Economic Perspective 1

THE TAKEOVER BATTLE FOR BRITISH SUGAR

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Throughout 1986 lines for a takeover battle for Britain's producer of domestic beet sugar have been drawn and redrawn. The cases of two potential suitors are currently being examined by the Monopolies and Mergers Commission (MMC). This Perspective examines the background to the fight to control the production of half of Britain's sugar and looks in particular at its implications for the survival of Greenock's sole remaining cane refinery, Westburn.

INSTITUTIONAL CHANGES IN THE UK SUGAR MARKET

For over sixty years the refining of imported raw cane sugar has co-existed in Britain with the processing of domestically grown sugar beet, making the UK one of the few countries in the world heavily involved in both major aspects of sugar production. Since the 1920s farmers, mainly in southern and eastern England, have been encouraged to grow sugar beet in order to guarantee a minimum level of domestic sugar needs. In 1936 the eighteen beet factories then operating were merged into a single unit, the British Sugar Corporation (BSC), in which the Government took a minority shareholding. The cane refiners were forced to relinquish their interests in beet-sugar production and, conversely the beet sugar processors were not allowed to refine cane sugar.

Prior to our joining the EEC, the UK sugar industry of the post-war period was largely controlled by the 1956 Sugar Act. This aimed at enabling Government commitments to both Commonwealth suppliers of raw cane sugar and British beet farmers to be compatible with a competitive market for sugar itself. The commitment to cane sugar suppliers was enshrined in the 1951 Commonwealth Sugar Agreement (CSA), which guaranteed a market for some 1.74 long tons of raw sugar (equivalent to about 1.66 million tonnes white sugar) at a price set annually on the basis of being reasonably remunerative to efficient producers.

The importance of this arrangement to the Commonwealth producers was substantial. The world sugar market has for a long time taken three forms: consumption of domestic production, export under preferential Special Agreements, and non-preferential trade in a relatively small, residual world market. Price in this residual market has frequently moved as follows: several years of stability at a low level, a short very sharp increase brought about by supply problems such as bad harvests, followed by an equally dramatic fall as new capacity induced by the price increase adds its output to the normal output, now restored, of existing capacity. In a typical year the world market price is too low to cover average costs of even efficient producers. Exporting countries have thus relied on more generous preferential arrangements (known as Special Agreements), such as the CSA.

UK entry to the EEC in the early 1970s threatened to upset this arrangement. Continental Europe was the cradle for the world beet sugar industry, developed in the early nineteenth century. It was thus not surprising that the EEC in the 1960s developed a Sugar Regime which was based on beet sugar as the mainstay of its sugar needs. Imports would be largely eliminated through the setting of a Threshold Price at a level higher than domestic production costs whilst domestic output behind this shield would be restricted by means of multi-tiered

quotas.

The system was much more successful in controlling imports than domestic output. By 1971/72 there was an excess in EEC production over consumption of 1.7 million tonnes (a self sufficiency ratio of 127%). Britain's proposed entry was thus a tempting target for EEC producers of surplus sugar. Hard bargaining in 1971, however, managed to secure the partial retention of the existing market for Commonwealth suppliers of cane raws for a temporary period until mid-1975, the only loser being Australia whose quota was cut to zero.

This situation was put on a permanent footing at a series of negotiations during 1973 and 1974 which produced a Sugar Protocol, to the Lome Convention, to cover raw sugar imports from those African, Caribbean and Pacific (ACP) states associated with the EEC. The conflicting interests of the Continental beet sugar and Commonwealth cane sugar producers were temporarily blunted by dramatic events in late 1974 which saw the world market price soar fivefold. The familiar response followed as both cane and beet producers saw opportunities to expand; the EEC beet sugar quotas, for example, were raised all round. The scene was thus set for future trouble when the world moved back into sugar surplus, as in order to secure entry for their sugar into the EEC, the ACP countries agreed not to oppose the exporting of surplus EEC beet sugar to the world market.

THE EFFECT OF ENTRY TO THE EEC ON THE STRUCTURE OF THE UK SUGAR INDUSTRY

In 1973 annual cane refining capacity in the UK was over 2 million tonnes of sugar. By contrast BSC was restricted under the 1956 Sugar Act to around 650 thousand tonnes of refined sugar; the quality of raw beet sugar produced above this level was sent to the cane refiners for further processing. Beet yields had not, however, remained static: in the 1960s yields were roughly 25% higher than in the 1950s. Even without UK entry to the EEC, pressure to raise domestic beet sugar's share in total UK output was building up. EEC entry acted as the catalyst to bring this about; Britain was given an initial beet sugar quota of 990 thousand tonnes for 1974/75 based on its production in the early 1970s. At the same time raw cane sugar imports were cut by over 300 thousand tonnes (Australia's quota).

The potential for beet's share in UK sugar production doubled overnight from under 25% to almost 50%. Britain's beet sugar production quota for the mid-1970s of around 1.3 million tonnes encouraged BSC to embark on a five-year expansion programme designed to almost double refined sugar capacity to 1.25 million tonnes.

The cane refiners were hit not only in relation to quantity; the financial margin available to them for their refining operations was now determined within an EEC Sugar Regime which was not designed to deal with this method of sugar making. The production of refined beet sugar is essentially a one-stage operation so that there is no real basis, within the beet regime, for costing the processing of raw sugar into refined sugar. The margin allowed by the difference between the Community price for refined sugar and the price agreed with the ACP countries for their raw sugar was to prove far less adequate than the margin previously given to the cane refiners.

Structural changes in the UK sugar industry were inevitable. Their scale was, however, intensified by changes on the demand side. Throughout the 1960s and early 1970s annual total demand for UK sugar was close to 3 million tonnes: this included exports which accounted on average for around 10%. From 1975 onwards demand fell sharply; to 2.6 million tonnes on average between 1975 and 1978. Profitable export oportunities were reduced by the cut in the cane refining margin; whilst on the domestic front there was a two-pronged attack, induced largely by the dramatic price rise in 1974. Household buying for beverage sweetening declined sharply, no doubt supported also on health grounds, and industrial users switched part of their sweetener demand to alternatives such as glucose.

Calculations made in the mid-1970s suggested that a viable cane refining industry required capacity of less than 1.5 million tonnes. As a first step, Tate & Lyle (T&L) - with Government approval - acquired the only other cane refiner, Manbre & Garton, in late 1976. Two refineries were closed and another was

reduced substantially in size during 1977-79. Trends on the domestic demand side, however, continued their decline and did not bottom out till 1980 (at around 2.25 million tonnes). Given the very limited opportunity for refined cane sugar export and the build-up in domestic beet sugar production to close to 1.25 million tonnes, further cane refinery closures became unavoidale. Two more refineries shut down between late 1979 and 1981, reducing cane refining operations in Britain to two plants - the large Thames refinery (1 million tonnes capacity) and the much smaller Westburn refinery in Greenock (150 thousand tonnes).

RECENT DEVELOPMENTS IN THE SUGAR MARKET

Not surprisingly BSC's profitability increased considerably under the EEC beet sugar biased regime. In 1980 it became the subject of a takeover bid by S & W Berisford. Berisford saw in BSC a manufacturing business which could usefully complement their existing commodity trading interests (Thus spreading risks) but one which they felt they understood given their long experience as Britain's largest sugar merchant. Because of Berisford's distribituion role in the sale of both UK beet and cane sugar, the bid was referred to the MMC. Their report, published in march 1981, argued that "we find it hard to identify any way in which the proposed merger is likely to operate positively for the public benefit". Nevertheless, it concluded that provided Berisford ceased trading in T&L sugar products "the merger would have no effect on competition". In addition, it argued that, if Berisford were allowed to proceed with the takeover, BSC should be maintained as a separate subsidiary carrying on substantially as before in terms of its activities and published accounts. Berisford gave undertakings covering both these points and the takeover subsequently went ahead, with BSC renamed British Sugar (BS).

Despite the change in institutional arrangements which boosted UK beet sugar's market share close to 50% by 1980, the years since then have been frustrating ones for BS. When agreement was finally reached in early 1981 for the EEC production quota period 1981/82 to 1985/86, the outcome was relatively unfavourable and basically unfair to UK beet sugar. The UK total quota was cut by 182 thousand tonnes, reducing it to 1.14 million tonnes. This action was based on certain quantitative criteria relating to performance in the mid-1970s, before BSC had had time to implement its expansion programme and when beet yields in the UK were well below average for abnormal climatic reasons. BSC reacted by closing four of its seventeen factories (though, given its modernisation programme, retention of all its factories probably would have required an increase in quota).

The cutback in EEC beet sugar quotas from a global viewpoint was very reasonable, though far from adequate. Reducing the UK quota relatively harshly was far less defensible; unit production costs in the UK are arguably lower than in most other EEC countries, despite lower beet yields, since beet factories in the UK operate on average for 120 days per annum compared with around 90 days elsewhere in the EEC. Although no directly comparable figures are published relating to costs, the capital-intensive nature of the process would suggest that within the EEC the UK is a relatively low-cost producer.

In 1985, as the time drew closer for fixing EEC quotas for the next production period, BS and T&L engaged in a propaganda battle. To date in the 1980s, UK sugar usage has stabilised at around 2.25 million tonnes. There are indeed signs that it may be on the increase, thanks to the very recent introduction of a price support scheme which effectively reduces the cost of sugar for use by biotechnological and chemical industries.

BS made this part of their case for an increase in quota of some 300 thousand tonnes, pointing in addition to their healthier production position compared with the mid-1970s. T&L took a much more cautious stance on potential new demand, arguing against any increase in beet quotas and presenting themselves as champions of the ACP countries whose abilities to export raw cane sugar to the EEC could be affected if either UK cane refinery closed.

At the end of last year the EEC decided to defer the decision on changes in quotas, and the 1985/86 quotas were continued for two more years. T&L have not, however, been content to wait on outside events. Their Group expansion programme has included sustained research into

alternative sweeteners, expansion of cane sugar interests in North America, and as recently as March 1985 re-entry after fifty years into sugar beet processing when a subsidiary, Western Sugar Co, was formed in the US Mid-West to run six beet factories.

THE CURRENT FIGHT FOR BRITISH SUGAR

BS's parent company, Berisford,ran into difficulties of its own in 1985, partly due to the collapse in the world tin market. Cash flow problems lowered Berisford's share price and it has subsequently attracted potential buyers. The takeover battle that has developed this year has proceeded as follows:

February/March The Italian multinational Ferruzzi bought 9% of Berisford shares and announced that its particular aim was to acquire BS; the rest of Berisford's interests would be offered back to the Berisford management. Exploratory talks with other interested parties such as the National Farmers Union produced a poor reception for Ferruzzi's proposals and the bid was dropped.

April The UK food and furnishing manufacturer Hillsdown Holdings (HH) bought a 14.7% stake in Berisford and announced an all-paper deal of 9 shares for 11 Berisford (worth around £430 million). Again the intention was to hold on principally to BS, but also the rest of Berisford's food interests, and to sell back the remaining interests. T & L were forced to respond and on 30 April made a part cash/part shares bid for Berisford, valued at £478 million.

May The original MMC report of February 1981 has argued that if any changes were proposed which would fundamentally affect the existing market arrangements "it would be desirable for any possible monopoly situation to be considered with a view to the establishment of any necessary safeguards in the interests of users of sugar". It was clear that T&L's bid if successful would create a strong monopoly situation: T&L would control almost 95% of the UK market if it acquired BS. On 20 May the Office of Fair Trading announced that both bids were to be referred to the MMC. It would appear to have accepted that the HH bid implied the sort of change in the existing market structure which the MMC in 1981 argued ought to be investigated. On 29 May HH withdrew its bid and subsequently sold its shares in Berisford to Ferruzzi, whose stake rose to 23.7%.

June/July On 26 June Ferruzzi requested that its shareholding in Berisford also be referred to the MMC, and a week later the implicit bid was indeed referred. It is expected that the enquiry will take at least six months, making it quite likely that the outcome will not be known before 1987.

IMPLICATIONS FOR GREENOCK

What are the implications of this takeover battle for the future of UK cane refining and in particular for Westburn?

Status quo

It is quite possible that the MMC will recommend that neither bid be allowed to proceed. Berisford have in the meantime managed to improve their financial position and seem quite happy now to continue to operate BS.

This effectively leaves Greenock in its present vulnerable position. There seems to be no doubt that Westburn is a marginal plant, given its small share in total UK cane refining, sustained by its locational advantage in supplying Scottish consumers. It is unlikely that the small price differential this allows is sufficient to cover its higher unit production costs and in the present circumstances the threat of closure (even if not specifically expressed by T&L) hangs over it.

A more rational attitude by the EEC to sugar production, bearing in mind its commitment to the ACP countries, would relieve this threat at least in the short- to medium-term (the next production quota period). However, politics and sugar are closely linked and, as will be argued below, the ACP commitment may in the future be maintained in a different way.

Tate & Lyle takeover

It might appear that the 95% control T&L would have of the UK sugar market would make it very difficult for the MMC to recommend their bid. However, even with this share, T&L's power to set sugar prices would be limited, given the sizeable surplus production available in France. Indeed the MMC in its 1981 report specifically argued that such a surplus was a "most important factor limiting the price of sugar in Great Britain".

In early June, plans for a major reorganisation through merger of the West German sugar industry were announced. Further rationalisation of European sugar seems hard to stop.

If T&L are permitted to takeover BS this greatly increases their flexibility in respect of operating options. In 1985 T&L pre-tax profit per tonne on UK sugar refining was approximately £11 whilst BS earned around £50 per tonne. T&L's latest half-yearly accounts, published at the end of April, show that profit this year on UK cane refining has almost disappeared, as price competition between the two rivals stepped up. In these circumstances it seems quite possible that T&L might decided that part of a rationalisation programme should include shutting Westburn.

Although this would cause problems initially for the EEC's ACP commitment, there are alternative possibilities for the refining of the ACP cane raws. It is interesting the T&L have recently bought into two cane refineries in Portugal, since Portugal's accession to the EEC introduces a new sugar deficit country which has traditionally refined imported raw cane sugar. Another option would be the processing of cane raws in beet factories in part of their lengthy off-season.

Ferruzzi takeover

Feruzzi already control much of beet sugar refining in Italy and the largest sugar company, Beghin-Say, in France, giving it 18% of the EEC market. It is reputedly interested in sugar acquisitions in West Germany and Spain. The vital question for Westburn is how aggressively Ferruzzi would compete against T&L. Although price competition between BS and T&L has been keen, it does not appear that BS has used its relatively greater power post-EEC entry to launch a sustained attack on T&L's UK cane refining operations. In recent years of above-average beet yields, BS has exported its extra output so as not to upset the UK market balance. It would seem less likely that Ferruzzi would be so generous.

Sugar is, however, a commodity whose production worldwide is subject to political interference, and it is difficult to see control of BS being allowed to pass onto foreign hands.

It is very open at this stage whether the MMC will recommend that T&L's bid go ahead or instead block both bids. In either event the future for Westburn seems bleak unless the EEC were to take the unlikely step of increasing its aid to Third World countries via a rise in the ACP quotas. Developments in alternative sweeteners seem very likely in the 1990s to reduce sugar's share of the market. Even before this happens, it would not take more than a further small reduction in the cane refining margin to force T&L to cut its losses in what was once its main operation.

REFERENCE

HMSO (1981) "S & W Berisford Limited and British Sugar Corporation Limited: A Report on the Proposed Merger" (HC241)