2 Conclusions

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Introduction

2.1. Interbrew[1] has acquired the brewing interests of Bass, known as Bass Brewers (see paragraph 2.11), and the Competition Commission (the CC) has been asked to investigate and report on whether the merger operates, or may be expected to operate, against the public interest. We are required to report to the Secretary of State by 6 December 2000.

2.2. On 6 July 2000 the European Commission was notified of a proposed concentration within the meaning of the European Community Merger Regulation (the ECMR[2]), by which Interbrew would acquire control of the brewing interests of Bass in the UK and the Czech Republic. Following a request from the UK Government, on 22 August 2000 the European Commission referred to the competent UK competition authorities that part of the merger which relates to the supply of beer in the UK. It also decided not to oppose the merger in as far as it relates to markets other than those in the UK beer sector. On 7 September 2000 the Secretary of State, acting on the advice of the Director General of Fair Trading (DGFT), referred the merger to the CC under the merger provisions of the Fair Trading Act 1973 (the FTA). The published version of the DGFT's advice appears as Appendix 2.1.

2.3. Our terms of reference (reproduced in Appendix 1.1) confine our consideration of the public interest effects of the merger to the production and supply of beer in the UK. Furthermore, Article 9(8) of the ECMR states that, where a case has been referred to the competent authorities of a member state with a view to the application of that state's national competition laws, the member state may take only the measures strictly necessary to safeguard or restore effective competition in the market concerned. As a consequence, our consideration as to whether any qualifying merger situation operates, or may be expected to operate, against the public interest under the FTA is confined to competition issues.

Establishing jurisdiction

2.4. In determining whether a qualifying merger situation has been created, we must establish whether enterprises carried on by or under the control of Interbrew have, within four months preceding the date of the reference to us, ceased to be distinct from enterprises carried on by or under the control of Bass. Interbrew announced on 14 June 2000 that it had reached

[1]In this chapter Interbrew refers to both Interbrew SA and to its subsidiary, Interbrew UK Limited.
[2]4064/89/EEC.

agreement with Bass to purchase its brewing activities in the UK and the Czech Republic, subject to regulatory approval (see paragraph 3.8). The terms of the agreement allowed for completion of the merger should it be referred to the UK under the ECMR. On 22 August 2000 Interbrew announced that the transaction had become unconditional (see paragraph 3.9). We are satisfied, therefore, that enterprises carried on by or under the control of Interbrew have, within four months preceding the date of the reference, ceased to be distinct from enterprises carried on by or under the control of Bass.

2.5. Our terms of reference require us to exclude from consideration one of paragraphs *(a)* and *(b)* of section 64(1) of the FTA, if we find the other satisfied. Paragraph *(a)* is the share of supply test and paragraph *(b)* the assets test. Broadly speaking, the share of supply test is met if, as a result of the merger, the combined enterprise accounts for at least 25 per cent of the supply or acquisition of particular goods or services, either in the UK as a whole or in a substantial part of it. If this was already the case before the merger, the test will be met if the market share is enhanced by the merger. The assets test is satisfied if the gross value of worldwide assets taken over exceeds £70 million. As the combined gross assets of Bass Brewers in Great Britain alone amount to just under £1 billion (see Appendix 3.7), we are satisfied that the assets test is met.

Interbrew

2.6. Interbrew is a quoted Belgian company that was formed in 1987 by the merger of two predominantly Belgian brewers, Artois and Piedboeuf. Interbrew has extensive worldwide interests in brewing. Over the last ten years it has acquired breweries in a number of Central and Eastern European countries, as well as in China and Korea. In 1995 Interbrew acquired the Canadian brewer John Labatt Limited (Labatt), which doubled the size of the company and made it the fourth largest brewer in the world. See paragraph 3.11.

2.7. Interbrew's major international brands are Stella Artois, Labatt Blue and Rolling Rock, but it also has a wide range of national brands and speciality beers. Interbrew styles itself as 'The World's Local Brewer' and has a stated policy of preserving and developing local brands, which it considers distinguishes it from other large international brewers. See paragraph 3.12.

2.8. In May 2000 Interbrew acquired the brewing business of Whitbread PLC (Whitbread), known as WBC.[1] A description of WBC is given in paragraphs 2.16 to 2.19. The subsequent acquisition of Bass Brewers made Interbrew the second largest brewer in the world (with an annual sales volume of around [✂] million hectolitres) behind Anheuser-Busch Inc (Anheuser-Busch), which sold 103 million hectolitres of wholly-owned brands in 1999. See paragraph 3.13.

2.9. Prior to its acquisitions of WBC and Bass Brewers, Interbrew's involvement in the UK beer market had primarily been through a licence agreement with Whitbread to brew and distribute Stella Artois in the UK. With the acquisition of Labatt in 1995, Interbrew acquired two subsidiaries in the UK, supplying Labatt's bottled beer and running a small estate of around 500 pubs. These businesses were sold to Whitbread and Enterprise Inns plc (Enterprise) respectively in the following year. See paragraph 3.20.

2.10. In addition to licensing Stella Artois to Whitbread, Interbrew imported a small amount of Leffe, Hoegaarden and own-label beer into the UK. In 1997 Interbrew granted a licence to Shepherd Neame Ltd (Shepherd Neame) to brew its Oranjeboom brand in the UK. See paragraph 3.21.

[1]In this report we generally refer to WBC when we are discussing the pre-merger situation and to Interbrew when we are discussing the post-merger situation.

Bass Brewers

2.11. Bass Brewers principally comprises Bass's UK brewing operations (Bass Holdings Limited), the assets of Bass Beers Worldwide, which exports beer and other alcoholic drinks from the UK, and an approximately 80 per cent shareholding in Prague Breweries, which owns three breweries in the Czech Republic. Bass retained its estate of managed pubs, which trade as Bass Leisure Retail (BLR). See paragraph 3.38.

2.12. Bass Brewers owns six breweries in the UK and it has an annual sales volume of around [✂] million hectolitres, including export sales from the UK and sales by its subsidiary in the Czech Republic. At the time of the merger it was the UK's second largest brewer, after Scottish Courage Ltd, which is part of S&N.[1] See paragraph 3.39.

2.13. Bass Brewers brews around 49 different beer brands in the UK. Its main brands are Carling, Tennent's Lager, Grolsch (all lagers), Caffrey's and Worthington (both ales). Grolsch is brewed by Bass Brewers and marketed and distributed in the UK by a joint venture between Bass Brewers and Royal Grolsch NV, the owner of the brand, under the terms of a licence agreement. The other main brands are owned by Bass Brewers. See paragraphs 3.39 to 3.41.

2.14. Bass Brewers also makes and sells a range of flavoured alcoholic beverages (FABs). These do not fall within our terms of reference, which confine our consideration of the public interest effects of the merger to the production and supply of beer in the UK. See paragraphs 2.3 and 3.41.

2.15. Products that are wholesaled by Bass Brewers,[2] including beers that it purchases from competing brewers and wholesales on its own behalf (known as factored beers), are distributed by Tradeteam Ltd (Tradeteam). Tradeteam is a joint venture between Bass Brewers, which owns 49.9 per cent, and Exel plc (Exel), a distribution logistics company, which owns 50.1 per cent. Interbrew also acquired the Bass Brewers' shareholding in Tradeteam. See paragraphs 3.43 to 3.50.

WBC

2.16. At the time of its acquisition by Interbrew in May 2000, WBC was the UK's third largest brewer, with three breweries and an annual sales volume of around [✂] million hectolitres. Whitbread retained its pub estate, but has subsequently put it up for sale during the course of our inquiry. See paragraphs 3.13 and 3.23.

2.17. Prior to its acquisition by Interbrew, WBC's principal brands were Stella Artois, brewed under licence from Interbrew (see paragraph 2.9), Heineken, Boddingtons and Murphy's. Heineken was brewed under licence from Heineken Brouwerijen BV, which is a subsidiary of Heineken NV, and Murphy's was brewed under licence from Murphy Irish Brewery Ltd (MIBL), which is also owned by Heineken NV. At the same time as the acquisition of WBC by Interbrew, Whitbread entered into a transitional agreement with Interbrew to leaseback the Salmesbury brewery, which brews Heineken and Murphy's. [*Details omitted. See note on page iv.*] Whitbread also has the right to supply these products to third parties. [*Details omitted. See note on page iv.*] The purpose of these arrangements was to allow Whitbread to exit from brewing, whilst at the same time honouring the terms of Whitbread's licences with HBV and MIBL until the licences expired or were terminated. HBV subsequently gave notice to terminate the Heineken licence in

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[1]In this chapter S&N refers to both the brewing interests (Scottish Courage Ltd) and the retail interests.

[2]Some Bass Brewers products are purchased and wholesaled by other brewers and by independent wholesalers. In addition, some retailers arrange their own wholesaling and distribution.

[✄] and Whitbread gave notice to terminate the Murphy's licence in [✄]. See paragraphs 3.27 to 3.29.

2.18. In addition to the brands referred to above, WBC brews a number of its own ale brands. It also has a distribution agreement with Wadworth & Co Ltd, a regional brewer, to distribute a cask conditioned traditional ale. See paragraph 3.25.

2.19. WBC distributes its own beers, factored beers and beverages supplied by third parties, but its coverage is not fully national. In parts of the country where it is not cost effective to have its own network of depots and vehicles, WBC has negotiated access to the distribution networks of other brewers. See paragraph 3.31.

The merger

2.20. For some years Bass had been pursuing a strategy of building leading market positions in hotels, restaurants and pubs and branded drinks, by focusing on strong brands and higher-growth sectors. To this end, in the last three years, Bass has acquired the Inter-Continental hotel business and disposed of four gaming businesses in the UK and just under 2,000 pubs. See paragraph 3.2.

2.21. Whilst Bass perceived that it had a strong position in brewing in the UK, it saw little scope for growth strategies that would add significant value to its brewing business, other than domestic consolidation where regulatory approval remained a significant risk. Bass had previously attempted a merger with Carlsberg-Tetley PLC (Carlsberg-Tetley) in 1997, which had been blocked by the Secretary of State following an inquiry and report (the 1997 report)[1] by the Monopolies and Mergers Commission (MMC). Accordingly, Bass decided to explore the possibility of achieving a sale of its brewing interests in the UK and the Czech Republic, with a view to enhancing shareholder value and focusing on its hotel and leisure interests. See paragraph 3.3.

2.22. Bass also perceived that there could be advantages in separating its brewing business from its pubs and hotels (ie breaking the vertical integration of the two businesses). Amongst other things, it might mean that a merger of Bass's brewing interests with another UK brewer would be viewed more favourably by the regulatory authorities, which would allow the creation of synergy benefits at the brewing level and enable Bass to realize a higher price for the brewing business. After a transitional period it could also allow Bass's pub business greater freedom as regards the purchasing of beer. See paragraph 3.4.

2.23. With the acquisition of Bass Brewers, Interbrew is now the largest brewer in Great Britain. Interbrew's overall market share has increased from just over 15 per cent to between 33 and 38 per cent, depending on the treatment of the Heineken and Murphy brands (see paragraph 2.17), while its share in particular segments of the market (for example, premium lager) is even greater. The number of breweries Interbrew owns in the UK has increased from three to nine and its annual sales volume of beer has increased from [✄] million hectolitres to around [✄] million hectolitres. Interbrew's brand portfolio now includes the number one selling lager brand in the UK (Carling), the number four lager (Stella Artois), the number five lager (Tennent's Lager), the number three ale (Worthington) and the number five ale (Stones). Interbrew controls the wholesaling and distribution operations of Bass Brewers and WBC, increasing its market share from just over 9 per cent to approximately 32 per cent. Finally, Interbrew has [✄]-year supply agreements with the retained estates of Bass and Whitbread (see paragraphs 3.8 and 3.30).

[1] *Bass PLC, Carlsberg A/S and Carlsberg-Tetley PLC: a report on the merger situation,* The Stationery Office, Cm 3662, June 1997.

Market definition

2.24. There are three main levels of activity in the vertical supply chain in the beer industry (see paragraphs 4.12 and 4.21):

(a) the supply of beer by brewers;[1]

(b) wholesaling and distribution; and

(c) the supply of beer by retailers.

2.25. A number of interested parties have suggested that the product market might be segmented both by type of beer—ale, lager and stout—and between the 'standard' and 'premium' categories (see paragraph 4.23). This may be true, but we think that identifying such segments, and trying to ascertain how independent they are from each other, is likely to have little effect on our assessment of the public interest. As shown in Tables 4.4 and 4.9, market shares after the merger are broadly similar (with the exception of the stout segment) whether one considers the market to be defined narrowly or broadly.

2.26. As regards the geographical market, the two parties to the merger are involved in the supply of beer as brewers and in wholesaling and distribution services throughout Great Britain and across all product segments (with the partial exception of stout). In assessing the effects of the merger we have considered primarily market shares for the whole of Great Britain and for all beer. However, we have also considered regional and segmental market shares (see Table 4.11). We have excluded Northern Ireland from consideration since we see it is a separate market from Great Britain, on which the merger has no effect (Interbrew currently has negligible sales in Northern Ireland, see paragraph 4.27). Our subsequent findings on the public interest (see paragraph 2.191) apply only to Great Britain.

2.27. We are satisfied that a distinction should be drawn at the wholesale and distribution level between on-trade sales (pubs, hotels and clubs) and off-trade sales (shops). The distinction arises from differences both in packaging (which affects production as well as distribution) and also in distribution requirements. Draught beer accounts for over 90 per cent of on-trade sales and it is distributed by a small number of companies with specialist expertise. By contrast, off-trade sales are mainly of packaged beers and distribution is carried out either by the multiple retailers (or their contractors) or by independent wholesalers and cash-and-carry operators. There are obvious differences between on-trade and off-trade at the retail level. See paragraphs 4.24 and 4.38.

The beer market

2.28. In this section we consider trends in the demand for beer, barriers to entry and expansion, and market shares after the merger.

Demand for beer

2.29. The merger has occurred in the context of a continuing decline in consumption of beer (see Figure 4.1) and the indications are that demand will remain stable at best, or decline slightly in the near future (see paragraph 4.2). Within the overall trend, consumption of lager

[1]We define brewing to include packaging (in kegs, casks, bottles or cans) and marketing of the beer as well as the actual brewing operation itself (see paragraph 4.13).

has continued to expand at the expense of ale (see Figure 4.1) and off-trade sales have continued to expand at the expense of the on-trade (see Figure 4.2).

2.30. In terms of consumer demand, studies have shown that the demand for beer is price inelastic (the long-run price elasticity of demand has been estimated to lie between –0.5 and –0.75).[1] While the brand of beer is an important influence on most consumers' choice of drink, the brand and type of beer offered is not the most important reason for choosing which retail outlet to visit. Price does not seem to be a major determinant of either choice. See paragraphs 4.7, 4.8, 4.9 and 4.22, and Tables 4.1 and 4.2.

2.31. Over the last ten years, and particularly in the last four years, the top ten beer brands have increased their share of total beer sales (see Table 4.3). The main reasons for this include (see paragraph 4.11):

(a) the reduction in the number of pubs owned and/or managed by brewers, which has increased the number of pubs that can sell the most popular brands and prompted a shift in brewers' focus towards brand development and marketing;

(b) the recent decline in sales of cask-conditioned beer, where brands tend to be regional or local rather than national, in favour of lager, which tends to be nationally branded; and

(c) consolidation among brewers and subsequent increased emphasis by some brewers on one ale brand.

2.32. Following the merger, Interbrew would control four of the top ten brands and, between them, Interbrew and S&N would control six of the top ten, if we regard Heineken as part of the Interbrew portfolio. Without Heineken, Interbrew would control three of the top ten brands and between them Interbrew and S&N would control five of the top ten. Carlsberg-Tetley has two of the top ten brands and Anheuser-Busch and Guinness each has one. See Table 4.3.

2.33. Looking at the various market segments and the market shares of the three leading brands (two in the case of stout) within each segment (see Table 4.4) the following post-merger picture emerges:

(a) *Standard lager:* Carling (Interbrew) has a market share of 27.6 per cent, Fosters (S&N) has 21.1 per cent and Carlsberg (Carlsberg-Tetley) has 10.5 per cent.

(b) *Premium lager:* Stella Artois (Interbrew) has a market share of 25 per cent, Budweiser (Anheuser-Busch) has 12 per cent and Kronenbourg (S&N) has 9.5 per cent.

(c) *Standard ale:* John Smiths (S&N) has a market share of 16.5 per cent, Tetley (Carlsberg-Tetley) has 9.4 per cent and Worthington (Interbrew) has 8.5 per cent.

(d) *Premium ale:* Caffrey's (Interbrew) has a market share of 16.1 per cent, draught Bass (Interbrew) has 8.9 per cent and McEwan's Export (S&N) has 8.8 per cent.

(e) *Stout:* this segment is dominated by Guinness, which has a market share of 86 per cent. Murphy's (Interbrew) has a market share of 9.6 per cent and Beamish Black (S&N) has 1.3 per cent.

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[1]Chambers, M J (1999), *Consumers' demand and excise duty receipts equations for alcohol, tobacco, petrol and DERV*, GES Working Paper no 138 and Tanner, S (1999), 'Alcohol taxes, tax revenues and the Single European Market', *Fiscal Studies*, 20:3.

Barriers to entry and expansion

In brewing

2.34. A potential entrant to brewing requires production facilities, an ability to market the beer and access to retailers (including distribution). The technology of brewing is well established and small-scale entry into production is relatively easy. It is also possible to enter the UK market by importing from abroad. However, small-scale UK producers are at a cost disadvantage as brewing and packaging are subject to economies of scale, while importers also tend to be at a cost disadvantage due to the extra transport costs. Another possibility for an entrant would be to concentrate on marketing the beer and contract out production either to a specialist contract producer or to a regional brewer. See paragraph 4.31.

2.35. Construction of a new efficient-scale brewery would involve large sunk costs, which tend to represent a barrier to entry. However, the need for an entrant to incur sunk costs is much reduced if a brewery can be purchased, second hand, from an existing producer (albeit any such brewery would be likely to have above-average costs). Although a large number of breweries have been closed over the last ten years, there is still some excess capacity among regional brewers which might be purchased by a hypothetical entrant. See paragraph 4.32 and Table 4.5.

2.36. Turning to marketing, a very small-scale entrant might rely on word of mouth while a small-scale importer might utilize its overseas reputation or may develop awareness through ‘niche’ strategies. However, an entrant attempting to penetrate into the market on a significant scale would have to develop at least one brand. This requires expenditure on advertising and promotion, which represents a sunk cost that can not be recovered if entry generates strong price competition and the entrant subsequently wishes to exit. Figure 4.5 shows that there has been some tendency for advertising expenditure to increase over time. See paragraph 4.33.

2.37. In addition to being sunk costs, other features of marketing expenditure may add to the difficulties faced by entrants. First, it takes time to build a brand’s image and market share. Interbrew told us that it could take up to 20 years to establish a leading brand, although, it said, an appreciable market share could be achieved in a relatively short period of time by an innovative brand. In addition, in our view, to maintain that market share it would need to continue to advertise, perhaps heavily. Second, unit costs have a tendency to decline with sales volume. See paragraph 4.34.

2.38. The need for expenditure on marketing for a UK brewer is reduced where an overseas brand owner shares in the advertising costs or it terminates the licence of the UK brewer and itself markets its own brand (in these circumstances, the brand owner benefits from the UK brewer’s previous marketing expenditure). Such entrants included Anheuser-Busch in 1995 and Holsten in 1999. With the exception of Heineken, the importance of brands brewed in Great Britain under licence is now limited as, consequently, are future entry opportunities by the overseas owners of these brands. See paragraph 4.35.

2.39. While entering with a look-alike brand that competes directly with existing brands of existing suppliers appears unattractive, new products may offer an opportunity to entrants. With new products, the problem of competing against existing suppliers who have already incurred the sunk costs of advertising and promotional expenditure does not exist to the same extent. Hence entry is likely to be easier in markets where new products are introduced frequently, ie where tastes and technology change rapidly. However, this does not seem to be the case in the British beer market. Table 4.3 shows that seven of the 1999 top ten brands in 1999 appeared in the 1989 top ten and the other three (Stella Artois, John Smiths, Budweiser) were all available in 1989. Furthermore, much of the recent new product development has occurred outside the beer market (for example, FABs). See paragraph 4.36.

2.40. Taking these factors into account, we believe that the need to invest in advertising and promotional expenditure represents an important barrier to entry into beer brewing.

2.41. A new entrant also requires access to retailers. There appears to be no difficulty in obtaining access to retailers in the off-trade, which is carried out either by multiple retailers themselves (or their contractors) or by independent wholesalers and cash-and-carry operators. We therefore concentrate on the on-trade, where potential barriers include vertical integration between brewers and retailers and brewers' control of distribution. See paragraph 4.38.

2.42. Up to 1990, a majority of pubs were owned by integrated brewer/retailers. In the 1997 report on the proposed merger of Bass and Carlsberg-Tetley the MMC stated that the 'market positions of the three national brewers [Bass, S&N and Whitbread] continue to be bolstered by their tied estates, which provide valuable secured outlets for part of their production'. Following the Beer Orders (see Appendix 3.8), the extent of integration has fallen especially among national brewers. The present merger has removed the link between Bass Brewers and BLR and thus contributed to the reduction in vertical integration and, in this respect, to a reduction in entry barriers. See paragraph 4.39 and Table 4.7.

2.43. Most larger on-trade retailers, including pub companies (pubcos), purchase beer from one or more suppliers on three- to five-year non-exclusive contracts, often with minimum purchase obligations (or other terms which encourage a high volume of purchases from the contracted supplier). Interbrew has [✂] contract with Whitbread and Bass Brewers has a [✂]-year contract with BLR, albeit with declining volumes. The terms of such contracts may make it difficult to gain large sales with a retailer except when contracts are renewed or renegotiated. However, different retailers' contracts expire at different times and we received evidence that contracts were sometimes renegotiated within term as well. Consequently, potential entrants and expanding firms may be expected to have a succession of opportunities with different retailers. Certainly, supply contracts are less of a barrier than full integration between brewer and retailer. See paragraph 4.40*(a)*.

2.44. A significant but declining number of smaller on-trade retailers receive loans from brewers at favourable rates in exchange for minimum purchase obligations. Under the Beer Orders such loans must be repayable within three months freeing the retailer of purchase obligations. In the light of this, we think it doubtful that such loans in themselves now act as a significant barrier to entry. See paragraph 4.40*(b)*.

2.45. To access the on-trade, an entrant's beer has to be delivered to the point of sale. Some of the larger on-trade retailers have separate supply and distribution contracts, with all the beer that they have purchased being delivered to regional depots for onwards transport to the retail outlets. Distribution to the outlets of these retailers is similar to that to off-trade outlets, and presents no particular problem for new entrants (although all such contracts have been awarded to companies associated with the large brewers). In order to obtain distribution to other on-trade retail outlets, an entrant would have the choice between arranging its own distribution, using independent wholesalers and selling to existing brewers, which also act as wholesalers. See paragraphs 4.41 and 4.42.

2.46. Because distribution costs fall sharply with drop size (see Appendix 4.2), it would tend to be cost effective for an entrant to arrange its own distribution (on a contracted out basis) only if each outlet takes a reasonably large quantity of beer, which would require that entrant to sell a wide range of brands. However, given that each new brand will incur possibly substantial and sunk marketing costs, entrants are most likely to enter with a narrow brand range. See paragraph 4.42*(a)*.

2.47. Independent wholesalers in theory offer an alternative to the high costs of setting up an own distribution system. However, they have a small share of distribution and appear to be weak competitors in the sale of beer to pubs and high beer volume clubs because of their small

scale of operations and consequently higher distribution costs. Some wholesalers told us that they were supplied with leading brands on unfavourable terms, in particular by Bass Brewers and S&N. See Table 4.12 and paragraph 4.62.

2.48. The existing brewers do wholesale third parties' beers but have little incentive to promote sales of products that compete directly with their own.[1] Carlsberg-Tetley told us that the large brewers did not regard the wholesaling of third party beers as a business activity in its own right, and that brewers only wholesaled third party beers in order to make up for gaps in their own portfolios. S&N similarly said that, when making sales to retailers, brewer/wholesalers tended to focus on their own brands. Table 4.8 shows that the large brewers' sales are primarily of their own brands. See paragraph 4.42*(c)*.

2.49. In our view, access to on-trade distribution continues to act as a barrier to entry and expansion in brewing, especially of draught products (packaged products can be distributed with other drinks and food products). Nevertheless, the development of retailer contracting in the on-trade, together with the expansion of the off-trade at the expense of the on-trade, suggest that distribution may be of gradually declining importance as a barrier to entry into brewing. See paragraph 4.43.

In distribution

2.50. The distribution of draught beer appears to involve some elements of special expertise. Further, distribution is characterized by economies of drop size and, to a lesser extent, of density (see Appendix 4.2). Economies of density imply that entry would need to be on a fairly large scale to be cost competitive with existing suppliers. Moreover, to compete on a national basis, a nationwide distribution system is required. However, most of the assets involved in distribution (depots and vehicles) have value in alternative uses and consequently sunk costs appear low. See paragraph 4.49.

2.51. It seems to us that the most likely entrants into distribution would be large logistics companies or retailers setting up their own distribution operations.

2.52. Although large logistics companies lack specific expertise, we regard them as plausible entrants into on-trade beer distribution. Exel is already involved via its majority shareholding in Tradeteam. We were told that Wincanton Distribution Services Ltd (Wincanton) had for a time provided distribution services to Greenalls Group Plc (prior to the sale of its pubs to S&N) and that Wincanton and at least one other company had bid (unsuccessfully) for retailer distribution contracts in competition with the established distributors. See paragraph 4.50.

2.53. A large retailer told us that it had considered the cost of establishing and operating its own distribution network. It estimated the initial capital cost at £9.50 per hectolitre, of which £6.00 would be start-up and warehousing costs which it considered to be irrecoverable sunk costs. Such a retailer would not necessarily need to purchase distribution assets to avoid reliance on existing brewers for distribution; it could contract with a logistics firm. The retailer also told us that the operating costs of its hypothetical distribution business would be higher than those of the existing brewers due to lower volumes. See paragraph 4.51.

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[1]As brewing is subject to economies of scale, price tends to exceed marginal cost even under conditions of strong competition. If a brewer sells a third party beer than its own, it loses the difference between price and marginal cost.

Market shares

In brewing

2.54. Prior to the acquisitions of WBC and Bass Brewers, the four leading brewers, in terms of market share, were S&N (26.0 per cent), Bass Brewers (23.4 per cent), WBC (14.5 per cent) and Carlsberg-Tetley (11.8 per cent). Between 1996 and 1999 both Carlsberg-Tetley (down 3 per cent) and S&N (down 2 per cent) lost market share. By contrast, both Bass Brewers and WBC gained approximately 1 per cent market share. See Table 4.9 and paragraph 4.54.

2.55. In assessing post-merger market shares, we have taken into account the contractual position regarding the Heineken-owned brands (see paragraph 2.17). Until the contract between Heineken and Whitbread is terminated, Whitbread is responsible for marketing the Heineken brands but the profit from sale of the Heineken brands accrues to Interbrew. Notice has been given that will formally bring to an end the two licences in [✄] and [✄]. See paragraphs 3.28 and 3.29.

2.56. The Heineken brands will continue to benefit from their current awareness with consumers and previous marketing and there seems to be no reason why they should not maintain their current market share in the off-trade (which accounts for [✄] per cent of the Heineken brands' sales). In the on-trade, however, Interbrew would be well placed to try to encourage retailers to replace the Heineken brands with alternative brands. Future market shares are speculative, but as a guide to what would happen after the termination of the contracts, assuming other factors remain constant, we consider it appropriate to assess the merger on the basis of a notional post-merger market share for Interbrew in between that including and that excluding the Heineken brands. On this basis, Interbrew would have a post-merger market share of 33 to 38 per cent. Whether the precise market share is 33 per cent, 38 per cent, or somewhere between the two, makes no difference to our conclusion. See paragraph 4.56 and Table 4.9.

2.57. Together with Guinness, which has a market share of 5.6 per cent, and Anheuser-Busch, which has a market share of 3.2 per cent (both heavily concentrated on single brands), the four largest brewers are responsible for all the leading brands (see paragraph 4.55).

2.58. The Wolverhampton & Dudley Breweries PLC (Wolverhampton & Dudley), an integrated brewer/retailer based in the West Midlands, has a market share of 3.1 per cent. It brews mainly ale and a small amount of lager and, reflecting the importance of its retailing activities, its on-trade market share is considerably greater than its off-trade share. See paragraph 4.55*(a)*.

2.59. Greene King plc (Greene King), an integrated brewer/retailer based in East Anglia, has a market share of 0.9 per cent. It brews only ale and, like Wolverhampton & Dudley, its on-trade share is considerably greater than its off-trade share. See paragraph 4.55*(b)*.

2.60. There are a number of other smaller traditional integrated brewer/retailers such as Young & Co's Brewery Plc (Young's), Fuller Smith & Turner Plc (Fullers) and Shepherd Neame, each of which has a very small market share. They tend to brew only ale and are stronger in the on-trade than in the off-trade because of their tied estates. See paragraph 4.55*(c)*.

2.61. Other sources of competition include branded imports (other than those marketed in Great Britain by companies already mentioned), which are almost all sold in packaged rather than draught form; imports and contract production for retailers' own-label brands, predominantly in the off-trade; and microbrewers, brewing very small quantities of specialist products. See paragraph 4.55*(d)* to *(f)*.

2.62. Table 4.11, which sets out the market shares of Interbrew and Bass Brewers and Herfindahl-Hirschmann Indices (HHIs) by product segment and region, shows that the product and, to a lesser extent, regional strengths of the two companies tend to be complementary. There is no product segment where both companies have market shares above the average for Great Britain and the only region where this is true is the Harlech and Westwood television region of Wales and the West country. See paragraph 4.59.

2.63. Following the merger, Interbrew's market shares (excluding the Heineken brands) by segment[1] would range from 29.6 per cent in premium ale to 37.2 per cent in premium lager. Including the Heineken brands, Interbrew's market shares by segment range from 29.6 per cent in premium ale to 46.8 per cent in premium lager. Whereas the overall post-merger HHI would be about 2,000 (excluding the Heineken brands) or 2,300 (including the Heineken brands), an increase of 400 to 700, the weighted average of the increases in HHI at segmental or regional level would be slightly less than the increase for the total beer market.[2] See Table 4.11.

2.64. As part of our survey of on-trade retailers (see Appendix 4.4), we asked respondents to name the three closest alternatives to seven leading brands of Interbrew and Bass Brewers. In six out of seven cases, an S&N brand was the most popular alternative. This also suggests that the product ranges of the two companies are complementary, with products of the other merging party appearing as only third most popular alternative in the case of three out of the seven brands (see Table 3 of Appendix 4.4). See paragraph 4.60.

In distribution

2.65. The four largest brewers also have the largest shares of on-trade distribution. WBC's share as an on-trade distributor is considerably lower than its share as a brewer, reflecting its weaker presence in the on-trade, the fact that it has not gained any contract distribution business and also, we were told, because it had put more emphasis on distribution through independent wholesalers. By contrast, reflecting their strength in the on-trade, Wolverhampton & Dudley, Greene King and smaller brewer/retailers have a larger share of distribution than of brewing. We estimate that independent wholesalers collectively have a share of about 6 per cent, about half of which is accounted for by The Beer Seller Limited (The Beer Seller), Matthew Clark plc (Matthew Clark) and Tavern Group Limited. See Table 4.12.

2.66. Post-merger, Interbrew (encompassing Tradeteam) would have a market share of 32.7 per cent. S&N and Carlsberg-Tetley would have market shares of 26.4 per cent and 12.0 per cent respectively (see Table 4.12).

Issues arising from the merger

2.67. The merger raises issues in the brewing, wholesaling and distribution, and retailing sectors of the beer market, which we consider in the following sections.

Issues in brewing

2.68. The principal issues in brewing are as follows. First, would Interbrew's enhanced portfolio of leading brands give it a much stronger position in the market? Second, would this lead in effect to the creation of a duopoly between Interbrew and S&N? Third, would such a

[1]This analysis excludes stout.
[2]The US Department of Justice and Federal Trade Commission joint guidelines state that a merger may be challenged if the change in HHI is more than 50 and the post-merger HHI is more than 1800.

duopoly, in turn, lead to an increase in prices, a shift to non-price competition and the raising of barriers to entry and expansion?

Interbrew's position in the market

2.69. A number of parties from whom we received evidence argued that Interbrew would acquire market power as a result of the enhancement of its portfolio of leading brands. Whereas formerly no brewer had a complete portfolio of leading brands, as a result of the merger Interbrew's portfolio included leading brands in every major product category, with the exception of stout. It was suggested that only S&N had a comparable portfolio. See, for example, paragraphs 6.4, 6.12, 6.55, 6.99 and 6.142.

2.70. These parties emphasized the importance to a brewer of having a strong brand portfolio. Brewers that were able to supply a range of leading brands, we were told, had a significant competitive advantage, while brewers that lacked a broad portfolio, such as Anheuser-Busch, Heineken and Guinness, were effectively niche players (see paragraphs 6.40, 6.45, 6.66 and 6.98). It was argued that pubs were increasingly reluctant to source from more than one or two brewers and they made their choice on the basis of the strength of the brand offering of potential suppliers. Therefore a brewer needed to provide brands holding the number one or two position in each product segment; a brewer unable to provide such a selection would find it very difficult to enter the market or to retain market share (see paragraphs 6.95 and 6.124).

Views of Interbrew

2.71. Interbrew told us that the main advantage of a wide portfolio was that it enabled a brewer to satisfy customer demand and spread its costs across a wider product range (see paragraph 5.41). It did not provide market power as competition took place at the level of individual brands, not between portfolios of brands. Interbrew asserted that it had no 'must stock' brands and no ability to use its portfolio of brands anti-competitively. See paragraphs 5.41 and 5.123.

2.72. Interbrew argued that the UK market was characterized by a high degree of brand fragmentation and of drinking 'promiscuity'. There was significantly more brand dynamism than was the case in most other beer markets or in other fast moving consumer goods markets in the UK. Interbrew identified only two brands that approached 'must stock' status, Budweiser and Guinness. See paragraphs 5.67 and 5.95.

2.73. Interbrew argued that it would continue to face strong direct competition from a wide range of brewers pursuing varied strategies: niche regional brewers, large international brewers pursuing focused brand strategies in the UK, and vertically integrated companies. Interbrew argued that there was no single correct strategy for a brewer to pursue in this market. As Interbrew had a market share of only 32 per cent and faced a range of powerful competitors, it would not be in a dominant position. See paragraph 5.123.

Our assessment

2.74. The merger would increase Interbrew's market share in brewing to between 33 and 38 per cent (see paragraph 2.56) and enhance its portfolio of leading brands, which would include (see Tables 4.3 and 4.4):

(a) four of the top ten selling brands (Carling, Stella Artois, Heineken[1] and Tennents), including two of the top three (Carling and Stella Artois);

(b) the leading standard lager (Carling) and the leading premium lager (Stella Artois); and

(c) the number three selling standard ale (Worthington) and the two leading premium ales (Caffrey's and draught Bass).

2.75. We note that the top ten brands have increased their share of total sales in the last ten years (from 32 per cent to 48 per cent), with most of the increase occurring in the last four years (see Table 4.3 and paragraph 4.11). We note also that whereas the brand and type of beer offered is not the most important reason for choosing which retail outlet to visit (see paragraph 4.9), the brand of beer is an important influence on consumers' choice of drink (see paragraph 4.7).

2.76. We recognize that there are various strategies for competing in the market; it is possible to compete with a portfolio of brands or with a single, high-volume, heavily-supported brand. Both strategies can succeed. But it is clear that a broad portfolio of leading brands is generally required if a brewer is to meet the full range of customers' requirements. In this respect, we believe that the merger would give Interbrew a much stronger position in the market.

2.77. In our view, the significance of Interbrew's enhanced portfolio cannot easily be separated from the issues that arise in the wholesaling and distribution sector. Accordingly, we return to this issue in that context (see paragraph 2.130).

Creation of a duopoly

2.78. Several parties expressed concern that the merger would in effect create a duopoly between Interbrew and S&N and increase the prospect of collusion, perhaps of a tacit nature, between the two. It was suggested that Interbrew and S&N had a common interest in eliminating competitors and increasing wholesale prices, particularly those to pubcos. See paragraphs 6.4, 6.140, 6.209 and 6.235.

2.79. A number of characteristics were identified which, it was alleged, indicated that the market might be susceptible to parallel pricing behaviour, and hence to a reduction in price competition. This in turn was likely to lead to an escalation in non-price competition, we were told, and a reduction in product innovation. The characteristics identified were: the homogeneous nature of the products; the limited scope for innovation and the similarity of the product ranges of Interbrew and S&N; the broadly symmetrical market shares and cost structures of Interbrew and S&N; the stable and inelastic demand for beer; high entry barriers and the absence of recent entry into national brewing and distribution, other than through acquisition; excess capacity in brewing; fragmented buyer power; and a transparent market. See paragraphs 6.22, 6.28, 6.260, 6.281 and 6.295.

Views of Interbrew

2.80. Interbrew told us that the headline market shares of the leading companies provided no basis for drawing any conclusion regarding possible coordinated behaviour or parallelism. Instead, we should consider the competitive dynamics of the market. There was no basis for concluding that the merger presented potential for coordinated behaviour. See paragraph 5.103.

[1]Three of the top ten if Heineken is excluded.

2.81. Interbrew said that, following the merger, the two leading brewers (Interbrew and S&N) would jointly account for less than 60 per cent of the UK beer market. Competition in the market was so intense, Interbrew said, that it would be impossible for them to act in parallel, even were they to seek to do so. See paragraph 5.104.

2.82. Interbrew pointed to the presence in the market of a number of competitors with strong brands. Carlsberg-Tetley operated nationally with an integrated wholesale and distribution operation focusing on a core portfolio of key brands and with a commercially attractive agreement with the former Allied-Domecq estate which had [✄] years to run (see paragraph 5.138).

2.83. Both Guinness and Anheuser-Busch operated on a national basis, each focusing on brewing and marketing of key brands, in keeping with their respective worldwide strategies, which allowed them to benefit from worldwide synergies in marketing and brand management. Both were backed by large international groups, and both had managed to grow market share, volumes and profits in the UK in recent years. See paragraph 5.138.

2.84. Interbrew described Heineken as a major international brewer with an existing market share in the UK of close to 5 per cent. It had a variety of alternative strategies now available to it to develop its UK business on its own terms and take a bigger proportion of the margin pool (see paragraph 5.138).

2.85. The regional brewers were also a significant competitive force. Interbrew argued that although different in size and scale from the three major national brewers, that did not make them any less competitive. Supplying a relatively densely-situated estate enabled them to keep distribution costs low. They were able to build brands through their own estates and achieve wider distribution through supply arrangements with other brewers. See paragraph 5.65.

2.86. Major Continental brewers, such as Beck's and Holsten, competed successfully by exporting beer to the UK, taking advantage in particular of the growth in popularity of packaged beers and the growth of the off-trade (see paragraph 5.138).

2.87. Imports, including personal imports, had become a significant competitive factor in the UK beer market, representing about 14 per cent of beer consumption (see paragraph 5.66).

2.88. In Interbrew's view, barriers to entry were falling fast as a result of the Beer Orders; a general decline in vertical integration; excess capacity and brand switching behaviour by consumers. See paragraph 5.104*(e)*.

2.89. Interbrew described beer as a highly portable and substitutable product, particularly in the UK where beer brands were weak compared with other European beer markets and other fast-moving consumer goods sectors. This was borne out in the on-trade, Interbrew claimed, by the willingness of the pubcos to change suppliers of beer as they re-tendered their supply contracts, either on termination of existing agreements or following retail consolidation, and in the off-trade by the very broad brand choice on offer by the larger off-licence retailers. The commercial power and acumen of multiple grocers to control their suppliers by sourcing from overseas and through their knowledge of own-label suppliers would prevent parallel behaviour occurring. See paragraph 5.104*(f)* and *(g)*.

2.90. Although there was substitution between beer brands, between beer types and between beer and other alcoholic beverages, beer was not a completely homogeneous product. Different beers catered for different consumers on different occasions. Whilst price was a key dimension of competition, brewers sought to differentiate themselves and their products through developing brands with distinctive consumer appeal and through the quality of products and services offered to customers and consumers. See paragraph 5.144.

2.91. Nor did Interbrew accept that there was limited scope for innovation. On the contrary, brewers sought to innovate in order to mitigate against declining consumption. Brewers continually introduced product innovations in order to attract consumers, particularly in the 18 to 24 age group, by means of new products, brand extensions, dispense methods and packaging. See paragraph 5.145.

2.92. Interbrew said that it and S&N chose to compete with each other and with other brewers, on the basis of broad brand portfolios, so it was not surprising to see a similarity between their portfolios. This was a result of normal competitive pressure: for example, the launch by S&N of John Smith's Extra Smooth to compete with Caffrey's. This behaviour was evidence of a competitive market, not of potential for collusion. See paragraph 5.146.

2.93. Although total demand for beer was declining, there was significant growth in demand in some segments of the market and some brands had grown noticeably even in declining segments. The mainstream lager sector showed modest growth in the second half of the last decade, whilst the premium lager sector grew more rapidly. Fullers' London Pride and Old Speckled Hen (both produced by regional brewers) had achieved annual growth rates of 7 per cent and 5 per cent respectively in recent years, despite the decline in demand in the ale segment. Demand could also increase significantly for short periods of time, as witnessed during the Euro 2000 competition when significant price reductions by Carlsberg-Tetley increased overall demand and enabled the company to take significant sales away from rivals. Moreover, demand at a wholesale level was extremely elastic, Interbrew said, as evidenced both by the pub companies' and off-trade multiples' readiness to switch suppliers. See paragraph 5.148.

2.94. Interbrew did not accept that the only recent entry into national brewing and distribution had been through acquisition. Anheuser-Busch initially grew through importing and then a joint venture eventually before buying its own brewing capacity. Tradeteam was an example of entry into the distribution market at a national level and Interbrew believed that this option was available to other potential new entrants. There were a number of new entrants in wholesaling taking advantage of new technology and increased access to relatively inexpensive software packages to develop e-commerce wholesaling activities. There were also new entrants at a microbrewery level and for packaged products. See paragraph 5.149.

2.95. The fact that there had been no recent entry at brewing level on a national scale was not surprising in Interbrew's view, because most leading international players were already present and the decline in consumption and in margins made by brewers. It did not of itself indicate high entry barriers, but rather that a highly competitive market existed. The methods of entry for brand-owners were many and varied, with brewers who were successful through licensing or importing able to move relatively easily to brewing directly in the UK. See paragraph 5.149.

2.96. In theory the presence of excess capacity could, in certain contexts, enable punishment to take place and therefore enable collusion to be 'policed and maintained' (ie disciplined). However, the presence of spare capacity could equally undermine the scope for collusion. In particular, the readily available excess capacity in the UK and the excess capacity in continental Europe meant that were S&N and Interbrew to seek to engage in any form of tacit collusion with a view to increasing wholesale prices, their competitors would have no difficulty in increasing their output to satisfy demand, thereby defeating such attempted collusion. Furthermore, the surplus capacity also meant that competitors would be able to meet demand without increasing fixed costs and could, therefore, justify utilizing marginal pricing to take advantage of any such collusion. In the present circumstances, Interbrew considered these effects would prevail and collusion would be hampered by the presence of excess capacity. See paragraph 5.150.

2.97. Interbrew said that it was wholly inaccurate to suggest that there was fragmented buyer power. Buyer power in both the off-trade and the on-trade was increasingly concentrated and would undermine any attempted collusion (see paragraph 5.151):

(a) The UK pub industry made six times more profit than the brewing industry.

(b) Pubcos sold over two out of every five pints drunk in British pubs.

(c) The total volume of beer purchased by Nomura International plc (Nomura) alone represented 15 per cent of the merged entity's total volume produced.

(d) Punch Group Limited (Punch) and Nomura together controlled nearly 20 per cent of all pubs.

(e) The recently announced intention by Whitbread to dispose of its pub estate and by Bass to dispose of approximately 1,000 pubs, was likely to lead to even larger pubcos.

(f) The six largest pubcos purchased nearly 30 per cent of total UK pub volume and the latest planned disposals were likely to push this still higher.

(g) Punch's total volume of approximately 1.2 million barrels equated to two and a half times the capacity of an average brewery, and to more than four times the volume of the Caffrey's brand in the on- and off-trade combined.

(h) Off-trade multiples accounted for approximately 25 per cent of total UK beer consumption.

2.98. Interbrew noted that in the 1997 report the MMC had recognized that, even in 1996, 'brewers and wholesalers' margins are declining as a result of the growth in buying power of the on- and off-trade retail chains'. Interbrew argued that this buying power had grown very considerably in the intervening four years. It failed to see how it could be suggested, therefore, that buyer power was fragmented. See paragraph 5.151.

2.99. Interbrew rejected as inappropriate a comparison of the combined market share of on-trade beer sales of the two leading pubcos with the market share accounted for by Interbrew and S&N respectively. This was not an appropriate means of establishing relative bargaining positions. Interbrew argued that pubcos had a wide choice of suppliers from whom to source products but that the loss of volume upon delisting by a pubco had significant effects on brewers who either had to suffer a loss of volume or compete aggressively to make that volume up elsewhere. The market share of the pubcos was therefore irrelevant. Interbrew argued that the pubcos had driven down net wholesale prices to the extent that these covered the direct cost of sales but were not margin-enhancing. Moreover, it said that the benefit of the decline in wholesale prices had in general been retained by on-trade retailers rather than being passed on to consumers, as was demonstrated by the widening gap in real terms between declining net wholesale prices and increasing retail prices. See paragraphs 5.151, 5.189 and 5.205.

2.100. Interbrew stated that the lack of price transparency made tacit collusion impossible, and it rejected the suggestion that the market for the supply of beer was transparent as to prices and other terms. Negotiations with retailers were highly confidential and the discounts achieved by retailers, as well as the other terms of the agreements with them, were not known by other players in the market (as indicated by the disparity between prices to different pubcos). The pubcos kept the terms of their supply agreements secret as a means of playing brewers off against one another. The existence of retrospective discounts in many supply agreements also added to the lack of transparency of prices. See paragraph 5.153.

2.101. In a related argument, Interbrew told us that in the on-trade there was no 'market price' because the terms of customer contracts were many, complex and secret. Successful

price coordination in such a complex process would be impossible, it said. However, we note that Interbrew also told us that factors putting pressure on prices to smaller on-trade customers included increased awareness of levels of discounts, which were published in *The Publican*. See paragraphs 5.57*(a)*, 5.153, 5.154 and 5.249.

2.102. Furthermore, Interbrew said, the severing of the vertical ties between each of Bass Brewers and WBC and the retail operations of their former parents meant that the two businesses no longer had knowledge of or dealings with other brewers in the capacity of retail customers themselves. In this, Interbrew differed from both S&N and the regional brewers. See paragraph 5.153.

2.103. Interbrew argued that the factors affecting marketing expenditure would not be altered by the merger. Advertising spending was subject to rapidly diminishing returns and expensive advertising was not necessary to launch or grow new brands. See paragraph 5.124.

2.104. Interbrew also argued that it had a very different commercial strategy to that of S&N. Whereas Interbrew had no retail interests and would focus exclusively on its brewing business, S&N was both a brewer and a retailer. This meant that the economic interests and incentives of the two companies would be different. This lack of symmetry between the business of S&N and Interbrew makes it very unlikely that the two businesses would collude post-merger. Interbrew identified several reasons for this (see paragraph 5.147):

(a) S&N's tied estate negated any benefit which S&N would gain from colluding on the wholesale price, since the wholesale price was largely irrelevant to its tied business. All that mattered for this business was the marginal cost of production.

(b) The tied estate would make it very difficult for Interbrew to detect 'cheating' by S&N, since such 'cheating' could take the form of cutting retail prices in its tied estate, as a way of increasing market share, rather than cutting wholesale prices. In such a situation, collusion would be unenforceable.

(c) S&N had commitments to other brand owners for whom it brewed under licence, which created a difference in terms of portfolio management.

(d) S&N's participation in the retail price of beer as well as the wholesale price was in contrast to Interbrew's direct concern with the wholesale price only. This divergence would make it hard to find a mutually agreeable collusive solution.

(e) Interbrew could not monitor S&N's wholesale price to its tied estate, making it hard to collude.

(f) The tied estate would make it harder for Interbrew to punish S&N for any deviation from the tacit agreement since S&N would always be able to rely on its tied estate. This would make it more likely that S&N would deviate and so undermine any tacit collusion.

Our assessment

2.105. While we accept that market shares do not of themselves provide a basis for drawing strong conclusions regarding possible coordinated behaviour or parallelism, we are not persuaded by Interbrew's assessment of the competitive dynamics of the market.

2.106. Beginning with the competitive discipline imposed by other brewers, we note that Carlsberg-Tetley has a significantly smaller market share and a weaker brand portfolio, in terms of leading brands, than either Interbrew or S&N (see Tables 4.4 and 4.9). Although

Carlsberg-Tetley's share as a brewer of the on-trade is in decline (see Table 4.9), it has sustained its share as a distributor at about 12 per cent by winning contracts to distribute for multiple retailers (see Table 4.12). Nevertheless Carlsberg-Tetley's share is less than half that of S&N and Interbrew (post merger) and its unit costs are consequently likely to be higher as costs decline with volume (see Appendix 4.2 and paragraph 4.61). Carlsberg-Tetley told us that whereas it was the only brewer, other than Interbrew and S&N, with a credible national product portfolio, it had lost market position in recent years and did not have the product strength, brand range or marketing budget to compete effectively with Interbrew and S&N. Carlsberg-Tetley said that, if the merger were to proceed, it could not survive as an independent brewer in the UK. [*Details omitted. See note on page iv.*] See paragraphs 6.9, 6.46 and 6.96.

2.107. Companies such as Anheuser-Busch, Heineken and Guinness are, in our view, niche competitors which compete in particular segments of the market but lack the brand portfolios necessary to compete with Interbrew and S&N for the full range of customers' beer requirements (see paragraph 4.55). The same applies to imported brands. Nor are we convinced that regional brewers provide a sufficient competitive discipline. The regional brewers concentrate on servicing their tied estates in particular regions of the country, and none has a portfolio of brands or a wholesaling and distribution network that can compare with those of Interbrew and S&N. We note that most do not brew their own lager. Further, the presence of excess capacity mainly in the breweries operated by the regional brewers might suggest that the regional brewers have a relatively weak competitive position, ie they are unable to sell sufficient volumes to enable them to utilize their capacity. See paragraph 4.55.

2.108. The merger has occurred in the context of a continuing decline in overall consumption of beer (albeit that there are some growth segments) and the indications are that demand will remain stable at best, or decline slightly in the near future (see paragraph 2.29). This is, therefore, a mature market with predictable demand patterns, which adds credibility to the suggestion that conscious parallelism could occur. We are satisfied that the demand for beer by consumers is relatively price inelastic; therefore it would not be difficult for retailers to pass on an across-the-board but modest increase in net wholesale prices[1] (see paragraph 2.30).

2.109. We recognize that there are various possible routes by which a new entrant could enter the brewing market (see paragraph 2.34). However, we believe that the need to invest large sums in advertising and promotional expenditure represents an important barrier to entry (see paragraphs 2.36 to 2.40). We think entry is likely to be easier in markets where new products are introduced frequently, but this does not seem to be the case in the beer market, as opposed to the wider market for alcoholic drinks (see paragraph 2.39).

2.110. We are not persuaded by the argument that were S&N and Interbrew to seek to engage in any form of tacit collusion, with a view to increasing wholesale prices, their competitors would have no difficulty in increasing their output to satisfy demand, thereby defeating such attempted collusion (see paragraph 2.96). No competitor has a brand portfolio that can compete for the full range of customers' beer requirements (see paragraph 2.106). Furthermore, although new entrants might be willing to make use of whatever spare capacity was available, we have not seen any persuasive evidence to suggest that the available excess capacity would necessarily be suited to high-volume, efficient production of the sort that would be required to compete effectively with Interbrew and S&N. Finally, entrants that wished to take advantage of higher prices would find it difficult to gain access to the market as a result of the control that Interbrew and S&N would have in wholesaling and distribution (see paragraphs 2.142 to 2.149).

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[1]The wholesale price accounts for approximately 16 per cent of the retail selling price (see Figure 4.4). So, an increase of 10 per cent in the wholesale price would translate to a modest increase of 1.6 per cent, or 3p per pint at the retail level.

2.111. Nor are we persuaded by Interbrew's argument that the pubcos' ability to change suppliers indicates that beer brands are highly substitutable (see paragraph 2.89). Their ability to switch depends on the nature of the pubco. Evidence suggests that the bargaining strength of managed pub companies, which can offer and withdraw access of particular brands to all their outlets as part of the negotiations, is greater than the bargaining strength of tenanted pub companies which have to take into account their tenants' wishes (see Appendix 4.4). We note that 72 per cent of pubs owned by retail chains are tenanted and 28 per cent are managed, although the managed pubs tend to be the largest in terms of volume of beer sold (see Table 4.7 and paragraph 4.17*(b)*).

2.112. Other factors relevant to retailers' bargaining strength include their total volume of sales, the importance of specific brands to the retailers' customers, and the existence of separate distribution and supply contracts. We estimate that the five largest pubcos together have just over 21 per cent of on-trade sales, which is less than the individual share of S&N and Bass Brewers (see Appendix 4.3). Individually (the basis on which they negotiate with brewers) they have much smaller market shares. See paragraph 4.63 and Table 4.13.

2.113. Relatively few retailers arrange their own distribution and supply: around 50 per cent of on-trade beer is supplied to independents and smaller pubcos which do not arrange their own distribution and additionally the two largest retailers do not have fully separate distribution contracts (see paragraph 4.45). Some [*Details omitted. See note on page iv.*] have arrangements whereby a brewer supplies its beer to their outlets under a combined supply and distribution contract and also delivers other brewers' beer for a (per hectolitre) 'porterage' fee. These contracts give retailers the option of negotiating directly with other brewers on price and volume (subject to any minimum purchase obligations in their main contract). Most of the smaller pub chains and independent retailers purchase beer and distribution on a bundled basis, ie they pay a delivered price covering both beer and distribution. See paragraph 4.41.

2.114. In our view, only a modest number of retailers would have sufficient countervailing power to resist increases in net wholesale prices, even if they wished to do so given their ability to pass on such increases to consumers. The majority of the pubcos lack this countervailing power. In all cases, the bargaining strength of the pubcos is considerably greater than that of the independent free trade.

2.115. We accept that beer is not a completely homogeneous product, that brewers seek differentiation through developing distinctive brands and that there is some degree of product innovation (see paragraphs 2.90 and 2.91). However, the main brands in each main product segment are similar and prices are directly comparable (see paragraph 4.3). Moreover, the fact that seven of the top ten brands in 1999 appeared in the 1989 top ten and the other three (Stella Artois, John Smiths, Budweiser) were all available in 1989 (see Table 4.3) indicates that the leading brands have been able to maintain their position despite product innovation. Innovation, in our view, mainly occurs at the margins of the beer industry, and in the development of other alcoholic beverages, such as FABs. We note Interbrew's evidence that it could take up to 20 years to establish a leading brand (see paragraph 4.34).

2.116. While we accept that the market is not completely transparent in terms of prices (see paragraph 2.100), we are not persuaded by Interbrew's argument that there is no market price in the on-trade and therefore successful price coordination would be impossible (see paragraph 2.101). We recognize that contract terms vary from customer to customer, depending on the outcome of negotiations, as they do in most markets. Parties to any negotiation summarize these complex contract terms down into a single net price per barrel; in our view, this is a focal point around which tacit understandings can occur.

2.117. We are not persuaded by Interbrew's arguments as to why it has a completely different commercial strategy from that of S&N (see paragraph 2.104). In our view, Interbrew and S&N share both a common interest in raising margins and a long-term commitment to the

market. These factors are not offset by S&N's retail interests. We note that S&N has only about 2 per cent of fully licensed on-trade outlets, including clubs, and a slightly higher percentage of sales, but as a brewer it has 26 per cent of the beer market (see paragraph 4.39 and Table 4.9). This indicates that only a small proportion of sales of S&N's brands are through its own estate, certainly not enough to have the effects claimed by Interbrew. Moreover, S&N's pubs would benefit if net wholesale prices for rival pubs were to rise.

2.118. Interbrew says that advertising spending is subject to diminishing returns (see paragraph 2.103). When measured as a relationship between advertising and brand awareness, there does seem to be evidence of diminishing returns, as Interbrew asserts. However, many brands have similar levels of awareness but very different market shares, and it seems to be the case that advertising does not rise proportionally with sales for leading brands (see Figure 4.6). This suggests the existence of increasing returns to advertising, meaning that large established brands are advantaged relative to smaller entrant brands. Moreover, while it may be possible to launch and grow a new brand without expensive advertising, such a brand will not become a market leader without extensive advertising and promotion (see paragraphs 4.33 and 4.34).

2.119. Looking at the respective portfolios of the two companies, we note that between them Interbrew and S&N would control 6 of the top 10 selling brands, and 15 of the top 20 selling brands, if Heineken is considered to be part of the Interbrew portfolio, or 5 of the top 10 and 14 of the top 20 if it is not (see Table 4.3 and paragraph 4.11). Within the various market segments (see Table 4.4):

(a) Interbrew and S&N would control the number one (Carling) and number two (Fosters) selling standard lager brands. The number three brand (Carlsberg) has approximately half the market share of the number two brand.

(b) Interbrew and S&N would control the number one (Stella Artois) and three (Kronenbourg) selling premium lager brands. Stella Artois has a market share twice that of the number two brand (Budweiser).

(c) S&N and Interbrew would control the number one (John Smiths) and number three (Worthington) selling standard ale brands. Interbrew's brand (Worthington) has a market share that is just under 1 per cent less than that of the number two brand (Tetley).

(d) Interbrew and S&N would control the top three premium ale brands (Caffrey's, draught Bass and McEwan's Export).

2.120. Our assessment leads us to the conclusion that the merger would in effect lead to the creation of a duopoly between Interbrew and S&N in most segments and, therefore, across the market as a whole. We also conclude that conditions in the market are such as to allow that duopoly to persist.

Effects of a duopoly

2.121. Concern was expressed that the creation of a duopolistic situation would enable Interbrew and S&N to reduce the level of price competition and increase the level of non-price competition ie marketing and advertising. This would give rise to several adverse effects. First, by reducing discount levels offered to customers, Interbrew and S&N could bring about an increase in net wholesale prices, which ultimately would lead to an increase in retail prices. While some pubcos are better placed to resist price increases, and other retailers may be less inclined to pass increases on to consumers, nevertheless the consequence would be that retail prices would generally rise. Second, by increasing the levels of marketing and advertising expenditure, Interbrew and S&N could raise barriers to entry by new brands and expansion by

existing, competing brands. Third, it might also result in brand rationalization, which in turn would mean reduced consumer choice. See paragraphs 6.4, 6.41, 6.44, 6.69, 6.83 and 6.209.

Views of S&N and Interbrew

2.122. For its part, S&N did not accept that there would be scope for duopolistic behaviour. It did, however, believe that Interbrew would have the financial resources to invest in aggressive marketing of its top brands and S&N would be forced to increase its marketing budget in order to compete. See paragraphs 6.90 and 6.99.

2.123. Interbrew stated that competition in the market was so intense that it would be impossible for Interbrew and S&N to act in parallel, even were they to seek to do so (see paragraph 2.81).

Our assessment

2.124. We have set out above our view that the merger would increase Interbrew's market strength and that it would in effect result in a duopoly between Interbrew and S&N (see paragraphs 2.76 and 2.120). We have also expressed the view that Interbrew and S&N share a common interest in raising margins (see paragraph 2.117).

2.125. We think it likely, therefore, that they would shift from price competition to non-price competition, by which we mean brand support ie advertising and marketing. Such a switch would have the effects described in paragraph 2.121. We expect that net wholesale prices would increase as discount levels are reduced. In this context, we note that several smaller brewers in favour of the merger expressed the view that this would or might happen (see paragraphs 6.98, 6.148, 6.149 and 6.156). Given that most consumers do not place a high value on price when choosing a beer brand (see paragraph 2.30), we expect that retailers would pass on increases in wholesale prices through to consumers.

2.126. An increased emphasis on non-price competition would also raise barriers to entry and expansion by competing brands. In addition, we think that even greater emphasis would be placed on the promotion of the leading brands, which in turn would lead to a greater degree of brand rationalization, and less consumer choice, than might otherwise occur.

2.127. During the course of our inquiry, it emerged that Interbrew was the subject of an investigation by the European Commission into a breach of Article 81 of the Treaty on European Union. Interbrew acknowledged that in prior years it had taken actions which were incompatible with the competition rules of the EC. It also stated that it was now compliant with the competition rules prohibiting restrictive agreements and concerted practices and it was committed to ensuring that its business practices were now fully compliant with the regulations in the markets where it operated. See paragraphs 5.169 to 5.171.

2.128. Interbrew provided us with details of the breach of Article 81 and of the subsequent steps it was taking to introduce a comprehensive compliance programme. On the basis of the information it provided, we do not consider that the breach of Article 81 has any bearing on our investigation of this merger.

Issues in wholesaling and distribution

2.129. The principal issues with respect to wholesaling and distribution are as follows. First, could Interbrew use its enhanced portfolio of leading brands in an anti-competitive manner? Second, would Interbrew, or Interbrew and S&N, be able to control the route to market for new and existing brands? Third, would Interbrew, or Interbrew and S&N, be able to

discriminate between different customers in a manner that would adversely affect competing wholesalers and distributors, and raise barriers to entry?

Interbrew's brand portfolio

2.130. It was put to us that Interbrew would be able to use its enhanced portfolio in a number of ways to its advantage, and to the disadvantage of competitors. For example, Interbrew would be in a strong position to exert continuing influence over the purchasing decisions of retail outlets; it could engage in full-line leveraging; it could spread distribution costs across multiple brands; it could target competitors by reducing or increasing prices of brands within its portfolio, depending on the strength and market position of any particular competitor; it could provide high promotional support; and it could offer high-volume discounts on specific brands within its portfolio (see paragraphs 6.4, 6.40, 6.59, 6.66, 6.69, 6.83, 6.90, 6.208 and 6.212).

Views of Interbrew

2.131. As noted above (see paragraph 2.71), Interbrew argued that a wide portfolio did not provide market power as competition took place at the level of individual brands, not between portfolios of brands. Interbrew asserted that it had no 'must stock' brands and no ability to use its portfolio of brands anti-competitively.

Our assessment

2.132. We have explained above (see paragraph 2.76) that a broad portfolio of leading brands is required if a brewer is to meet the full range of customers' requirements and that in this respect, the merger would strengthen Interbrew's market position.

2.133. We also noted (see paragraph 2.77) that the significance of Interbrew's enhanced portfolio cannot easily be separated from the issues that arise in wholesaling and distribution, to which we now turn.

Controlling the route to market

2.134. Several parties from whom we received evidence argued that, as a result of the merger, Interbrew, or Interbrew and S&N, would be able to control the route to market for existing and new brands (see paragraphs 6.24, 6.184, 6.201 and 6.295).

Views of Interbrew

2.135. Interbrew considered that wholesaling and distribution were fundamentally different and that different issues arose in relation to each of those functions. Over time, large retailers in both the on- and the off-trade had taken control of the supply chain, dealing directly with brewers and taking control of distribution, and in some cases wholesaling. This had led to fundamental changes in the nature of distribution services operated by brewers, and to the emergence of a market for contract distribution services. It was increasingly common for pubcos to arrange for secondary distribution from main depots to managed or tenanted estates by one distributor who would deliver a range of beers supplied by a number of brewers. Several retail groups collated orders from individual outlets. Brewers employed a range of distribution arrangements and distributed a significant volume of products manufactured by competitors. See paragraph 5.174.

2.136. As to competition in wholesaling, Interbrew said that national brewers and independent wholesalers had a strong incentive to wholesale other brewers' products where these were demanded by customers. Bass Brewers, for example, currently factored over 150 beer brands and Interbrew factored more than 70. No UK brewer had sufficiently strong brands to be able to satisfy customer demand completely. If the merged entity were to refuse to supply beers desired by the pubcos, other brewers would willingly supply them. See paragraph 5.176.

2.137. As to competition in distribution, Interbrew submitted that it would not be able to influence the conduct of Tradeteam, which was managed by Exel. To the extent that Bass Brewers obtained a dividend generated as a result of revenues from third party distribution, it had a commercial incentive to encourage Tradeteam to carry out third party distribution. Interbrew's logistics activity, formerly Whitbread Drinks Logistics, generally did not carry out third party distribution. It did tender for third party secondary distribution contracts but not on a marginal basis and it had not yet been successful in winning third party business. See paragraph 5.177.

2.138. Interbrew concluded that the merger would have no significant impact on competition in the distribution of beer, given that Bass Brewers was not active in distribution other than through its equity stake in Tradeteam and that Interbrew had only very limited third party distribution services. See paragraph 5.178.

2.139. Interbrew argued that competition in the wholesaling and distribution of beer would remain strong following the merger. The existing options for wholesaling and secondary distribution would continue, ensuring that brands had a number of available routes to market. In addition to Bass Brewers for wholesaling, Tradeteam for secondary distribution and Interbrew, brewers and retailers would have available to them the wholesaling and distribution services of S&N, Carlsberg-Tetley and a range of regional brewers, as well as independent wholesalers such as The Beer Seller and Matthew Clark, and independent logistics providers such as Hays Distribution Services Ltd and Wincanton. See paragraph 5.179.

2.140. As to whether the merger would increase barriers to entry or expansion in wholesaling or distribution, Interbrew submitted that it would not do so. Pubcos had themselves entered the wholesaling market and had subcontracted certain elements of this activity. Entry to wholesaling activities did not need to be on a large scale. Even entry on a relatively large scale was not subject to significant barriers. Opportunities had also been opened up by virtue of e-commerce. See paragraph 5.180.

2.141. As to entry into distribution, Interbrew argued that the contracting out of distribution activities also provided opportunities for entry and many pubcos had sufficient scale to be able to set up their own in-house distribution operations or partnerships with a logistics provider should they wish to do so. See paragraph 5.181.

Our assessment

2.142. As noted earlier (see paragraph 2.45), to access the on-trade, beer has to be delivered to the point of sale. Some of the larger pubcos have separate supply and distribution contracts with all beer delivered to regional depots for onwards transport to the retail outlets. However, in order to obtain distribution to other on-trade retail outlets, a brewer has the choice of arranging its own distribution, using independent wholesalers and selling to existing brewers, which also act as wholesalers.

2.143. We have established (see paragraph 2.46) that because distribution costs fall sharply with drop size, it would tend to be cost effective for a brewer to arrange its own distribution (on a contracted-out basis) only if each outlet took a reasonably large quantity of beer, which would require that the brewer supply it with a wide brand range. However, with the exception of

Interbrew and S&N, and to a lesser extent Carlsberg-Tetley, competitors and new entrants have very focused portfolios.

2.144. We have also established (see paragraph 2.47) that, although independent wholesalers in theory offer an alternative means of accessing retail customers, in practice they have a small share of distribution and appear to be weak competitors when compared with Interbrew. As to e-commerce, we are not persuaded that it has had a significant impact on the market to dated, although it may do so in the future.

2.145. Finally, we have noted (see paragraph 2.48) that brewers, such as S&N, Carlsberg-Tetley and Interbrew, do wholesale third parties' beers but have little incentive to promote sales of products that compete directly with their own. We have also established that Carlsberg-Tetley's share of the market is considerably less than that of Interbrew (Tradeteam) or S&N (see Table 4.12). Given that distribution is characterized by economies of drop size and, to a lesser extent, of density (see paragraph 2.50), this suggests that Carlsberg-Tetley's wholesaling and distribution operations may well have a higher unit cost than those of Interbrew or S&N, a point made to us by third parties (see paragraphs 6.27, 6.281, 6.292 and 6.296).

2.146. As to distribution itself, we have established (see paragraph 2.50) that the distribution of draught beer appears to involve some elements of special expertise. Distribution is characterized by economies of drop size and, to a lesser extent, of density. Economies of density imply that entry would need to be on a fairly large scale to be cost competitive with existing suppliers. Moreover, to compete on a national basis, a nationwide distribution system is required (see paragraph 2.50). However, the assets involved in distribution (depots and vehicles) have value in alternative uses and consequently sunk costs appear low.

2.147. We have expressed the view (see paragraph 2.52) that, although large logistics companies lack specific expertise, we regard them as plausible entrants into on-trade beer distribution.

2.148. This analysis has led us to conclude (see paragraph 2.49) that, while access to on-trade distribution continues to act as a barrier to entry and expansion in brewing, the development of retailer contracting in the on-trade, together with the expansion of the off-trade at the expense of the on-trade, suggest that distribution may be of gradually declining importance as a barrier to entry.

2.149. Nevertheless, following the merger, Interbrew and S&N would have the largest and most efficient wholesaling and distribution operations. Their combined market share would be approximately 59 per cent (see Table 4.12). Competing brewers may well be able to rely on the centralized wholesaling and distribution arrangements offered by some pubcos to access those pubcos. But this will not enable those brewers to access either pubcos that do not offer such services or the independent free trade. These two groups of retailers account for at least 50 per cent of the on-trade (see paragraph 4.45). We believe that for these customers, Interbrew and S&N would effectively control the route to market.

Discrimination among customers

2.150. Of particular concern is the prospect that Interbrew would be better placed to price selectively in a manner that would discriminate against independent wholesalers and other customers in the on-trade (see paragraphs 6.162 and 6.178 to 6.180).

Views of Interbrew

2.151. Commenting on variations in the prices charged to different channels (by which we mean multiple retailers, the independent free trade, other brewers, independent wholesalers, and

the off-trade), Interbrew told us that the net prices charged took account of, among other things, differences in the direct cost of supply and the importance of obtaining brand exposure in retail outlets. It also said that differences in the costs of serving different types of customer and the volumes supplied to them, meant that a differential in the discounts offered to pub companies and to the independent on-trade was likely to persist. See paragraphs 5.187 and 5.245 to 5.247.

Our assessment

2.152. Sales of beer through the off-trade are predominantly through multiple grocers, off-licence chains and independent off-licences. In this sector of the market a wide range of brands is typically offered by retailers and the products of the large brewers face more competition than in the on-trade from branded imports and own-label products, which may be manufactured overseas or by UK contract brewers. Off-trade prices and volumes are typically negotiated annually and it is not usual for there to be multi-year supply agreements. We are, accordingly, not concerned with price discrimination in this sector. See paragraph 4.71.

2.153. Bass Brewers and Interbrew have offered large average discounts to on-trade multiple retailers[1] and earn low net margins on this business. This appears to reflect the bargaining strength of the larger multiple retailers, the importance to brewers of obtaining brand exposure in such outlets, and the strong competition, up to now, between the existing brewers to supply them (see paragraph 4.67). In addition, we were told that when retail outlets were divested, there was an incentive to set low wholesale prices to increase the value of the retail estates, and these low prices had since been built into the bargaining position between brewers and retailers (see paragraph 6.234). This situation has arisen despite the low market share of such retailers relative to large brewers and the existence of some switching costs for retailers. See Tables 4.12 and 4.13 and Appendix 4.4.

2.154. Independent on-trade outlets (the free trade) pay higher prices for beer than do the multiple retailers. Bass Brewers' net on-trade prices (including duty) to the free trade are [✂] per cent higher than to multiple retailers; cost differences reduce this to [✂] per cent. See paragraph 4.70 and Table 4.14.

2.155. Independent wholesalers are unable to provide low prices to independent outlets: the price difference between pubcos and independent wholesalers is [✂] per cent and this increases to [✂] per cent after allowing for cost differences (see paragraph 4.70 and Table 4.14). In part this differential reflects the bargaining power of the pubcos, but there are other factors, in particular those set out in 2.153. This is consistent with the suggestion that competition between large brewers to supply independent outlets is much less vigorous than to supply multiple retailers; large discounts to pubcos are partially subsidized by the higher prices charged to other customers.

2.156. Pubcos increasingly contract separately for beer supply and distribution. We were told that bidding between S&N, Tradeteam and Carlsberg-Tetley for distribution contracts had been vigorous, with WBC, independent wholesalers and entrants also bidding. We received evidence that successful bids were below average cost per hectolitre, reflecting economies of density and other fixed costs in distribution. See paragraph 4.73.

2.157. We also received evidence that Bass Brewers had discouraged retailers from contracting separately for distribution by linking the price reductions for unbundling distribution from beer supply with the award of the distribution contract to Tradeteam. We note Interbrew's statement that the pricing policy was not intended to discriminate against Tradeteam's competitors in this way, but that the terms of the contract between Bass Brewers and Tradeteam unintentionally had this effect. See paragraphs 4.74 and 5.241.

[1]Including pubcos, hotel chains and nightclubs.

2.158. As described in paragraphs 2.154 and 2.155, Interbrew is already able to price discriminate between different types of customers and the differences are only in part explained by differences in costs incurred. The evidence indicates that Interbrew offers more attractive prices to multiple retailers than it does to the independent free trade or independent wholesalers. This has the effect of making the independent free trade less competitive with the multiple retailers than would be the case if the price differences were attributable only to cost differences. It also makes it difficult, if not impossible, for the independent wholesalers to compete for the business of the multiple retailers. Nor are they able to offer low prices to the free trade. We expect that the merger would enhance Interbrew's ability to price discriminate as a result of its increased market share and because some pubcos have access to distribution systems independent of the major brewers, whereas other retailers do not.

Issues in retailing

2.159. The main issues in retailing relate to the long-term supply agreements with the retained estates of Bass and Whitbread.

The long-term supply agreements

2.160. It was put to us that the long-term agreements with the retained estates of Bass and Whitbread (see paragraphs 6.23, 6.43 and 6.102) would:

(a) foreclose this part of the market to other competitors, both for the duration of the contracts and beyond;

(b) provide Interbrew with a guaranteed sales base, thereby enabling it to increase market share by pricing on a marginal cost basis; and

(c) enable Interbrew to sell Bass Brewers' brands into the Whitbread estate and WBC's brands into the Bass estate, thereby increasing the market shares of the brands of Bass Brewers and WBC.

Views of Interbrew

2.161. Interbrew told us that the severing of the ownership links between the brewing and retailing businesses of Bass and Whitbread had been a major change for both the brewing and retail operations concerned and they needed time to adapt. Interbrew regarded the supply agreements as a reasonable means of effecting an extremely significant structural change. See paragraph 5.207.

2.162. The supply agreements would, Interbrew argued, extend competition by breaking the previous vertical integration. It failed to see how they could foreclose access. On the contrary, they represented the first stage in freeing the estates up to full competition. The two estates could be expected to seek to achieve the lowest possible prices for their beer supplies. If existing large pubcos acquired some of the outlets, their purchasing power would increase still further. As the minimum purchase requirements from Bass Brewers and Interbrew reduced, the estates would almost certainly go out to tender for the supply of the extra volume and the bidding process would undoubtedly be highly competitive. See paragraph 5.208.

2.163. In the case of the Bass retail estate, by the end of the [✂] year about [✂] of that estate's volumes would not be subject to minimum purchase obligations in the supply agreement with Bass Brewers. The level of churn of supply to retailers of all sizes undermined any notion that retailers' purchasing was driven by inertia. See paragraph 5.209.

2.164. Interbrew did not accept that the supply agreements would enable it to compete more aggressively for other business. It would be in a weaker position than either Bass Brewers or WBC had been when they were part of vertically-integrated groups, Interbrew claimed. See paragraph 5.210.

2.165. Interbrew provided us with a very detailed description of the provisions of the supply agreements with the Bass and Whitbread estates. [

Details omitted. See note on page iv.

]

Our assessment

2.166. We accept that the supply agreements have been put in place as a measure to facilitate the severance of the vertical ownership links between brewer and retailer. As they are of finite duration, they offer the prospect of access by competing brewers to the Bass and Whitbread estates, in the short to medium term, access that did not exist when they were vertically integrated.

2.167. The estates are accustomed to being supplied by WBC and Bass Brewers, which may lead to some inertia when they are eventually free to purchase from other suppliers. Nevertheless, we think such inertia can be overcome and competing brewers will have an opportunity to supply the estates, if they are able to make a competitive offering.

2.168. Post-merger, the supply agreements would enable Interbrew brands to be substituted for each other within the minimum purchase obligations, but this would not increase their aggregate share. We are particularly concerned that the Whitbread agreement could be used to replace Heineken with other Interbrew brands. We think it unlikely that the agreements will provide Interbrew with any particular advantage in terms of being able to compete more aggressively for other business in the medium to longer term. While cross-selling of Interbrew brands might occur, we think that the agreements are in general too short in duration for inertia to occur and lock the affected pubs into the newly cross-sold brands.

Our consideration of the public interest

2.169. The merger would increase Interbrew's market share in brewing within Great Britain to between 33 and 38 per cent and it would enhance its portfolio of leading brands, giving it control of leading brands in all beer segments, with the exception of stout (see paragraph 2.74). We think this particularly significant given the increasing importance of the leading brands in terms of market share (see paragraph 2.75).

2.170. We accept Interbrew's argument that there are various strategies for competing in the market, but we are satisfied that a portfolio of leading brands is generally required if a brewer is to meet the full range of customers' requirements. We conclude, accordingly, that the merger would strengthen Interbrew's market position in this respect. See paragraph 2.76.

2.171. While we accept Interbrew's argument that market shares do not of themselves provide a basis for drawing any conclusion regarding possible coordinated behaviour or

parallelism, we are not persuaded by its assessment of the competitive dynamics of the market, for the reasons set out in paragraphs 2.105 to 2.118.

2.172. Between them Interbrew and S&N would control the majority of the leading brands in every segment except stout (see Tables 4.3 and 4.4).

2.173. We conclude, accordingly, that the merger would in effect lead to the creation of a duopoly between Interbrew and S&N. We also conclude that current conditions in the market are such as to allow that duopoly to persist. See paragraph 2.120.

2.174. In our view, Interbrew and S&N share a common interest in raising margins (see paragraph 2.117) and we think it likely that they would shift from price competition to non-price competition. We expect that net wholesale prices would increase as discount levels are reduced. Given the price inelasticity of consumers, we expect that retailers would pass higher wholesale prices through to consumers. See paragraphs 2.117 and 2.125.

2.175. We conclude that an increased emphasis on non-price competition would also raise barriers to entry and expansion by competing brands. In addition, we think that even greater emphasis would be placed on the promotion of the leading brands, which in turn would lead to a greater degree of brand rationalization, and less consumer choice, than might otherwise occur. See paragraph 2.126.

2.176. Brewers require a means of delivering their beer to the point of sale. We believe that it would be cost effective for a brewer to arrange its own distribution (on a contracted out basis) only if each outlet took a reasonably large quantity of beer, which would require a wide brand range. However, with the exception of Interbrew and S&N, and to a lesser extent Carlsberg-Tetley, competitors and new entrants have very focused portfolios. See paragraph 2.143.

2.177. While independent wholesalers in theory offer an alternative means of accessing retail customers, in practice they have a small share of distribution and appear weak competitors compared with Interbrew. As to e-commerce, we are not persuaded that it has had a significant impact on the market to date, although it may do so in the future. See paragraph 2.144.

2.178. Brewers do wholesale third parties' beers but have little incentive to promote sales of products that compete directly with their own. Although Carlsberg-Tetley offers some degree of competition, we believe that its wholesaling and distribution operations have a higher unit cost than those of Interbrew or S&N. See paragraph 2.145.

2.179. Our analysis has led us to conclude that, while access to on-trade distribution continues to act as a barrier to entry and expansion in brewing, the development of retailer contracting in the on-trade, together with the expansion of the off-trade at the expense of the on-trade, suggest that distribution is of declining importance as a barrier to entry. See paragraph 2.148.

2.180. Nevertheless, following the merger, Interbrew and S&N would have the largest and most efficient wholesaling and distribution operations. While competing brewers may well be able to rely on the centralized wholesaling and distribution arrangements offered by some pubcos to access those pubcos, this will not enable entrants or smaller brewers to access either pubcos that do not offer such services or the independent free trade. We believe that for these customers, Interbrew and S&N would effectively control the route to market with a combined market share of approximately 59 per cent. See paragraph 2.149.

2.181. We have established that Interbrew price discriminates between different types of customers and the differences are only in part explained by differences in costs incurred. In particular, Interbrew offers more attractive prices to multiple retailers than it does to the

independent free trade or independent wholesalers. This has the effect of making the independent free trade less competitive with the multiple retailers than would be the case if the price differences were attributable only to cost differences. It also makes it difficult, if not impossible, for the independent wholesalers to compete for the business of the multiple retailers. Nor are they able to offer low prices to the free trade. We expect that the merger would enhance Interbrew's ability to price discriminate as a result of its increased market share and because some pubcos have access to distribution systems independent of the major brewers, whereas other retailers do not. See paragraph 2.158.

2.182. At the retail level, we consider that the supply agreements with the retained retail estates of Bass and Whitbread have been put in place as a measure to facilitate the severance of the vertical ownership links. They are of finite duration and, in due course, they offer other brewers the prospect of access to the Bass and Whitbread estates, access that did not exist when they were vertically integrated. See paragraph 2.166.

2.183. While there may be some inertia on the part of the estates when they are eventually free to purchase from other suppliers, we think such inertia can be overcome and other brewers will, in due course, be able to compete to supply the estates. See paragraph 2.167.

2.184. We think that in considering the effects of the merger, we should take into account both the ending of the vertical links between Bass Brewers and the Bass estate and the creation of the supply agreement. This will mean a limited enhancement of competitive pressures, for the reasons given in paragraphs 2.182 and 2.183, in the medium to longer term. However, given the small market share that is involved, we think that this effect would only go a small way towards compensating for the adverse effects on competition arising from the duopoly we have identified.

Adverse effects

2.185. For the reasons set out in paragraphs 2.169 to 2.184, we conclude that the merger would strengthen Interbrew's market position, resulting in an effective duopoly between Interbrew and S&N; it would enable Interbrew and S&N to dominate the route to market to many retailers; and it would enhance Interbrew's ability to price discriminate. We conclude that the merger would have the following adverse effects in Great Britain:

(a) raise net wholesale and, ultimately, retail prices;

(b) lead to increased non-price competition (in the form of advertising and marketing) resulting in increased barriers to entry and expansion and a somewhat greater degree of brand rationalization than would otherwise have been the case;

(c) allow Interbrew and S&N to promote their own brands at the expense of competing brands; and

(d) make the independent free trade and independent wholesalers less competitive.

Benefits of the merger

Views of Interbrew

2.186. Interbrew told us that it expected to achieve synergy benefits and cost savings amounting to approximately £[✂] million a year after four years by combining the businesses of WBC and Bass Brewers with its own international business (see paragraph 3.70 and Table 3.7). It assessed the cost of implementing these cost savings to be £[✂] million, mainly

incurred during the [✂] complete years of ownership of Bass Brewers (see paragraph 3.74.).

2.187. [

Details omitted. See note on page iv.

]

2.188. It also told us that the synergies generated by the merger would enable it to continue to offer competitive pricing to all channels without further erosion of already tight margins (see paragraph 5.222).

Our assessment

2.189. We note that Interbrew paid £[✂] million more for Bass Brewers than its own estimate of fair value and considered this a reasonable premium to pay in order to achieve the synergistic savings, which have a net present value of £[✂] million. The payment of this premium limits any beneficial effects that consumers would experience from those synergies even if Interbrew realized all the synergies that it claims are available. See paragraph 3.64.

2.190. In any case, the merger is likely to lead to Interbrew increasing prices and hence to raising rather than maintaining margins.

Public interest finding

2.191. For the reasons set out above, we find that the merger may be expected to operate against the public interest with the adverse effects to the public interest that we have specified in paragraph 2.185.

Remedies

2.192. In our Issues and Remedies Statement (see Appendix 2.2) we invited views on a range of possible structural and behavioural remedies. We also invited Interbrew to make an assessment of the ongoing regulatory costs associated with alternative remedies.

2.193. Interbrew's assessment may be found at Appendix 5.1. We note that most of the costs identified are those which Interbrew would incur if it were required to dispose of Bass Brewers or WBC. These are normal commercial risks implicit in Interbrew's decision to purchase Bass Brewers unconditionally, and which should be borne by shareholders. We do not regard such costs as relevant regulatory costs. For its part, the Office of Fair Trading did not anticipate any significant regulatory costs.

Behavioural remedies

2.194. We proposed three behavioural remedies:

(a) requirement not to discriminate in pricing, that is, to avoid differentials not justified by cost differences, as between sales to wholesalers and direct sales to retailers;

(b) requirement not to discriminate in pricing, that is, to avoid differentials not justified by cost differences, as between sales of Interbrew beers and sales of competitors' beers; and

(c) requirement not to engage in line forcing, that is, not to require, or induce through differential terms, the purchase of a full range of Interbrew products.

2.195. Almost all the third parties from whom we received evidence were of the view that these behavioural remedies would not of themselves be sufficient to remedy the public interest detriments and they would be difficult, if not impossible, to enforce. Interbrew was of the view that these remedies were unnecessary, they were impracticable and they would have perverse consequences (see paragraphs 5.247 to 5.253).

2.196. We too believe that these remedies would not remedy the public interest detriments and they would be difficult to enforce.

Structural remedies

2.197. We also proposed six structural remedies:

(a) divestment of the Bass Brewers business in its entirety; or possibly without its activities in Scotland and Northern Ireland;

(b) divestment of the Whitbread brewing business, either with or without the rights to the Stella Artois brand;

(c) divestment of such brands and associated brewing and wholesaling capacity as would enable the creation of a competitive fourth brewer-wholesaler;

(d) divestment of the wholesaling and distribution businesses of Bass Brewers and/or Whitbread;

(e) divestment of the Interbrew/Bass Brewers' interest in Tradeteam; and

(f) termination of the supply agreements with the retained estates of Bass and/or Whitbread.

2.198. We consider each in turn, beginning with termination of the supply agreements and ending with divestment of the Bass Brewers' business.

Termination of supply agreements

2.199. For the reasons set out in paragraph 2.168, we think it unlikely that the agreements will provide Interbrew with any particular advantage in terms of being able to compete more aggressively for other business in the medium to longer term. We do not, therefore, believe that this remedy would of itself address the adverse public interest effects that we have set out in paragraph 2.185.

Divestment of interest in Tradeteam

2.200. We see a number of drawbacks to this remedy, which lead us to conclude that it would not of itself address the adverse public interest effects. First, because Tradeteam is almost exclusively a distribution business, divestment would not address our concern that the merger would enable Interbrew and S&N to control the route to market, which depends upon their strength in wholesaling and distribution, not distribution alone. Second, Tradeteam is effectively dependent on the business of Bass Brewers (see paragraph 3.45), a situation that would not be altered by divestment. Third, we do not believe that divesting Tradeteam would convert it into a successful secondary distributor for pubcos or for other brewers; S&N owns its own distribution facilities outright, yet this has not stopped it from bidding successfully to provide secondary distribution to pubcos which have centralized their wholesaling and distribution services (see paragraph 4.73).

2.201. In addition, we believe that to require divestment would place Interbrew at a disadvantage to S&N, which has fully-integrated brewing, wholesaling and distribution functions. Finally, we note Interbrew's statement to us that it intends to alter its contractual relationship with Tradeteam in order to remove the anti-competitive effects described in paragraph 2.185 (see paragraph 5.244).

Divestment of the wholesaling and distribution businesses

2.202. We accept Interbrew's argument that wholesaling comprises a collection of integrated business functions and not a single separable business that could be sold (see paragraph 5.238). Moreover, we believe that it is the combination of the extensive portfolios of leading brands and the control over the route to market afforded by their wholesaling and distribution functions that brings about the adverse public interest effects described in paragraph 2.185.

Divestment of brands and associated brewing and wholesaling capacity

2.203. This remedy would involve divesting from the business of Bass Brewers a combination of brands, and brewing, wholesaling and distribution capacity, that would enable the creation of a fourth competitive brewer-wholesaler.

2.204. Interbrew told us that the sale of such a package was infeasible from both a financial and operational point of view, and would be tantamount to the sale of Bass Brewers in its entirety. As noted above, there was no wholesaling capacity per se that could be sold off in whole or in part within these assets. Furthermore, a clean split of these assets would not be feasible as there was significant interdependence among them. Any carve out would, as a result, have a detrimental and disruptive effect on the assets and on the public interest. See paragraph 5.236.

2.205. Referring specifically to a possible sale of Carling, Interbrew said that this was 'not practicable'. Production of Carling was inextricably bound to other Bass Brewers' operations. Given production schedules and the Bass Brewers' brewing system, Carling's disposal would

lead to such a level of disruption in the business, and such a significant loss of synergies that it would compel Interbrew to reassess its entire British strategy, and possibly require the sale of the entire Bass Brewers' business. The sale of Carling would reduce Interbrew to a 22 per cent market share and cause major operational disruption to the remaining assets that, without the benefit of the Bass retail estate, would be unlikely to remain profitable. See paragraph 5.236.

2.206. We accept Interbrew's arguments and believe that it would be extremely difficult successfully to divest a suitable combination of brands, brewing capacity, and wholesaling and distribution capacity in a manner that would not seriously damage Bass Brewers as a competitor. We also think it would be undesirable to attempt artificially to create a new business in this manner.

Interbrew's proposals

2.207. Interbrew told us that it was prepared to undertake that it would not close any breweries before 2003 and that it would maintain its current brand portfolio until 2003 (see paragraph 5.254). We do not believe that these would remedy the adverse effects we have identified.

Interim conclusion on remedies

2.208. In our view, the behavioural and structural remedies set out above would not, either individually or in combination, remedy the adverse effects we have identified. None of these remedies, where practicable, will remedy the situation in brewing that we believe will follow from the creation of what is effectively a brewing duopoly. This, in turn, means that we believe that there are no options short of divestment which would remedy the adverse effects of this merger. This leaves us, then, with two final structural remedies.

Divestment of WBC

2.209. We believe that for divestment of WBC to be an effective remedy, it would need to include the pre-merger licence rights with respect to Stella Artois, which ran until 2018, we were told, and which account for some [✂] per cent of the profits of the business. Without the rights to Stella Artois, WBC would not be a viable stand-alone business, nor would it be an attractive proposition for another brewer to purchase. Nor were we able to give brands to WBC from the portfolio of Bass Brewers that would compensate for the loss of Stella Artois. The divestment of WBC without Stella Artois would not, therefore, allay the adverse public interest effects.

2.210. Interbrew strongly opposes the sale of Stella Artois. It told us that one of the main drivers behind the acquisition of WBC was to regain control of the Stella Artois brand. Interbrew 'seriously values' the strategic and financial benefits of reuniting the UK rights to Stella Artois with those in the rest of the world. A forced sale would be such an extreme measure that Interbrew would be forced to reassess its strategy and investments in the UK market. See paragraph 5.234.

2.211. One of us, Mr Richmond, believes that there are advantages to Interbrew's ownership of Bass Brewers that arise from its commitment to local brands and its focus on brewing alone. He believes that the divestment of WBC with the rights to Stella Artois would be a sufficient remedy to the adverse public interest effects, subject to the following undertakings from Interbrew:

(a) the grant of a new licence for the rights to Stella Artois on similar terms and conditions to those pertaining prior to the merger with WBC; and

(b) that these rights will continue in the event of a future change of ownership of WBC during the period of the licence; and, furthermore,

(c) that any material changes in such rights will require the prior approval of the DGFT.

2.212. Mr Richmond believes that such a divestment would result in the following market structure in brewing: S&N with 26 per cent, Interbrew with 24 per cent, WBC with 10 per cent (assuming the loss of the Heineken brands; with the Heineken brands it would have 14.5 per cent), and Carlsberg-Tetley with 12 per cent. This would return the distribution of market shares to close to what they were before the merger. Subject to the Heineken and Murphy's licence arrangements, WBC would comprise three breweries, a distribution platform, and a supply agreement with Whitbread. This would make WBC a viable business and a strong competitor, in Mr Richmond's view.

2.213. In addition, Mr Richmond believes that WBC could be a possible merger or alliance partner for another international brewer seeking to develop a UK base, in which case it would become a more formidable competitor and this would render less effective a potential duopoly between Interbrew and S&N.

2.214. Three of us are not convinced that this would be a sufficient remedy. We are not convinced that any undertakings in respect of the Stella Artois licence would be effective. Moreover, without Stella Artois in its portfolio, Interbrew would be forced to develop another premium lager, possibly Grolsch. We do not believe that Interbrew would use a licensed brand (ie Grolsch) to compete actively with a brand that it owns but is licensed to a competitor (ie Stella Artois), and on which it was receiving a stream of royalties (see paragraph 3.20). We think separating the management of a brand from its ownership will undermine the long-term health of the brand in a market where the brand manager and owner are both operating and where brands are of increasing importance. Furthermore, we are concerned that Interbrew would use its position as owner of the Stella Artois brand to persuade WBC not to compete as vigorously against Grolsch as it otherwise might do. Finally, we believe that WBC on its own would be a weak competitive force (being very reliant on Stella Artois for sales and profits) and an unattractive platform for other brewers to use as a vehicle for large-scale entry into the market.

Disposal of Bass Brewers

2.215. Disposal of the Bass Brewers business in the UK is the final remedy that we considered. Three of us believe that Bass Brewers is a viable business that can be disposed of without complications. We also believe that there are a number of international brewers who would find it an attractive vehicle for entry or expansion in the UK. Further, disposal of Bass Brewers would leave Interbrew owning and managing its major brand and it would make WBC, owned by Interbrew, a stronger competitor than it would be as a stand-alone business.

2.216. Interbrew submitted that this remedy would leave a weakened WBC. In the absence of the ownership link to the Whitbread estate, or the support that could have been provided from the integration of WBC and Bass Brewers, WBC would be unable to support its many smaller, largely ale, brands. Interbrew would be left with no obvious strategy to pursue in the UK market. See paragraph 5.227.

2.217. On the possible remedy of divesting Bass Brewers without its activities in Scotland and Northern Ireland, Interbrew told us that this would be likely to lead to a decrease in brand diversity and a serious disruption of the regional business of Bass Brewers. In practice, a business that would sustain profits could not be created by dividing up the former Bass Brewers' assets in this way. See paragraph 5.228.

2.218. We think that it would be neither useful not practicable to divest Bass Brewers without its activities in Scotland and Northern Ireland.

2.219. Regarding the divestment of the entire UK business of Bass Brewers, the three of us considered whether it would be proportionate to require the disposal of what would amount to 75 per cent of Interbrew's business in the UK. We would have recommended another remedy, or combination of remedies, if we were satisfied that to do so would have remedied the adverse effects of the merger. However, we believe that no individual remedy, or combination of remedies, would have this effect. Accordingly, the majority recommend that Interbrew should be required to divest the UK business of Bass Brewers to a buyer approved by the DGFT.