guelph based beef material going to ORENCO, the round trip mileage is around 60 miles, for a cost of [redacted] (see attached Table 1). This makes the value at the renderer's facility [redacted] Therefore, with comparable values of inedible material for a competing renderer 192 round trip miles from the account (e.g. Buffalo), the competitor's transport costs are [redacted] and they would be willing to pay [redacted] Consequently, the local renderer (ORENCO) has a [redacted] cost advantage [redacted] over a more distant renderer (Buffalo). Accordingly, for this example, the amount of the potential price decrease is [redacted] relative to the base price of [redacted] or an 11 percent price decrease. Information provided by Maple Leaf Foods indicates that the purchase price of beef material can be much higher than [redacted] Consequently, the potential price decrease would be much lower, in percentage terms. The transportation cost advantage of local renderers to other competitors is also outlined in Table 1.

IV SWITCHING BETWEEN POULTRY AND RED MEATS

4. Both Professor Ross in paragraph 14 of his rebuttal affidavit, and Dr. Smith in paragraph 22 of his rebuttal affidavit state that if Maple Leaf Foods was required to divest the ORENCO plant, the Moorefield plant would continue to exert competitive pressure on ORENCO through its ability to switch from rendering poultry material to red meat by-products or vice versa.

5. At present, the Rothsay Moorefield facility renders both poultry and red meat products. As outlined in my previous affidavit at Table 3.11, poultry offal and feathers are projected

to grow by 19% between now and 1996. Poultry offal will represent 19% of the raw material supplied, and feathers 7 percent. [redacted]

6. In the case of ORENCO, the existing equipment can not be partially diverted to poultry. This results from the technological processes used at the plant. For ORENCO to become a renderer of poultry by-products requires a new stand alone rendering line. Moreover, environmental approvals are necessary to render poultry feathers which a supplier will insist that the renderer take together with the poultry offal. [redacted]

[redacted]

7. Based on a five year service life, the capital and interest costs (at 10%) are [redacted] and [redacted] respectively. This results in a capital plus interest cost per tonne of poultry offal at [redacted] per tonne of poultry offal, feathers and blood [redacted] The

incremental annual operating costs of labour, fuel, utilities and chemicals is [redacted] or [redacted] per tonne. Thus the total cost structure is [redacted] per tonne before raw material costs.

8. Based on the above cost structure and the difficulties in obtaining the appropriate environmental approvals to render poultry feathers, the likelihood of a red meat processing plant switching to poultry is quite low.

V DECLINING RED MEAT INDUSTRY IN ONTARIO

9. At paragraph 10 of his rebuttal affidavit, Dr. Smith states that the respondents' experts do not consistently show that the relevant markets (i.e. red meat by-products) will decline. While Professor van Duren's estimate of the decline in the supply of red meat by-product is greater than is found in my affidavit, it should be noted that the main focus of my affidavit sworn August 2, 1991 was not to attempt to forecast the supply of raw material into the future. For the purpose of my analysis, I relied on the forecasts of Agriculture Canada, with all of their problems, and made certain assumptions to revise the forecasts to estimate Ontario red meat by-product supplies. Professor van Duren also recognized the deficiencies of Agriculture Canada's forecast for red meat by-product supplies, but she goes further and focuses on this particular issue in her affidavit and compares them to other forecasts which used other sets of information and procedures. She also focuses in detail on the structural changes occurring in the Ontario red meat industry.

VI RELATIVE BARGAINING POWER OF RAW MATERIAL SUPPLIERS

10. Professor Ross, in discussing Professor McFetridge's trade-off analysis, drew conclusions on competition in the rendering industry based on concentration data. Professor Ross' conclusions on price enhancing (for rendering services) do not reflect the reality of the rendering industry. The economic and bargaining power of the raw material suppliers has not been taken into account to arrive at conclusions regarding a reduction in competition and price paid for inedible raw materials.

[redacted]

11. Michael E. Porter of the Harvard Business School, a widely acclaimed expert on industry and national competitiveness, outlines the forces driving competition in an industry. They include:

    1) Threat of New Entrants;
    2) Rivalry Among Existing Firms;
    3) Bargaining Power of Buyers;
    4) Bargaining Power of Suppliers;
    5) Threat of Substitute Products and Services.

12. **New entrants** are a real threat to the rendering industry. As outlined in my original affidavit, the threat of new entrants from Quebec, Buffalo and Detroit places considerable price discipline on Ontario renderers. The cost of moving raw materials from Toronto to Montreal is [redacted] per tonne, and [redacted] per tonne for a Toronto-Buffalo run (refer to Table 1). However, the cost difference relative to Dundas is [redacted] for Montreal and [redacted] for Buffalo. This places the difference between P_2 and P_1 in figures 2.1 and 2.5 in my original affidavit at [redacted] for Buffalo. This means the maximum price decline that is possible is [redacted] percent for material valued at [redacted] The merger has no negative impact on the entry of new market participants.

13. Evidence provided to me by Maple Leaf Foods indicates that there is considerable **rivalry** between renderers. Renderers do attempt to steal accounts from other renderers by offering higher credits for material. According to Maple Leaf Foods, this rivalry results in the rendering matching the competitor's offer to maintain business volume. The excess capacity of Ontario renderers and the competition from non-Ontario renderers contributes to this intense rivalry.

14. The **bargaining power of suppliers** can result in a very competitive rendering sector, independent of its structure. As outlined by Porter, a supplier group (supplier of raw materials for rendering) is powerful when the following conditions apply:

    1) *Suppliers are dominated by a few companies and are more concentrated than the (rendering) industry it sells to.* Attached table 2 illustrates the

concentration in the hog and beef slaughtering markets in Ontario. As outlined in table 2, one packer accounts for 39 percent of beef slaughter, and the top 4 companies provide 79 percent of the beef material from slaughter facilities. Also illustrated is that three companies provide 77% of pork supplies. Maple Leaf Foods has indicated to me that [redacted] Renderable material from grocery stores is predominantly (90% or more) beef. The concentration data indicates that the supplier industry is very concentrated.

2) *Suppliers are not obliged to contend with other substitute products for sale to the (rendering) industry.* There are no substitutes for the inedible materials that renderers process. Within inedible materials, poultry by-products can not substitute for inedible red meat materials for certain end-product uses. The lack of substitutes precludes the price competition provided by substitute supplies and contributes to the power of raw material suppliers.

3) *The (rendering) industry is not an important customer of the supplier group.* As documented in my original affidavit of August 2, 1991, the sales of renderable material range between [redacted] and [redacted] This would be a lower percentage of suppliers' sales revenue. Thus, in terms of revenue, the renderer is not an important customer to the red meat packer/processor, another fact supporting the power of the supplier industry.

4) *The suppliers' product is an important input to the buyer's/renderer's business.* Inedible material is the only supply source for renderers. The suppliers have some leverage in this economic relationship since they supply a product which is a very low contribution to their

revenue line, but is the crucial and dependent operating input to renderers.

5) *The supplier group's products are differentiated or it has built up switching costs.* The switching costs to shift between renderers are minimal.

6) *The supplier group poses a credible threat of forward integration (into rendering).* This is a major threat to renderers who operate in the free market. Proof exists with the extent of captive material and the historic structure where slaughters performed their own rendering. This is still prevalent with Ontario hog slaughterers. Large slaughter houses often assess the business case of providing their own rendering services. As outlined by Mr. Bisplinghoff at paragraph 29 of his affidavit sworn August 2, 1991, the trend is toward more integration with the large packers (e.g., the Cargill facility in Alberta) into rendering. This forward integration threat places a powerful discipline on the price behaviour and performance of renderers.

15. The above conditions of a powerful supplier group all apply to the suppliers of red meat material in Ontario to renderers. Thus, given the relative power of these suppliers, a merger which enhances the concentration in the rendering industry does not change these basic supplier conditions. An increase in concentration in the rendering industry has limited impact relative to the bargaining power of suppliers. This is particularly true when transportation costs are the only entry barrier to the Ontario market and the beef market is in decline.

VII POTENTIAL PRICE IMPACT OF THE MERGER

16. The Ross rebuttal affidavit at paragraph 45 suggests a 347 percent price change (Table 1) when the elasticity of demand for rendering services is 0.1. This does not reflect the

realities of the rendering market. Using a marginal cost of renderable material of [redacted] a 347 percent price decline results in a debit of [redacted] This result is not sustainable.

17. Rather, as outlined in previous paragraphs, the outer limit of any potential price decline is the cost of transporting materials to non-Ontario rendering facilities relative to local transport costs (see also my Table 1). The potential price consequences are less than 10 percent for beef with the real threat of Buffalo re-entering the market as suggested by industry observers.

VIII SUBSTITUTABILITY OF END PRODUCTS

18. The Ross rebuttal affidavit, at paragraph 23, suggests that the end products of beef materials and other raw materials are perfect substitutes. They are not perfectly substitutable. For example, beef can substitute for pork, but pork can not substitute for beef in the high value end product markets. No other product (aside from sheep offal) can substitute for beef offal to produce the high titre "high value" products. It is this point which results in a high value placed on obtaining and retaining a beef account.

IX WILLINGNESS TO PAY AND COMPETITION FOR BEEF MATERIAL

19. At paragraph 9, Professor Ross suggests that I did not provide any support for the beef end product values and the degree of competition. My report included examples to support the assertion. To further the exposition, the attached figure 2 is a reproduction of Table 6.1 in my affidavit. This figure shows the willingness to pay for beef materials at various quantity requirements (from the column labelled "marginal value of material" in Table 6.1). Consequently, a renderer requiring an additional [redacted] of beef material is willing to pay [redacted] In contrast, the average value is significantly less. Antecodal evidence substantiates the findings, as well as other sections of my original affidavit and this reply.

20. My August 2, 1991 affidavit provides empirical evidence on the competition for beef. One example was the need to purchase raw beef tallow from western Canada to meet contract

obligations for a 41 titre value. Another was ORENCO's need to import product from Taylor By-products prior to the merger.

X MODELS OF THE RENDERING INDUSTRY

21. Professor Ross, in paragraph 36, uses elasticities of demand for rendering services of 0.1, 0.2 and 0.5. As I have outlined in my original affidavit, the supply of renderable material is fixed and results in a nearly perfect inelastic supply relationship (see figure 2.1 in my August 2, 1991 affidavit). The resulting supply elasticity can be represented with a value of 0.01 or less. Using Professor McFetridge's methodology, this equates an elasticity of demand for rendering services of 0.023 or less. In this range, very little deadweight loss results if a price decrease does occur.

22. The construct used by Ross in paragraphs 23 to 62 is based on false premises. The first false premise is that other types of renderable material can substitute for beef material. The second is a premise of a dominant firm model. No evidence has been provided to support such a case, aside from the fact that Rothsay/ORENCO would account for a large part of the Ontario market. My analysis and understanding of the rendering industry refutes the dominant firm model used by Professor Ross.

XI CONCLUSIONS

23. The merger should not result in any measurable increase in the price of rendering services (decrease in the price of renderable materials). The outside limit of any price change is limited to the transportation cost advantage provided by other renderers to a particular account. For a beef account relative to the influence of the Buffalo market, this would translate into an increase of less than 10 percent.

24. The potential price impact, based on transportation/location advantage, is conditioned by the behaviourial aspects of the rendering market. In particular, the bargaining power of raw material suppliers for the non-captive market is substantial. Given the power of raw

material suppliers, a Rothsay/ORENCO merger will not lessen the competition in the red meat rendering industry, which is a declining industry subject to competitive threats from forward integration, entry from other markets, and where all participants are chasing the increasingly scarce free-market red meat material.

Figure 1 W ingness to Pay for Dis. .nt Beef Accounts

Figure 2 Willingness to Pay by Renderer for Incremental Beef Material

TABLE 1: COST OF MOVING MATERIAL FROM SOURCES OF SUPPLY TO RENDERING POINTS

Weekly Ontario Hog Slaughter and Industry Concentration

Weekly Ontario Beef Slaughter and Industry Concentration