

# Provisional findings report

## Proposed acquisition by Serviced Dispense Equipment Limited of the Technical Services Function of Coors Brewers Limited

### Contents

	<i>Page</i>
Provisional findings .....	2
1. The reference.....	2
2. The beer industry and the companies.....	2
The beer industry .....	2
The Four Brewers' Initiative .....	5
SDEL and the SDEL brewers .....	7
Coors .....	9
3. The proposed merger .....	9
History of the proposed merger .....	9
The structure of the proposed merger .....	10
The rationale for the proposed merger .....	14
Jurisdiction .....	16
4. Market definition.....	18
TSE .....	19
TS .....	23
TSE and TS—two interdependent markets .....	25
Conclusions on market definition.....	26
5. Assessment of the competitive effects of the proposed merger .....	26
Providers of TSE and TS .....	27
Underlying factors affecting rivalry in the relevant markets .....	29
Market shares .....	30
Existing features of the markets .....	31
Existing levels of competition in the market .....	39
Market entry and expansion in TSE and TS .....	43
TSE market .....	43
TS market.....	45
Counterfactual.....	49
Effects of the proposed merger.....	51
TS market.....	53
TSE market .....	59
Beer market.....	63
6. Provisional conclusions on SLC test.....	64

### Appendices:

- A: Terms of reference and conduct of inquiry
  - B: Market shares
  - C: Market definition
  - D: The FBI
  - E: Financial details of the transaction
  - F: Customer satisfaction and TS service levels
  - G: Cases of single sourcing of TS
- Glossary

## Provisional findings

### 1. The reference

- 1.1 On 29 September 2004 the Office of Fair Trading (OFT) referred the proposed acquisition by Serviced Dispense Equipment Limited (SDEL) of the Technical Services function of Coors Brewers Limited (Coors) to the Competition Commission (CC) for investigation and report. The reference was made under section 33(1) of the Enterprise Act 2002 (the Act). Our terms of reference are set out in Appendix A. We are required to publish our final report by 15 March 2005.
- 1.2 This document, together with its appendices, constitutes our provisional findings which we are required to notify to the parties (SDEL and Coors) under the CC's Rules of Procedure. Further information, including our Industry Background paper, non-sensitive versions of written submissions, summaries of third party arguments and views, the results of our buyer survey, and the results of our questionnaires to suppliers of Technical Services (TS) and Technical Services Equipment (TSE), can be found on our web site.<sup>1</sup> We refer to these documents as appropriate.

### 2. The beer industry and the companies

#### *The beer industry*

- 2.1 Around three-quarters of the beer sold in the UK is consumed in on-trade outlets (outlets), primarily in public houses (pubs), but also in other licensed premises including clubs and hotels. The remainder is sold at off-trade outlets, including off-licences and supermarkets. There are approximately 149,000<sup>2</sup> outlets including

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<sup>1</sup>[www.competition-commission.org.uk](http://www.competition-commission.org.uk).

<sup>2</sup>Includes all premises with on-licences including registered clubs: 113,370 on-licences and 19,913 registered clubs in England and Wales (DCMS Statistical Bulletin October 2004), 10,944 on-licences and 2,349 registered clubs in Scotland (Scottish Executive December 2003) and 2,238 on-licences and 584 registered clubs in Northern Ireland (Licensing Laws/Drugs Alcohol for 2000).

60,000 pubs in the UK. There has been a gradual decline in consumption in outlets over the past 20 years, with sales declining by 2 per cent in 2003.<sup>3</sup>

2.2 Historically the national brewers were vertically integrated: brewing beer, owning outlets, and owning and servicing the dispense equipment. Following the Monopolies and Mergers Commission's report into the supply of beer<sup>4</sup> and the implementation of the Beer Orders in the early 1990s, the vertically integrated market of the national brewers was broken down, leading to an increasingly free retail market and much higher levels of brand switching. More than three-quarters of beer is currently supplied by the four national brewers. They are Scottish Courage Limited (Scotco), Coors, Interbrew UK Limited (Interbrew) and Carlsberg UK Limited (Carlsberg). They no longer own any pubs,<sup>5</sup> but continue to own TSE and provide TS.

2.3 Pub companies (pubcos) were established principally through acquiring the tied and managed estates of the national brewers. There are currently approximately 70 large pubcos<sup>6</sup> which together operate 32,500 pubs, as well as many smaller pubcos. There has been significant consolidation of pubcos in recent years. The four largest are Enterprise Inns Plc (Enterprise Inns), Punch Taverns plc (Punch), Spirit Group Limited (Spirit) and Mitchells & Butlers plc (M&B). Together these four pubcos own more than 22,000 outlets.<sup>7</sup> Some of the pubcos' outlets have long-term beer supply agreements with particular brewers (legacy contracts), most of which date from the sale of the outlets by the national brewers. These legacy contracts are gradually coming to an end and it is estimated that contracts accounting for approximately

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<sup>3</sup>Interbrew UK Market Report 2004.

<sup>4</sup>*The Supply of Beer: a report on the supply of beer for retail sale in the United Kingdom*, HMSO, Cm 651, March 1989.

<sup>5</sup>The only exception is Scottish Courage which manages 1,100 pubs on behalf of the Royal Bank of Scotland and 364 pubs on behalf of Globe Pub Company.

<sup>6</sup>With more than 30 pubs.

<sup>7</sup>This includes the total outlets of the recently acquired Unique Pub Company by Enterprise Inns and Innspired by Punch.

20 per cent of on-trade sales will be coming up for renegotiation in the next couple of years.<sup>8</sup>

2.4 Pubs can be further classified as managed, tenanted or independent pubs. Managed pubs tend to be larger than tenanted pubs<sup>9</sup> and are owned and operated by a brewer or pubco, with the publican managing the pub on their behalf. Decisions on beer supply and associated equipment and servicing are often taken centrally. Tenanted pubs are run by a publican who leases the pub from a brewer or pubco. The publican has much more independence in decision-making. The two largest pubcos, Enterprise Inns and Punch, operate tenanted estates, whereas Spirit and M&B operate managed outlets. There are also many independent outlets.

2.5 The regional brewers (including, for example, Greene King PLC (Greene King) and Wolverhampton and Dudley Breweries PLC (W&DB)) generally remain vertically integrated, brewing beer, owning outlets, and owning and servicing their own beer dispense equipment. Regional brewers account for not more than 15 per cent of beer supply. Diageo Great Britain Ltd (Diageo) and Anheuser-Busch Europe Limited (Anheuser-Busch) have brands in many outlets (in particular, Guinness and Budweiser respectively), and own their own TSE and provide TS. Diageo services Guinness [✂] itself. The provision of TS to Budweiser TSE is outsourced to City Refrigeration Services (City) under a partnership arrangement.

2.6 TSE is the equipment used to dispense draught beer and cider at outlets. A distinction is commonly drawn in the trade between branded TSE, specific to the dispense of a particular brand, and generic TSE, which can be shared between

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<sup>8</sup>Interbrew UK Market Report 2004.

<sup>9</sup>Coors estimated that the average value of a tenanted outlet is one-third that of a managed outlet (£300,000 vs £1 million).

brands.<sup>10</sup> Brewers purchase TSE from a range of manufacturers, both national and international. TS comprises the installation, servicing (including maintenance and refurbishment), replacement and removal of TSE. TS activity is currently carried out by a combination of the brewers' in-house employees and a network of mainly local or regional subcontractors (see section 4 and Appendix C for further details).

2.7 For many years brewers have provided outlets with TSE, TS and distribution bundled into the price of a barrel of beer, a legacy of the integration of dispense and distribution with brewing. TSE and TS represent a small proportion<sup>11</sup> of the overall price of a barrel of beer to the retailer, and may have been perceived by some retailers to be provided free of charge. The national brewers, however, offer unbundled prices to the regional brewers, which in general provide their own generic TSE and TS, directly or through subcontractors.

2.8 The vertical disintegration described in paragraph 2.2 has led to the creation of new markets, as brewers have concentrated on their core business. They have been looking to cut costs in non-core activities, in part by outsourcing to specialist providers. This has already taken place in the provision of kegs (TrenStar) and to a more limited extent in distribution. The parties have told us that the proposed merger extends this principle to TSE and TS.

### ***The Four Brewers' Initiative***

2.9 The increased levels of brand switching which followed the Beer Orders and the divestment of pubs by the brewers caused problems arising from the transfer of

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<sup>10</sup>Generic TSE can also be subdivided into shared generic TSE (primarily the remote cooler and python) and non-shared generic TSE. Further details are set out in section 4.

<sup>11</sup>We estimated that the component represented by TSE and TS was less than 5 per cent of the price of a barrel of beer.

ownership of TSE. The Four Brewers' Initiative (FBI)<sup>12</sup> is an informal agreement which was set up in 1995 to reduce waste, recover asset value and minimize customer disruption when equipment was installed in an outlet or was transferred between the signatories. The current signatories to the FBI are the four national brewers and Constellation Europe Limited (Constellation). Under the FBI, the brewer with the majority of taps on the bar is identified as the 'principal supplier'.<sup>13</sup> The principal supplier owns the shared generic TSE and has the responsibility for servicing that TSE. If the principal supplier changes or brands are switched, Must Buy Must Sell (MBMS) arrangements ensure that generic TSE is sold to the incoming principal supplier or new brand owner at a standard price irrespective of age or condition. The principal supplier will also provide lines to secondary suppliers at an outlet for a one-off rental charge inclusive of service and maintenance of the generic shared TSE.<sup>14</sup>

2.10 The FBI Steering Group meets quarterly to discuss issues of common concern relating to the dispense of beer. Decision-making is by consensus. The FBI agreements set out the spirit of the arrangements and is driven by a common interest among its members in minimizing wastage. Industry practice extends the FBI principles to brewers/brand owners which are not members of the FBI through bilateral arrangements, although we were told that prices were generally at a premium to the MBMS rates. We have been told that membership of the FBI is open to other brewers but to date none have chosen to join. FBI members are free to withdraw from the FBI at any time should they wish to do so.

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<sup>12</sup>The Five (now Four) Brewers' Initiative was preceded by the 1994 Code of Practice.

<sup>13</sup>The concept of 'Cooler Python Owner' (the brewer with the most brands on the bar) is used in the latest FBI protocol and will normally equate to the 'principal supplier'. We continue to refer to the principal supplier in the remainder of this report.

<sup>14</sup>The fixed fee is £100 for another FBI member and is negotiated on a bilateral basis with independent brewers.

2.11 The FBI was investigated by the OFT in 2001 in the context of Chapter 1 of the Competition Act 1998. The OFT considered that it did not raise any significant competition issues.

2.12 Further details of the industry can be found in the Industry Background paper on the CC web site. Appendix D sets out more details on the FBI.

### ***SDEL and the SDEL brewers***

2.13 In November 2003, Serviced Dispense Equipment (Holdings) Limited (SDEH) was incorporated as a joint-venture company owned by Scotco, Carlsberg, Mordaunt & Foster Limited (M&F) and Hallriver Limited (Hallriver) (see paragraph 2.17). SDEL is a wholly-owned subsidiary of SDEH. On 7 April 2004 SDEL purchased the existing assets of Scotco and Carlsberg (the SDEL brewers) for the dispense of draught beer, cider and wine, as well as the SDEL brewers' TSE and TS business (including TS employees).<sup>15</sup> SDEL provides TSE and TS to the SDEL brewers under a ten-year rolling contract. The original merger was submitted for clearance to the OFT. The OFT did not believe that it would be expected to result in an SLC and therefore did not refer it to the CC.<sup>16</sup>

2.14 Under the original merger, the contractual relationship for the supply of TSE and TS remains between the SDEL brewers and the retailers as part of their beer supply arrangements. However, the SDEL brewers have entered into a ten-year rolling contract with SDEL for the provision of TSE and TS. The TSE assets transferred from the SDEL brewers to SDEL were valued at £140 million on 7 April 2004. SDEL

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<sup>15</sup>Innsolve has subcontracted the provision of TS back to the SDEL brewers pending the implementation of new IT systems.

<sup>16</sup>The OFT's decision on the first transaction (Anticipated merger of the Technical Services Divisions of Scottish Courage Limited and Carlsberg-Tetley Brewing Limited: The OFT's decision on reference under section 33 given on 24 March 2004) is given in more detail on its web site [www.of.gov.uk](http://www.of.gov.uk).

had a turnover of £[~~3~~] million in the first seven months of trading and made a minimal profit of £[~~3~~].

- 2.15 Scotco is wholly owned by Scottish & Newcastle plc (S&N), which is quoted on the London Stock Exchange. S&N, through its subsidiaries, brews and wholesales beer and other beverages in the UK and the rest of Europe. Scotco's main beer brands in the UK are Fosters (brewed under licence), Kronenbourg and John Smith's. It had the highest volume of sales in Great Britain in the on-trade sector in 2003, with a market share of 26 per cent.
- 2.16 Carlsberg is a wholly-owned subsidiary of Carlsberg UK Holdings plc, which is in turn a wholly-owned subsidiary of Carlsberg A/S. Carlsberg A/S is a Danish company quoted on the Copenhagen Stock Exchange. The core business of Carlsberg A/S is the production, sale and distribution of beer, but it is also active in the supply of soft drinks, wines and spirits. Carlsberg's main beer brands in the UK are Carlsberg, Holsten Pils and Tetley's. It had the fourth highest volume of sales in Great Britain in the on-trade sector in 2003, with a market share of 14 per cent.
- 2.17 SDEL subcontracted the provision of TS to Innserve Limited (Innserve) under a ten-year contract. Innserve was incorporated in 2003, and is a wholly-owned subsidiary of Innserve Holdings Limited (Innserve Holdings). Innserve's principal activity is to provide TS. Mr Michael Foster and Mr Nicholas Bryan are the directors of Innserve and the shareholders of Innserve Holdings. In addition, M&F is owned by Mr Foster and his wife, and Hallriver is controlled by Mr Bryan (see Figure 1).
- 2.18 Further details of the contractual relationships and charging mechanisms between the SDEL brewers, SDEL and Innserve are set out in paragraphs 3.5 to 3.12 and Appendix E.

## Coors

2.19 Coors is a subsidiary of Adolph Coors Company (ACC), a company incorporated in the USA and listed on the New York Stock Exchange. Coors is a brewer and wholesaler of beer and other beverages in the UK and elsewhere. In 2002, ACC entered the UK beer market by acquiring Carling Brewers (achieved through the acquisition of Bass Brewers Limited (Bass) after the hive off of certain parts of the business to Interbrew). Coors's main beer brands in the UK are Carling, Grolsch and Coors Fine Light Beer. It was second in terms of volume of sales in Great Britain in the on-trade sector in 2003 with a market share of 20 per cent. On 22 July 2004 ACC announced its intention to merge with Molson Inc, the Canadian brewer, subject to shareholder and regulatory approval.

2.20 Table 1 sets out some key financial data for Coors, Scotco and Carlsberg.

TABLE 1 **Brewers' summary financial data**

	<i>£ billion</i>		
	<i>Coors</i>	<i>Scotco</i>	<i>Carlsberg</i>
UK revenue	1.7	3.0	0.8
Worldwide revenue	3.3	5.0	4.5
Market capitalization (approx), December 2004	1.6	3.9	2.0
	<i>£ million</i>		
TSE assets	[	✂	]
Ingoing TS cost per year	[	✂	]

Source: Parties, company accounts and CC analysis.

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Note: Asset values based on SDEL valuation. US\$:£ exchange rate of 1.63; Danish krone:£ exchange rate of 10.7.

## 3. The proposed merger

### *History of the proposed merger*

3.1 We were told by Scotco that the SDEL/Innserve concept was originally discussed between [✂] and Scotco around three years ago. As discussed in paragraph 2.8, it was seen as the next logical step for the brewers in outsourcing or selling off non-core business to specialist operators. Scotco told us that it had considered a number

of alternative partners. All would have involved creating a similar business model, removing Scotco's TSE assets from its balance sheet and creating a specialist TS company. However, we note that Scotco chose to proceed with a deal between itself and another brewer, which enabled it to continue to exercise the greatest level of control over TSE and TS decisions, notwithstanding the strategic intention to divorce itself from non-core activities. We were told by Scotco that other parties, including prospective new (non-brewer) entrants, were considered at the time to have insufficient experience or commitment.

- 3.2 Scotco told us that it had chosen Carlsberg in preference to Coors in the first instance [REDACTED]. However, the SDEL brewers told us that it was envisaged from an early stage in the negotiations on the original merger that Coors might join at a later date.

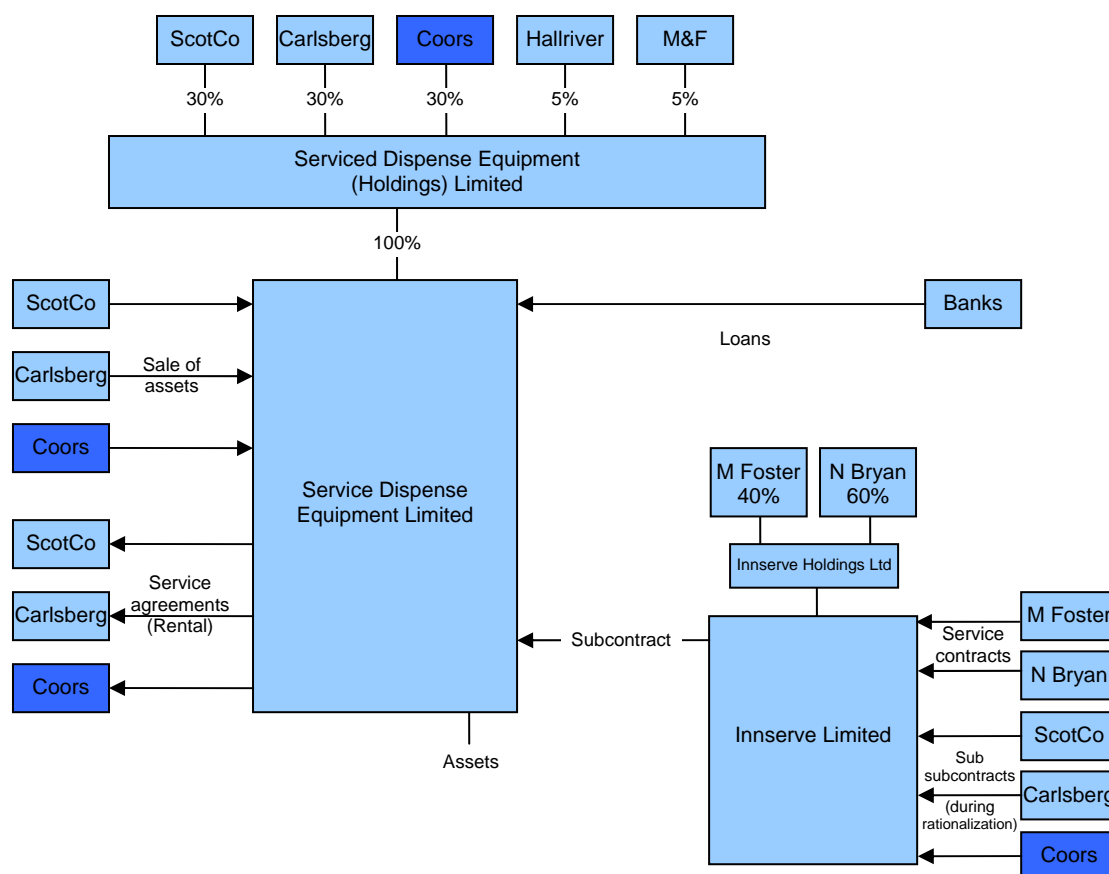
### ***The structure of the proposed merger***

- 3.3 Under the proposed merger, Coors would [REDACTED] a minority shareholding in SDEH. Coors's TS business, including its TSE assets, would be purchased by SDEL. SDEL would rent TSE assets to Coors, and would simultaneously enter into a ten-year rolling services agreement with Coors under the same terms as SDEL's agreements with the SDEL brewers. SDEL, as in the original merger, would subcontract the TS element to Innserv for a fixed ten-year period. Coors, like Scotco and Carlsberg, would continue to contract directly with the retailers for the provision of beer, usually bundled with the supply of TSE and TS.
- 3.4 On completion of the proposed merger, each of the SDEL brewers and Coors would own 30 per cent of the ordinary share capital of SDEH, with M&F and Hallriver each continuing to own 5 per cent. Thus the SDEL brewers/Coors would continue to have a 90 per cent share in the TSE-owning vehicle, with the remaining 10 per cent owned

by the ultimate owners of SDEL's service provider, Innserve. Dividends on any profit made<sup>17</sup> would be payable to the SDEL brewers/Coors through their ownership of preference shares, in proportion to their TS cost bases at the time of the purchase of their assets by SDEL (see Appendix E). The structure of the transaction is set out in Figure 1.

FIGURE 1

**The proposed transaction**



Source: Adapted from a submission from the parties.

3.5 SDEL will charge the SDEL brewers and Coors for TS and TSE as follows:

- (a) TS charges to SDEL from Innserve. The TS charges would be a fixed amount, adjusted for additions and deletions to the number of lines serviced by a

<sup>17</sup>The parties have told us that any profit in SDEL would be returned to its brewer shareholders in the form of a rebate on its charges and that they do not intend to pay any dividends.

variable amount of £[x] per line (indexed by RPIX) from [x], to cover the maintenance element. An agreed ratecard would be used for 'per event' TS work, including installations. (We note that, as at 30 December 2004, the ratecard had yet to be agreed, and it is therefore difficult to know the percentage of total TS costs that would be represented by ratecard charges.)

(b) TSE rental charges of [x] per cent for generic TSE and [x] per cent for branded TSE. These would represent the cost of depreciation of the TSE asset base,<sup>18</sup> together with a finance charge.

3.6 The current practice in the industry as set out in the FBI agreements is for the principal supplier to charge other brewers who have taps at an outlet a fixed one-off fee for access to a line which covers the rental and service of the shared generic TSE. Between the SDEL brewers (and in the proposed merger, between the SDEL brewers and Coors) this has been replaced by an annual charge based on the number of lines owned by each brewer. The charging mechanism between each of the SDEL brewers/Coors and the other FBI members (Interbrew and Constellation) would continue to be governed by FBI principles.<sup>19</sup>

3.7 The TSE rental charges will generate a sum of money each year which will allow SDEL to invest in new generic TSE. SDEL has in place contractual mechanisms to ensure that Innserve achieves the appropriate repair or replace decision, [x].

3.8 SDEL has adopted Scotco's capitalization and depreciation policies, and hence has locked in Scotco's asset valuation. Carlsberg's policies differed from Scotco's, primarily in relation to non-capitalization of labour costs, and this gave rise to a

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<sup>18</sup>Depreciation charge of [x] per cent per year of the current generic TSE and [x] per cent per year of the branded TSE asset bases.

<sup>19</sup>However, SDEL is not itself a signatory to the FBI agreements. Therefore SDEL would not be bound under the FBI arrangements by MBMS unless it chose to buy and sell its TSE under similar arrangements.

substantial (£[REDACTED] million) write-off in Carlsberg's accounts. Differences in capitalization and depreciation policies between Coors and SDEL would lead to a write-back in Coors's accounts (of approximately £[REDACTED] million). [REDACTED].<sup>20</sup>

3.9 Innserve would carry out TS on behalf of SDEL under an exclusive arrangement for the existing businesses of the SDEL brewers and Coors. Innserve cannot itself enter into any other contracts relating to the provision of TS on behalf of other brewers, but has told us that there is no restriction on TS being provided to other brewers by Innserve Holdings or any newly created affiliates of it. Indeed, Innserve told us that it envisaged Innserve Holdings achieving greater efficiencies and profits by providing similar services to other customers.

3.10 Service levels have been agreed between SDEL and Innserve (see Appendix F). If an agreed service level is not achieved for two consecutive quarters, Innserve can be fined; further breaches could result in termination of the contract if they were not rectified (see paragraph 5.84).

3.11 We note in general the close links and long-term nature of the contract between Innserve and SDEL. Innserve told us that whilst it had not sought ownership of TSE, it had been important to ensure some control over TSE decisions in order for it to run a successful TS business. Scotco, Carlsberg and Coors would each appoint a director to the board of SDEL, while M&F and Hallriver would jointly appoint a further director. M&F and Hallriver have appointed Mr Bryan as director, who is also a director of Innserve. Mr Bryan and Mr Foster control M&F and Hallriver, which have minority shareholdings in SDEH. They also control Innserve Holdings. The parties told us that the intention was for SDEL to have only one employee (a Finance

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<sup>20</sup>This was confirmed [REDACTED].

Director). As an asset-holding vehicle, SDEL is seen as a cash-flow-neutral entity which transfers any profits from the TSE/TS business to the SDEL brewers/Coors via reduced TS charges. Innserve's staff will carry out much of SDEL's day-to-day operational role, including purchasing of assets and inventory management. The original agreements also provided for representation of the SDEL brewers and Coors at meetings of the FBI as required.<sup>21</sup> We were told that Innserve would have around 35 members of staff working exclusively on SDEL-related TSE matters.

3.12 Innserve is committed, through its contract with SDEL, to achieving the overall levels of savings (see paragraph 3.17) agreed by all parties as a realistic objective of the proposed merger. Savings beyond the contracted levels would generate a profit for Innserve, which would be split [X] between Innserve Holdings and the SDEL brewers/Coors. We understand that it is the parties' intention that savings be passed on to the SDEL brewers/Coors via reduced TS charges.

3.13 Further details of the financial aspects of the deal, including charging mechanisms and depreciation policies, are set out in Appendix E.

### ***The rationale for the proposed merger***

3.14 The parties told us that the supply of TSE and TS was an important but non-core activity for brewers. Brewers' primary focus is competition in beer brands. They have therefore been looking to cut costs, in part through outsourcing non-core activities to specialist service providers (see paragraph 2.8). The proposed merger sees the addition of Coors's TSE and TS business to SDEL. The parties told us that it was expected to generate efficiencies and consequential cost savings for the SDEL

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<sup>21</sup>At a late stage in the inquiry the parties told us that the SDEL brewers/Coors would continue to represent themselves at FBI meetings.

brewers and Coors, which, we were told, would be to the ultimate benefit of the consumer.

3.15 The parties also told us that the pooling of TSE in SDEL would mean that a change of principal supplier or brand switching between SDEL brewers/Coors would not lead to a change in the ownership of shared generic TSE. This would provide SDEL with a greater incentive to make long-term investment decisions, generating benefits over time as replacement costs were reduced. There would also be a reduction in the level of inventories held, and possibly some rationalization of the TSE supplier base. The parties told us that controls built in to the service contracts between each of the SDEL brewers/Coors and SDEL, and between SDEL and Innserve, would ensure that quality was maintained in the provision of TSE and TS.

3.16 The parties told us of other benefits arising from the transfer of TSE assets to SDEL. First, TSE assets would be taken off the balance sheets of the SDEL brewers and Coors.<sup>22</sup> Second, there were cash-flow benefits to the SDEL brewers and Coors arising from the sales of their TSE assets at the agreed valuation, from deferred capital spending on new generic TSE assets, and from operational synergies. [X] In addition, the parties told us that the asset tracking system, which had been deficient in the past, will be much improved.<sup>23</sup>

3.17 The parties said that there were significant ongoing cost savings arising both from the original merger and especially from the addition of Coors, with net annual cost savings rising from £[X] million under the original merger to £[X] million under the proposed merger. This would more than offset the one-off costs of bringing the businesses together. The payback period improves from [X] months for the original

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<sup>22</sup>Coors told us that at least two brewers' assets must be pooled to meet US asset accounting rules.

merger to [X] months for the combined mergers. The savings would arise both from economies of scale and economies of density (resulting in more effective deployment of technicians) and savings in overheads. The addition of a third brewer would allow fixed costs to be spread over a greater volume of business.

### ***Jurisdiction***

3.18 Under section 33 of the Act, the CC is required to decide whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation qualifying for investigation. There are two considerations for determining whether there is a relevant merger situation:

- (a) whether two or more enterprises cease to be distinct; and
- (b) whether the turnover test or share of supply test is satisfied.

3.19 An enterprise is defined as the activities or part of the activities of a business carried on for gain or reward, or in the course of which goods or services are supplied other than free of charge.<sup>24</sup> Under the proposed transaction, Coors has agreed to sell and transfer its TSE and TS business to SDEL. The TSE and TS business<sup>25</sup> comprise the installation, repair, maintenance, refurbishment and removal of dispensing and in-line cooling equipment for beer, cider and other beverages in licensed on-trade premises, together with associated goodwill, technical services and operational assets, supplier contracts, business information and records. The transfer of the TSE and TS business also includes the transfer of those employees employed wholly or mainly by Coors in its TSE and TS business.<sup>26</sup> Therefore, for the purposes of the

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<sup>23</sup>Coors told us that asset tracking is particularly important given the US Sarbanes-Oxley Act 2002 regarding asset accounting.

<sup>24</sup>Section 129(1) of the Act.

<sup>25</sup>Definition of the TSE and TS business is set out in the Sale and Purchase Agreement between SDEL and Coors dated 2 August 2004.

<sup>26</sup>The employees are ultimately transferred to Innserve, which will have a contingent of about 35 staff dedicated solely to SDEL-related TSE matters.

Act, paragraph 3.18(a) is satisfied because Coors's TSE and TS business cease to be distinct from that of SDEL.

3.20 Under a proposed Shareholders' Agreement, Coors would subscribe for preference shares in SDEH, SDEL's holding company, and 30 per cent of SDEH's ordinary shares. Both Scotco and Carlsberg would also each hold 30 per cent of the ordinary shares of SDEH, having already transferred their respective TSE and TS business to SDEL (see paragraph 3.3).

3.21 Under a proposed Customer Services Agreement, Coors would appoint SDEL to be its exclusive provider of TS, including the provision of TSE, in Great Britain for a rolling period of ten years. Both Scotco and Carlsberg have previously entered into similar agreements with SDEL. The share of supply test is satisfied under the Act because the condition that at least one-quarter of both TSE and TS are to be supplied by one and the same person (TSE by SDEL, and TS by SDEL through a subcontracting arrangement with Innserve) in a substantial part of the UK (see paragraphs 5.11 to 5.15) will prevail to a greater extent as a result of the proposed merger. As noted in paragraph 3.11, SDEL and Innserve are closely linked, in terms both of structure and operation. We believe that the nature of the links between them is such that they cannot be understood other than as interdependent businesses. We have therefore taken the contractual arrangement between SDEL and Innserve into account in considering the proposed merger.

3.22 Since the share of supply test is met, we are not required to consider whether the turnover test is met.

3.23 For the reasons set out in paragraphs 3.19 to 3.22, we concluded that arrangements were in progress which, if carried into effect, would result in the creation of a relevant merger situation.

#### **4. Market definition**

4.1 We defined markets for the supply of TSE and TS. We did not formally define the market for the supply of draught beer, although we considered (in section 5) any possible competitive effects in the supply of draught beer to outlets arising from the links between the supply of TSE, TS and beer.

4.2 As stated in the CC's guidelines,<sup>27</sup> market definition is determined by the extent to which customers can readily switch between substitute products. We also took account of the ease with which suppliers could switch to supplying alternative products, although we were more likely to regard supply-side substitutes as being potential entrants unless switching costs were low and switching could take place within one year.

4.3 We used the underlying concept of the hypothetical monopolist test as far as possible in determining our market definition, although the standard test was particularly difficult to apply in this case for two reasons. First, identifying 'the price' of TS/TSE is relatively complex, since their prices are usually bundled with the price of beer. Second, because both TSE and TS are nascent markets, and many retailers had not thought about alternative suppliers, it might be difficult to obtain considered responses to specific switching questions such as those typically used in small but significant non-transitory increase in price (SSNIP) tests. Instead, we considered each product provided by the merging firms, narrowly defined, and assessed how

easily users could substitute between it and the most obvious alternatives. The results of our TS and TSE supplier questionnaires, as well as evidence from the parties, the SDEL brewers and third parties, contributed to our assessment.

- 4.4 We included all outlets in our definition of the markets for TSE and TS. Although some restaurants and hotels might be thought to be more likely than pubs to view bottled beer as a substitute for draught beer, we believed that the supply of draught beer was of some significance for almost all outlets, and hence all should be included in the market or markets. Beer was defined to include all draught ale, lager and cider, and to include both keg and cask beer.<sup>28</sup>

## **TSE**

- 4.5 The supply chain for TSE is shown in Figure 2. It encompasses three main activities: the manufacture of TSE; purchasing, financing and distribution of TSE (primarily by brewers); and end use of TSE in the outlet. Brewers interact both upstream with the TSE manufacturers and downstream with the outlets.

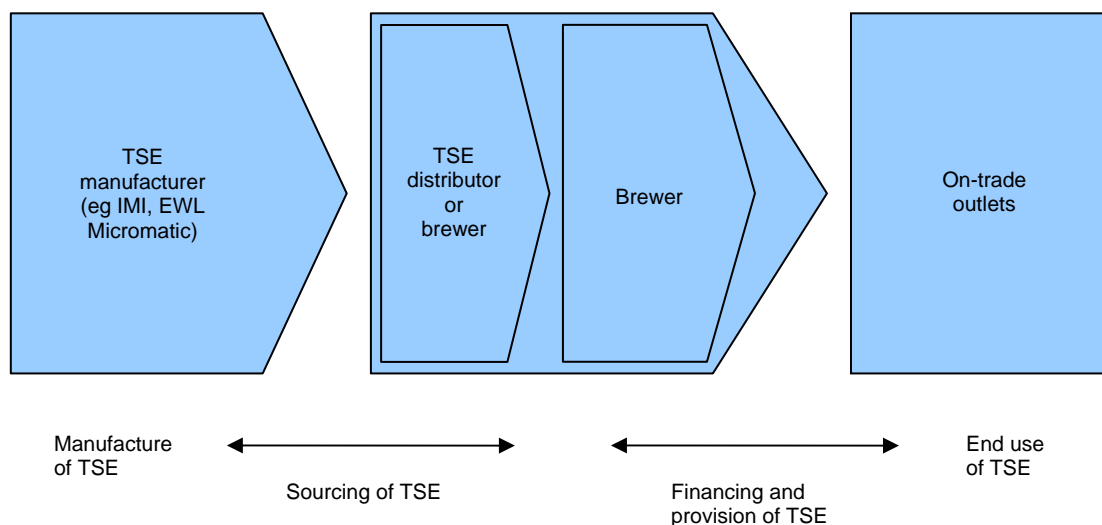
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<sup>27</sup>CC2—*Merger References: Competition Commission Guidelines*, June 2003.

<sup>28</sup>Equipment and servicing for draught wine was also included in the transaction. However, given the relatively small quantities involved, and the fact that in many cases draught wine is not dispensed using the same equipment, we have not considered it further in our report.

FIGURE 2

**Role of brewers in TSE value chain**



Source: CC.

4.6 The Brewing, Food & Beverage Industry Suppliers Association (BFBi) told us that there are two or three large international manufacturers of TSE,<sup>29</sup> which form the top tier of the market. The remaining firms are smaller companies operating within one or more product niches, forming the second and third tiers of the market. Many of the large international and national manufacturers provide a single source of TSE (and supply chain management) for brewers, sourcing components as appropriate. There are a large number of manufacturers of fonts, T-bars and keg fitting equipment; somewhat fewer manufacturers exist for product lines, pressure systems and gas control equipment. Some of the larger manufacturers have significant sales outside Great Britain, although the BFBi told us that around 80 per cent of the TSE used in outlets is manufactured in Great Britain. We were told that the UK and Ireland have unique dispense systems within Europe. The BFBi also told us that in general the smaller specialist manufacturers served the regional brewers, while the large companies tended to supply the national brewers.

- 4.7 Branded TSE may in some cases be specified jointly by a brewer and a manufacturer, and purchased exclusively from that manufacturer. Generic TSE is sourced more widely. [X] The brewers (or SDEL on their behalf) purchase the TSE, in some cases using distributors, and source, store, and distribute new and refurbished TSE.
- 4.8 The parties told us that the brewers were not active in the design and manufacture of generic TSE. They said that the brewers performed a purchase and financing function, and that the market should be defined as the market for the purchase and finance of generic TSE. In principle this role could also be carried out by leasing companies, and they told us that this meant that, given the possibility of supply-side substitution, the market should be considered to be wider than the purchasing and financing of generic TSE by brewers. However, we did not consider the identity of potential entrants to be relevant to our market definition.
- 4.9 We believed, however, that the current structure of the market was more a result of history than economic choice. There was no intrinsic reason why TSE manufacturers should not supply generic TSE directly to outlets as they do in some other European countries. We were also told that a few outlets in Great Britain owned their own generic TSE. Several third parties told us that, in the absence of the legacy of vertical integration, it would be more natural for outlets to own their own generic TSE and arrange for TS provision. The parties told us that one leading manufacturer [X] was conducting small-scale trials leasing generic TSE directly to outlets.
- 4.10 TSE refers to the equipment used in a pub or other on-trade outlet for the purpose of dispensing draught beer. TSE can be divided into two broad categories:

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<sup>29</sup> SDEL told us that there were at least ten large international manufacturers of TSE.

- (a) Generic TSE: can be used to dispense any brand of beer and hence is substitutable between different suppliers of beer. There are two types of generic TSE—shared generic TSE, consisting of a remote cooler and a python (enclosing beer lines), which tends to be built into the fabric of the building, and non-shared generic TSE, consisting of the equipment specific to a particular beer line, such as the pump and controller; and
- (b) Branded TSE: specific to the dispense of a particular brand. It includes the fonts that are visible on the counter top, as well as other equipment which may be used to differentiate the brand. It is always provided by the brewer.

See Appendix C for a list of TSE within each category.

4.11 Both generic and branded TSE are needed to dispense beer and we believe that both generic and branded TSE should be included in our TSE product market definition. In fact, all generic and branded TSE belonging to Coors is being transferred to SDEL.

4.12 We do not, on the other hand, think that TSE should include the equipment used to dispense soft drinks. The parties told us that some manufacturers<sup>30</sup> currently supply soft drinks dispense equipment as well as beer dispense equipment. However, the fact that a firm produces and sells two or more goods or services does not mean that they are in the same market. Whilst there were some similarities in dispense arrangements, there are significant differences between the product lines, cooling systems and pressure systems used for soft drinks and beer. Soft drinks dispense equipment mixes syrup with water and carbonates it. It is not a demand-side substitute for beer dispense equipment. This was confirmed by evidence received

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<sup>30</sup>For example [REDACTED].

from the major suppliers of soft drinks. Further details of the differences between dispense equipment for beer and soft drinks is set out in Appendix C.

4.13 Similarly, we have not included other cellar or kitchen equipment in the product market. Once again, the parties argued that supply-side substitution could take place by manufacturers currently supplying other cellar equipment and kitchen equipment.<sup>31</sup> However, we consider that this equipment is complementary in use to TSE rather than a substitute for it, when viewed from the demand side. The gas equipment used for carbonation and providing pressure for dispense also has particular safety requirements which call for specialized skills and equipment. Whilst the suppliers of this equipment might in principle have a platform for entry into the TSE supply market, this does not imply that they are in the same market. Since we do not believe that such switching could be done either swiftly or at minimal cost, we have not included these in the product market.

4.14 The parties told us that they did not own generic TSE in Northern Ireland. The BFBi told us that the TSE and methods used in Great Britain were unique in Europe, and although some suppliers were European-wide it was primarily a domestic market. We therefore concluded that the geographic scope of the supply of TSE was Great Britain.

## **TS**

4.15 The parties told us that TS is the on-site technical maintenance (excluding weekly cleaning),<sup>32</sup> repair, installation and replacement of TSE to outlets.

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<sup>31</sup>For example the parties said that [X] supplies air conditioning equipment for pubs, cellar cooling, gas valves and bottle cooling and [X] supplies ice making machines and stainless steel equipment for kitchens.

<sup>32</sup>Weekly cleaning is the responsibility of the publican.

- 4.16 We did not consider that the servicing of soft drinks dispense equipment should be included in the market. We believed that from a demand-side perspective, TS for soft drinks and TS for beer dispense were not substitutes. From a supply-side perspective, the parties told us that there were many firms<sup>33</sup> which already provided TS for both beer dispense and soft drinks dispense, and some current suppliers of other services such as gas installations either provided TS or were looking to enter the market. Third parties have said that, while the skills required were not dissimilar, the technical expertise required for servicing soft drinks equipment is somewhat different than for beer equipment. Moreover, switching from supplying TS for soft drinks to TS for beer would require some training, additional overhead, and equipment costs. In addition, one major soft drinks supplier told us that it also regarded TS for soft drinks as a non-core activity. We received no evidence to suggest that the suppliers of TS for soft drinks dispense were interested in expanding into TS for beer dispense. We therefore treated these companies as possible entrants rather than supply-side substitutes.
- 4.17 We had no evidence to suggest that other services, such as broader facilities management, formed part of the economic market, although companies active in these areas could be future entrants. As with companies involved in TS for soft drinks dispense equipment, such a transition would involve a certain amount of additional recruitment, training, overhead and equipment costs.
- 4.18 TS can be provided both by brewers and by third party TS providers. Brewers supply TS to outlets both through in-house resources and third party subcontractors. Although there are many small and regional suppliers of TS, they generally work exclusively as subcontractors to national brewers or to regional brewers, rather than

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<sup>33</sup>For example, City and Total Cellar Systems Ltd (TCS).

in competition with them. Contractual relationships are typically between the brewers and the pubcos for beer supply and do not involve these TS subcontractors as principals.

4.19 The parties told us that they did not carry out TS in Northern Ireland. We therefore concluded that the geographic scope of TS was Great Britain.

### ***TSE and TS—two interdependent markets***

4.20 Generally ownership of TSE and supply of TS remains in the hands of brewers, so outlets may reasonably regard their provision as a single service for beer dispense. Moreover, TSE and TS are not generally priced separately from each other or separately from the price of beer. Although this might suggest that TSE and TS form a single market, we believed that TSE and TS were two separate but interdependent markets for the following reasons:

- (a) the evolution of competition in the provision of TSE and TS has differed over time. A few large pubcos have negotiated separate contracts with third parties for TS supply. There is little evidence of TSE alone being contracted for and supplied separately from beer;
- (b) the original merger created separate, if linked, companies to deal with TSE and TS respectively. Prior to the creation of SDEL/Innserve, both TSE and TS were almost always supplied jointly by the brewers;
- (c) there is limited substitution between TSE and TS, although there is a choice to be made between replacing or repairing worn equipment; and
- (d) Despite the importance of TSE ownership, we heard evidence to suggest that third party TS providers were willing to contract directly with the retailer for the provision of TS and were prepared to carry out TS without owning the assets. We were told that this was a plausible business model if sufficient controls governing the terms of access to TSE were in place. The fact that brewers

have in the past been prepared to take on single supplier contracts also suggests that they were prepared to carry out TS on TSE owned by other brewers.

4.21 We therefore considered that TSE and TS were separate but interdependent markets, and the parties agreed. However, we did not believe that our analysis and conclusions on the proposed merger would differ substantially if we defined a single market for TSE/TS with two clear market segments.

### ***Conclusions on market definition***

4.22 We therefore concluded that the markets primarily affected by the proposed merger were two separate but interdependent markets for the supply of TSE and the supply of TS in Great Britain.

## **5. Assessment of the competitive effects of the proposed merger**

5.1 We are required under the Act to decide whether the proposed merger may be expected to result in an SLC within any market or markets in the UK for goods or services.<sup>34</sup> In this section we look at the competitive effects of the proposed merger having regard to our guidelines.<sup>35</sup> We first describe the other providers of TSE and TS, and then discuss factors affecting rivalry in the relevant markets, including market shares and existing features of the market. We then discuss the levels of existing competition in the relevant markets and the opportunities for market entry. Following a discussion of the counterfactual, we examine the competitive effects of the proposed merger. This leads to our conclusion as to whether we expect an SLC or SLCs as a result of the proposed merger.

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<sup>34</sup>Section 36(1)(b).

<sup>35</sup>CC2—*Merger References: Competition Commission Guidelines*, June 2003.

## **Providers of TSE and TS**

- 5.2 We outline here the other key providers of TSE and TS to retailers (see paragraphs 2.15, 2.16, 2.19 and Table 1 for a description of Scotco, Carlsberg and Coors respectively). Paragraphs 5.35 to 5.44 discuss in more detail the existing level of competition between these providers and the SDEL brewers/Coors.
- 5.3 Aside from the parties, the key providers of TSE and TS on a large scale fall into two categories:
- (a) Other owners of TSE who provide TS—including Interbrew, Diageo and the regional brewers; and
  - (b) Independent service providers—including City and TCS.
- 5.4 Most of the brewers or brand owners mentioned in paragraph 5.3(a) provide TSE and TS together with the supply of beer. In some cases Interbrew will act as principal supplier under the FBI and hence provide TS for the shared generic TSE.
- 5.5 In terms of the other brewers that own TSE but provide TS, the most significant is the fourth national brewer, Interbrew. Interbrew's parent company, InBev SA (InBev), is based in Leuven, Belgium and is publicly traded on EuroNext.<sup>36</sup> It is one of the leading global brewers with a net turnover of more than €7 billion. InBev has a portfolio of more than 200 brands, including its three global flagship brands Stella Artois, Brahma and Beck's.<sup>37</sup> In 2000 InBev (then known as Interbrew) acquired the Whitbread Beer Company and Bass thus starting Interbrew. Following the sale of Carling Brewers to Coors (see paragraph 2.19), Interbrew had the third largest

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<sup>36</sup>InBev was created in 2004 when Interbrew SA merged with Companhia de Bebidas das Américas (AmBev). Stichting Interbrew, a Dutch foundation that represents the Interbrew founding families and the shareholders of Bracos SA (the company that controlled AmBev), holds a substantial percentage of InBev shares.

<sup>37</sup>Beck's is distributed by Scotco in the UK.

volume of sales in the UK in on-trade outlets in 2003, with a market share of around 16 per cent.

5.6 Diageo was formed in 1997 following the merger of Guinness plc and Grand Metropolitan plc. Diageo completed its exit from the food business in December 2002, and is focused on beer, spirits and wine. In 2004 Diageo had worldwide sales of £6.6 billion and profits of £1.9 billion. It is listed on the New York and London stock exchanges. Diageo's major draught product in Great Britain is Guinness. It had the fifth largest volume of sales in the UK in 2003, with a market share of around 6 per cent. It provides TS and TSE to outlets with its brands (primarily Guinness). Coors told us that Diageo also provided TS and TSE to Heineken UK.

5.7 The largest regional brewer is W&DB. It produces a national brand—Marston's—and several regional brands such as Banks's and Mansfield. It has an estate of over 1,500 pubs. Two-thirds of these are tenancies or leases within The Union Pub Company trading division, with the remaining third directly managed by W&DB's retail arm (Pathfinder Pubs). It provides TSE and TS to its own estate of vertically integrated pubs either directly or through subcontractors. Other major vertically integrated regional brewers include Greene King and Fuller's.

5.8 There are many TS providers that do not own TSE. However, as described in paragraph 4.18, the vast majority act exclusively as subcontractors to one or more brewers and are regionally based. The parties provided a list of 18 of the largest TS subcontractors. City was the only national player, providing TS both as a subcontractor and as an independent contracting directly with retailers. It does not own the TSE it services. The parties told us that the second and third largest TS providers were Total Cellar Systems Ltd (TCS) and DJ's Refrigeration and Air

Conditioning, which both only operated in a number of UK regions. Eight of the 18 largest TS subcontractors only operated in one region.

5.9 City is a family-owned business which was started in 1985 by Mr Willie Haughey and his wife Susan providing TS to pubs and clubs in Scotland and the North-East. In 1997 the company won a contract to provide facilities management services to some ASDA stores and became a more broadly based facilities management company. City now has 10,500 employees and made a profit of £11 million in the last financial year. It employs around 200 TS engineers, and offers a national service, primarily as a sub-contractor to the national brewers, but also has independent contracts (particularly with Spirit Group, see Appendix G).

5.10 TCS was formed 16 years ago and now provides a complete range of cellar services, including TS for soft drinks. It offered national coverage for about three years but in 2003 it ceased operations in London and the South-East and in 2004 it withdrew from Scotland. It employs around 110 technicians and has an annual turnover of approximately £[redacted] million. Between 85 and 90 per cent of its business is as a subcontractor to the parties to the proposed merger, and it told us that, although in the past it had contracted directly with the pubcos, it was now primarily interested in subcontract work.

### ***Underlying factors affecting rivalry in the relevant markets***

5.11 We first considered market shares in the TSE and TS markets. We then looked at several existing features of the market unrelated to, but not necessarily unaffected by, the proposed merger, which might affect competition. These included issues of pricing, ownership of assets, switching costs, asset valuation and customer inertia.

## *Market shares*

- 5.12 We cannot measure market shares directly for TS and TSE, because their prices are virtually always bundled with that of beer and in consequence there are no separately identifiable revenue streams associated with each. We have used proxies to estimate the size of each of the TS and TSE markets as described below. Appendix B sets out further details of our calculations of market share.
- 5.13 Given the links between TS, TSE and beer, we looked at the market share of beer supply. The SDEL brewers have about 40 per cent by volume of the on-trade draught beer market, which would rise to around 60 per cent for the SDEL brewers/Coors as a result of the proposed merger. The next largest beer supplier was Interbrew, with a 16 per cent market share in 2003, followed by Diageo with 6 per cent. We did not regard these as good estimates of TS and TSE market shares. However, at a late stage in the inquiry, the parties provided us with a calculation of their TS market share based on the total beer sales for which the SDEL brewers (together with Coors following the proposed merger) have TS responsibility. This produced a market share of 30 to 35 per cent for SDEL, rising to 50 to 55 per cent following the proposed merger.
- 5.14 We chose to estimate TS market share by looking at the share of the installed base of TSE which the SDEL brewers would be responsible for servicing. In the majority of cases, brewers are responsible for servicing the TSE that they own. Because of occasional differences between the shares of TSE ownership and servicing,<sup>38</sup> this should be viewed as an approximate measure. Based on our conservative assumptions, the market share by value for SDEL is 40 per cent of the installed base, rising to 52 to 57 per cent with the addition of Coors. This was broadly in line with

the parties' calculation based on their estimated beer sales supported by TS (see Appendix B for further details).

5.15 We measured TSE market shares by looking at the annual churn in the installed base of TSE, which must be replaced either by new purchases from manufacturers, or by refurbishments. We compared the actual annual TSE purchases by the SDEL brewers and Coors to this annual churn. According to this calculation, SDEL had a market share of 30 to 35 per cent, rising to 55 to 60 per cent with the addition of Coors.<sup>39</sup>

5.16 Overall, we considered that prior to the proposed merger SDEL had much the largest share of both the TS and TSE markets (30 to 40 per cent). Coors, the next largest TSE and TS provider prior to the proposed merger, would increase SDEL's market share by around 15 percentage points for TS, and 25 to 30 percentage points for TSE, leaving SDEL several times larger than the next largest TS and TSE providers. While none of these estimates give a precise measure of market shares, the various different measures that we considered produced broadly similar results. We noted that, given that almost all regional brewers carry out TS in-house and own their own TSE, this could well be an underestimate of SDEL's share of the market in which SDEL/Innserve operates.

### *Existing features of the markets*

5.17 It is important to note that the markets for independent supply of both TSE and TS are very much in their infancy, particularly in the case of TSE. The consequences of the vertical separation of the national brewers have, to some extent, yet to work

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<sup>38</sup>These differences occur primarily when the retailer has single supplier arrangements for TS in place, either through a third party service provider or one of the national brewers.

<sup>39</sup>The parties' TSE market shares are based on a single year's data on purchases and refurbishments of TSE, and may be distorted by particular products launches and other one-off factors (see Appendix B for further details).

through the industry, and brewers still provide almost all<sup>40</sup> of the branded and generic TSE to outlets. The parties told us that there is currently no demand for the provision of generic TSE independent of the supply of beer, and hence there is no existing competition in the TSE market. However, some pubcos have expressed an interest in acquiring their generic TSE assets provided this could be done at a reasonable cost: 7 per cent of respondents to our buyer survey, and 28 per cent of the large buying groups<sup>41</sup>, said that they had considered buying shared generic TSE. Similarly, 4 per cent of respondents to our buyer survey, and 29 per cent of the large buying groups, said that they had considered sourcing TS independently.

5.18 Although a market for TS in particular is slowly starting to emerge (see paragraphs 5.35 to 5.44), we believed that competition in both TSE and TS is currently limited by existing features of the market that have an effect on the levels of competition, independent of the proposed merger:

- (a) bundled pricing of TSE and TS with beer supply;
- (b) interdependency of TSE and TS;
- (c) switching costs associated with TSE;
- (d) valuation of TSE; and
- (e) customer inertia.

*Bundled pricing of TSE and TS with beer supply*

5.19 TSE and TS prices are usually bundled into the price of a barrel of beer. Prices may also include other beer-related services, including distribution. The parties told us that although brewers publish a wholesale beer price, almost all retailers receive some discount off the wholesale price. Discounts vary widely by retailer. We were

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<sup>40</sup>This was the case for 92 per cent of respondents to our buyer survey.

<sup>41</sup>Buyers for multiple outlets

told that some retailers may pay twice as much per barrel of beer than others,<sup>42</sup> depending on a range of factors, including the volume of beer sold, the exclusivity of any supply arrangements and the number of outlets and type of outlets at which the beer will be served. In some cases, retrospective discounts are granted if the retailer meets certain conditions, usually related to volume of sales.

5.20 Pricing in the beer market is opaque. Although the wholesale price is known, actual prices depend on the outcomes of bilateral negotiations which are not made public. In addition, bundled pricing makes it difficult for the retailer to know the element of the price associated with TSE and TS provision. Further, given the bundled pricing, brewers have a flexibility in price negotiations to price strategically that is not available to a third party provider of TSE or TS.

5.21 Another feature of bundled pricing is that TSE and TS costs are included in the per barrel price of beer. These are not necessarily cost-reflective, since costs reflect the number and nature of the beer lines supplied and serviced as well as the volume of throughput. Several third parties did not know the element of the price per barrel which might relate to TS and TSE. Of those that did, estimates ranged from £4 to £8 per barrel, including £2 to £3 for TSE. This would comprise the cost of labour, replacement parts, the provision of the necessary infrastructure (eg call centre, planning and scheduling), TSE and, possibly, some element of profit. For TSE, the price per barrel includes a depreciation charge to cover the cost of equipment and a financing charge. A national brewer [X] estimated the value of TSE/TS at £6–9 per barrel, split roughly 50:50 between the two. A TS provider [X] told us that the benchmark cost of TSE/TS was about £10, of which about £4.50 was related to maintenance. In reality, however, the parties told us that the price per barrel of beer

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<sup>42</sup>This was supported by the respondents to our buyer survey who indicated that the average discount for the independent free

is the subject of commercial negotiation in which neither the price of TSE/TS nor the cost of provision is likely to be discussed explicitly. The uncertainty regarding the TSE/TS element of the price of a barrel of beer illustrates the lack of transparency in the markets.

5.22 Price unbundling would be critical to the likely success of any alternative arrangements that the retailers may wish to make for the separate provision of TSE or TS. Such arrangements will depend in part on the ability of the retailer to obtain an appropriate discount off the price of a barrel of beer from the brewers that is at least sufficient to meet the cost of an alternative TSE or TS provider. When unbundled pricing has been agreed in the past, discounts reflecting the fact that TS was no longer being provided varied from £[redacted] to £[redacted] per barrel (see Appendix G for more details). It is not clear whether the agreed discounts reflect the marginal or average costs to the brewer of not providing TS for a particular outlet, nor how they are related to the amounts shown in paragraph 5.21. One of the national brewers provided us with estimates of £[redacted] as a marginal cost and £[redacted] as an average cost for the provision of TS servicing. In addition, the SDEL brewers/Coors provided us with calculations of their avoidable TS costs per barrel, which were again somewhat lower than the total cost figures shown in paragraph 5.21.<sup>43</sup>

5.23 We heard conflicting evidence from parties as to whether there is an increased trend towards unbundling. Around one in five of the respondents to our buyer survey indicated that they had obtained unbundled TSE and TS prices in the past five years, although it was unclear how significant this was in practice and how much independent provision of TS took place as a consequence. We considered it likely that as pubcos look more carefully at their costs, they would continue to press for

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trade was around 30 per cent, rising to nearer 65 per cent for the large buying groups.

<sup>43</sup>[redacted] for Scotco, [redacted] for Carlsberg and [redacted] for Coors, after revision.

unbundled prices provided there were credible alternative providers of TSE and TS. We discuss in paragraph 5.80 the likely impact of the proposed merger on the SDEL brewers/Coors's responses to requests for unbundled prices.

*Interdependency of TSE and TS*

- 5.24 Second, as described in paragraphs 4.20 to 4.21, although we have defined TSE and TS as separate markets, they are interdependent. Repair or replace decisions that need to be taken daily inevitably create tensions when ownership and servicing are in different hands. Given the continuing ownership of TSE by SDEL or the brewers, this in principle creates difficulties for an independent provider of TS. The SDEL brewers/Coors have recognized this difficulty and are in the process of drafting a protocol for access to assets by independent TS providers.
- 5.25 In addition, more detailed 'rules of engagement' are likely to be required for a third party TS provider requiring access to TSE in order to service it. Such rules would also need to be acceptable to the retailer. The intrinsic difficulties of separate ownership mean that the success of third party TS provision would depend not only on a clear set of TSE access rules, but also on goodwill and cooperation. 51 per cent of respondents to our buyer survey thought that the owners of shared generic TSE were able to prevent independent servicing. In our TS questionnaire, 33 per cent of respondents who had carried out independent servicing work had found access to shared generic brewer-owned TSE difficult while 40 per cent found access to branded and non-shared generic TSE difficult. Whatever the extent of the difficulties encountered in practice, it seems clear that access to brewer-owned TSE is widely perceived in the industry to be an issue.
- 5.26 The two most significant examples of separate provision of TS by an independent contractor are Punch's and Spirit's experiences in subcontracting TS provision to

City. In the case of Punch, whose outlets are tenanted, the difficulties it experienced resulted in TS provision returning to the brewer after about a year. We were told that Punch did not obtain a sufficient discount on the price of a barrel of beer, and there was uncertainty over City's likely servicing costs for a new, large customer. In addition, there were no working agreements put in place between the retailer, the brewer-owners of TSE [X], and the independent TS provider (City) about, for example, rights of access, repair or replace decisions and labour costs. This appeared to have contributed to difficulties in day-to-day operations, with delays in getting expenditure approval and payment of accounts. We were told that the effects on Punch were particularly serious in the hot summer of 2003, and resulted, at its peak, in beer being unavailable in up to 300 outlets. We were told that the brewer concerned had insisted on a level of verification and documentation that the TS supplier found burdensome and costly in practice.

- 5.27 Although Spirit, which operates a managed estate, had a more successful experience of third party provision of TS with City, which continues today, we were told that this has not been straightforward, that it was costly to set up and remains costly to maintain. [X] Further details of both of these examples are set out in Appendix G.

*Switching costs associated with TSE*

- 5.28 Third, there are significant switching costs associated with replacing generic TSE. Generic TSE is often integrated into the structure of the outlet, with pythons and lines running through the floors and walls. Installing new generic TSE would therefore be likely to involve closing the outlet for at least a couple of days. Whilst changes of ownership between the national brewers are generally covered by the MBMS arrangements of the FBI (or largely similar arrangements for brewers which are not members of the FBI), if a retailer were looking for a change of ownership of TSE

away from SDEL (either by sale to a TSE manufacturer, a financing house, independent service provider or ownership by the retailer), these switching costs mean that the retailer would need to reach an agreement with the owner of the generic TSE (either a brewer or SDEL) to sell at a price reflecting the current economic value of the assets in place (not necessarily reflected by the rates paid by non-FBI members). This might be complicated by what were described to us as the lack of detailed records on the age and state of assets. Even when SDEL has a complete and accurate asset register, [✂]. A potential buyer would be reluctant to buy a set of generic TSE assets unless he could be satisfied that the total valuation adequately reflected their age and condition.

#### *Valuation of TSE*

- 5.29 Fourth, the national brewers have told us of some significant differences in the way that assets are valued in their books, relating to depreciation lives, and the capitalization of labour costs. These differences, combined with the lack of transparency, might make it more difficult for the TSE assets to be valued and therefore sold. (See paragraph 5.28 and paragraphs 5.49 to 5.49.)

#### *Customer inertia*

- 5.30 Finally, we note from the responses to our buyer survey that there is a relatively high level of inertia in the markets for TSE and TS. Only 16 per cent of respondents said that they had changed their main supplier in the previous three years. Around three-quarters of respondents felt that they had no options to change their TSE or TS provider.
- 5.31 We have identified two causes for this inertia. The first is suggested by our buyer survey which showed that around 95 per cent of respondents were satisfied or very satisfied with their current TSE and TS provision. This may in part be influenced by

the perception of many publicans that TSE/TS are provided free of charge. Theoretically pubcos might switch the brewer designated as the principal supplier without changing brands<sup>44</sup> in order to change the shared generic TSE and TS providers. However, the parties told us that this seldom, if ever, happened in practice, and any switching was likely to be led by a change in beer brands. A change in beer brands was an important commercial decision for an outlet and was much more likely to be driven by factors other than the price and quality of TSE and TS provision.

5.32 The second cause of market inertia is the fact that the markets for TSE and TS are only just emerging. The pubcos are consolidating and considering how best to use their position to make effective TSE/TS purchasing decisions. Many of them are now publicly quoted companies with professional management teams in place who are looking at all areas of cost control. We expect them to become more demanding in the future (see paragraph 5.23).

5.33 Our view is that many retailers will not consider switching without plausible alternatives being readily to hand since the cost of inadequate provision of TSE/TS will outweigh any potential savings. The nascent state of the TSE and TS markets might therefore explain in part why so many respondents to our survey considered that they were satisfied with their existing TSE/TS provision and had not, apparently, considered switching. As the market develops, so would the willingness to use it. We also took into account evidence from some of the professionally managed pubcos that there were shortcomings in the level of service provided as well as a lack of flexibility in dealing with non-standard requests for TSE and TS, which have led some of them to look for independent TS provision.

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<sup>44</sup>An option that is allowed for in the FBI.

5.34 In summary, we consider the TSE and TS markets to be only just emerging, particularly in the case of TSE provision and ownership. We believe that the development of these markets has been hindered by some or all of the features of the market set out in paragraphs 5.18. These features of the market are not a result of the proposed merger. We have been careful, however, to avoid attributing to the proposed merger the impact of any existing market features on the competitiveness of the market. However, in examining the effects of the proposed merger, we have considered, among other things, the impact of the proposed merger on these existing features of the market.

### ***Existing levels of competition in the market***

5.35 We consider that there are, at least in theory, both direct and indirect mechanisms through which retailers can choose their TSE and TS provider.

5.36 The indirect mechanism occurs through the retailer influencing which brewer is principal supplier and hence supplies the shared generic TSE and provides associated TS in their outlet or outlets. As set out in paragraph 5.31, this could occur in two ways—first through a change in beer brands leading to a change in the supplier of shared generic TSE and associated TS through the operation of the FBI and, second, through the outlet opting to switch the brewer designated as principal supplier despite not having changed beer brands. We recognize that the choice of principal supplier will be driven primarily by beer supply issues, and we were told that whilst retailers theoretically had the choice of principal supplier, this was rarely, if ever, exercised in practice. Several third parties [redacted] told us, however, that competition between principal suppliers for the provision of the bundled product, including TSE and TS, offers the retailer an element of choice, in that TSE/TS pricing and supply issues could be taken into account in purchasing decisions. Some of the pubcos have also told us that they have used this negotiating power to keep prices

down and quality standards up for both TSE and TS. In addition, 10 per cent of respondents to our buyer survey saw a change in brewer as their best alternative to current supply arrangements for TSE (7 per cent for TS<sup>45</sup>).

5.37 Overall, however, the levels of inertia set out in paragraph 5.30, combined with the bundled pricing and interdependency between TSE and TS, suggest that this indirect mechanism is not very active, particularly for TSE. It may also be less applicable to independent pubs and outlets with lower throughput.

5.38 Retailers can contract directly with independent providers, or choose to provide the TSE or TS themselves. About 20 per cent of respondents to our buyer survey thought that they had alternative options for their TSE and/or TS provision, with about half of the larger buyer groups believing that they had alternatives. In the case of TS, there has in the past been competition, not only from third party service providers, but also from one or two of the brewers (Coors in particular) which were prepared to offer a 'single supplier' contract to provide TS for TSE not necessarily supplied by that brewer. Such single supplier contracts are attractive to pubcos, which benefit from the simplicity of a single number to call and a single invoice to pay. It also means fewer call-outs overall, since the same technician can fix whatever difficulties arise.

5.39 The parties have told us of several occasions on which retailers have sought to arrange single supplier contracts with one of the brewers (see Appendix G). However, we have been told that neither Coors nor Interbrew wish to offer single supplier contracts any longer, and will only provide TSE and TS associated with the supply of beer. At least in the case of Coors, this would appear to be a recent

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<sup>45</sup>This increased to 21 per cent for the large buying groups (with an average of 267 outlets each).

change of strategy. We received no evidence to suggest that the regional brewers generally saw TSE/TS provision outside their own estate as core business.

5.40 Direct competition in the TS market today and in the near future is therefore effectively limited to third party TS providers, which may provide not only a single supplier contract for beer dispense, but also a more widely based 'one-stop shop', including, for example, the servicing of soft drinks dispense equipment. There are many third parties which provide TS, and all the national brewers use a network of third party TS providers to complement their in-house staff, especially for non-routine work (installations and out-of-hours calls). The two best-known examples to date of a retailer contracting directly with a third party for the supply of TS are Spirit's and Punch's contracts with City (see paragraph 5.25). Several third parties have told us that the negative experience of Punch and City was likely to discourage retailers in future from seeking to contract directly with third parties.

5.41 In terms of existing competition, City is the strongest competitor to the brewers and SDEL for the provision of TS. It is a national TS provider, for whom TS represents a relatively small share of its business, and it can provide a wide service offering covering not only TSE but also soft drinks dispense equipment and broader facilities management. However, although City might well be regarded as an independent TS provider in the market, very few other third parties can claim to be truly independent of the national brewers and SDEL, since the vast majority of their business is performed under subcontracts to the national brewers. We believe that only City, and possibly TCS, have the credibility to tender for the provision of an independent service to a large retailer. For many regional TS providers, their dependence on subcontract work from the national brewers could make them unwilling to threaten their existing business by entering into head to head competition to provide TS to retailers.

- 5.42 In the TSE market, we have seen less evidence of direct competition than in the TS market. We have been told that one or two retailers have entered into small-scale trial arrangements with a major equipment provider [redacted] to supply them with generic TSE. However, we were told that none of these arrangements has, after several years, resulted in a substantive contract. City told us that had it been able to acquire the TSE assets alongside the TS provision in the case of Punch, the contract might have been successful, although it is not clear that City requested such a purchase.
- 5.43 As an alternative, retailers could seek to buy their generic TSE assets from SDEL or the brewers, or install their own generic TSE assets. Traditionally, the TSE assets have always been owned by the brewers, and many retailers still see them as provided free of charge. The SDEL brewers have told us that they would be willing to arrange for SDEL to sell its generic TSE at a fair market value to the retailers (or to other entrants, including the retailer's independent TS provider or a third party leasing company). However, there remains a difficulty in agreeing such a 'fair market value' given the absence of any benchmark transactions (see paragraphs 5.24 and 5.29). Furthermore, as mentioned previously, [redacted]. In addition, some third parties told us that some of the pubcos would not currently be in a position to fund such an acquisition, which might amount to over £5,000 per outlet, since they were relatively highly geared. In any case, retailers might be reluctant to incur the cost, for an uncertain improvement in dispense quality, as it would not be easy to demonstrate a satisfactory rate of return that would flow from the acquisition of TSE given the current opacity of bundled pricing.
- 5.44 In summary, as set out in paragraphs 5.35 to 5.43, we consider that the indirect mechanism for competition is relatively weak in both the TSE and TS markets. There is little direct competition in the TSE market, but more history of direct competition from third party providers in the TS market. However, it is important to note that as

these two markets emerge and develop, and despite the features of the market set out in paragraph 5.18, we would expect levels of competition to increase in the future in the absence of the proposed merger, particularly in the TS market.

### ***Market entry and expansion in TSE and TS***

5.45 We next address market entry and expansion in TSE and TS. This is of particular relevance to the proposed merger because the nascent nature of the two markets means that the future competitiveness of these markets will be driven in part by how fully and quickly they are populated, and by whom. We first address existing barriers to entry. We return later to the impact of the proposed merger on barriers to entry.

#### *TSE market*

5.46 We described the TSE market in paragraphs 4.5 to 4.14. We have focused our analysis of entry on the procurement and provision of generic TSE to outlets. The brewers are active in the procurement and provision of TSE, and the merger impacts primarily generic rather than branded TSE.

5.47 Entry could occur either through the provision of generic TSE alone or in conjunction with the provision of TS. We have identified a number of different mechanisms for entry into the supply of generic TSE to retailers, with or without the provision of TS:

- (a) self-supply by retailers (ie retailers purchasing their own generic TSE);
- (b) retailers leasing generic TSE through finance companies;
- (c) provision of generic TSE direct to retailers by TSE manufacturers, possibly linked to TS provision (with the manufacturers retaining ownership of generic TSE);
- (d) purchase and supply of generic TSE by TS provider or other third party; or
- (e) creation of a non-brewer or brewer joint venture (JV) (similar to SDEL/Innserve) to supply and service generic TSE.

5.48 In principle, we regard all of these entry mechanisms as credible alternatives. We have discussed all mechanisms other than option (b) elsewhere in the report (see paragraphs 5.42 for (c) and (d), paragraph 5.43 for (a), and paragraphs 5.53 and 5.56 for (e)). With regard to (b), the parties told us that brewers and SDEL performed a purchasing and finance function for TSE which would be straightforward for a number of leasing companies to carry out, implying that barriers to entry in the provision of TSE to outlets were insignificant. One of the SDEL brewers [REDACTED] told us that a finance leasing company [REDACTED] had expressed interest in entering the market via a leasing arrangement with the brewers, and this was a model that could be used by others. While we agree that in theory leasing companies might be potential entrants, this seemed to us much more likely to occur with a brewer than with a retailer or any other third party. We received no evidence to suggest that any other leasing companies were planning to enter the market for the provision of generic TSE.

5.49 However, regardless of entry mechanism, we considered that three of the existing features of the market described in paragraphs 5.18—bundled pricing, switching costs, and difficulties in valuing TSE assets—represented barriers to entry for those looking to acquire TSE in, or lease TSE to, outlets. In particular, bundled pricing makes it difficult to attribute a market price to the generic TSE assets or to identify a rate of return attributable to ownership of generic TSE assets. This lack of knowledge of either the price or the true economic value of the TSE assets could, in itself, act as a barrier to entry. There are two particular issues associated with the valuation of generic TSE. First, these assets are usually valued in aggregate using an average age, but it would be necessary for any potential buyer to be satisfied that the total valuation of any particular set of generic TSE assets adequately reflected their age and condition. Second, as set out in paragraph 3.8, SDEL is [REDACTED]. Such a value might be a poor representation of their true worth. Both of these aspects could represent a barrier to the sale of TSE assets, particularly in the absence of any

benchmark transactions which could provide a comparison against which to assess prices.

5.50 Finally, SDEL currently represents a large buyer in the TSE industry, accounting for around 30 per cent of industry sales. For some manufacturers, SDEL represents the majority of their sales. The consequence is that SDEL may be able to purchase TSE at lower prices than other buyers, giving rise to absolute cost advantages vis-a-vis non-brewer entrants.

5.51 There has been no history of entry into the TSE market, other than limited trials that some retailers have had with a major equipment manufacturer, [REDACTED], and some limited purchasing of generic TSE by retailers [REDACTED]. In addition, the levels of investment required to purchase generic TSE, whilst not large for an individual outlet,<sup>46</sup> would represent a substantial investment across a pubco's portfolio. Although we heard evidence to suggest that there were at least two serious potential entrants [REDACTED] which might have entered by means of a JV (see paragraph 5.47(e)) prior to the proposed merger, we were told that the proposed merger presented an 'insurmountable' barrier to entry to them (see paragraph 5.57). We return to the impact of the proposed merger on the likelihood of entry in the section on the effects of the proposed merger on the TSE market.

### *TS market*

5.52 Entry into the provision of TS could occur either through large scale entry at national level, or through smaller scale entry at a regional or multi-regional level. National pubcos have told us that if they were looking for one-stop shop TS provision, they would look for a national provider. Although small scale entry would be much easier,

we do not believe that this provides a real competitive threat to SDEL/Innserve in the short to medium term. Nor would small scale entry give those retailers looking for a national service a viable alternative to SDEL/Innserve or perhaps City. The pubcos have told us that it would not be practical to set up their TS provision using a patchwork of smaller regional suppliers, not least because of the need to negotiate access to TSE in each case, and the need to ensure consistent levels of service. We have therefore focused our analysis on large scale entry.

5.53 We were told by two potential entrants of the importance of having a substantial platform for entry. Both said that it would be important to have a sufficient volume and density of outlets. One said that it needed at least two national brewers' businesses. The other said that one brewers' business might be sufficient as a platform provided there were sufficient headroom for growth.

5.54 The parties told us that pubcos provided a better entry platform, and it has been suggested that it might be possible to enter through one large pubco.<sup>47</sup> However, we did not agree that pubcos provided a better platform for entry, due to insufficient scale, lack of ownership of TSE assets, and lack of infrastructure (including ready access to staff and skills,<sup>48</sup> as well as physical infrastructure such as a call centre). In terms of scale, for example, Coors told us that it was principal supplier in around 17,000 outlets and provided TS to more than 40,000 outlets in total. The two largest pubcos between them own around 15,000 outlets, but the next largest pubco had fewer than 3,000 outlets. In addition, a managed pubco might provide a better entry platform than a tenanted pubco, due to the greater centralization of decision-making, but there were only two large managed pubcos, with fewer than 5,000 outlets

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<sup>46</sup>Average new cost of approximately £5,300 per outlet; average net book value based cost of approximately £3,000.

<sup>47</sup>We heard conflicting evidence about the number of large pubcos that would provide a reasonable entry platform. One of the national brewers told us that this might be as many as four; another revised its estimate from two down to one.

<sup>48</sup>The entry models adopted by Innserve, [3<] all assumed that the brewers' TS workforce would be transferred to the new TS provider under TUPE.

between them. Third parties told us that a successful business could not be created by providing TS to a network of independent retailers, to regional brewers, or to pubcos. These options would fail to provide a sufficiently large entry platform to gain the synergies required. Moreover, as we noted earlier, there would be likely to be ongoing tensions with the owners of the TSE assets if the TS provider did not own them.

5.55 As we noted earlier, two existing features of the market—bundled pricing and the interdependency of TS and TSE—create barriers to entry to the TS market. Bundled pricing is an issue because of the difficulty of establishing a benchmark against which to compare an entrant's bid, and the need to negotiate an appropriate discount off the beer price. With the creation of SDEL, the densities of TS provision have been improved, leading to cost savings. Assuming that the cost reduction from the brewer would be likely to be based on the marginal cost saving to the brewer of no longer providing the TS, the improved densities that have been achieved as a result of the creation of SDEL would be likely to reduce the potential discount and make it difficult for a new entrant (which would need to cover its average costs) to offer a competitive service unless it were of comparable size to SDEL (see paragraph 5.22).

5.56 The conflicts between ownership of assets and third party TS provision were discussed in paragraph 5.24, both in terms of the potential administrative obstacles that might arise, and the inherent tension in the need to balance repair and renewal decisions. These are likely to make it difficult for a national scale entrant unless it were also prepared to take on ownership of the TSE assets, or detailed 'rules of engagement' for access and for repair/replace decisions were developed and implemented efficiently. We heard from two potential entrants which told us of the importance of ownership of assets for the effective provision of TS. One considered a TS provision-only model to be unworkable; the second thought that it could be

achieved provided appropriate agreements could be put in place to ensure fair and reasonable access to the assets.

5.57 The history of entry into this market has primarily been at the very small end of the scale, with firms being set up as subcontractors to the brewers to assist them with any gaps in geographic coverage, managing peaks in demand, covering installations and in some cases providing an out-of-hours service. As set out in paragraph 5.52, we did not consider such small scale entry to be a relevant factor in our assessment of competition. The only independent national firm at present is City, with TCS offering TS provision in a large part of the country. We have been told that there were at least two other large potential national entrants, but their business model was predicated on taking over TS provision from one or more of the national brewers. They both told us that the proposed merger presented an insurmountable barrier (see paragraph 5.53).

5.58 The parties said that there were no significant barriers to entry into the supply of TS, because there were no major sunk costs associated with setting up a TS business and none of the relevant inputs were in short supply. They also told us that there were a number of firms operating in related fields that could readily begin supplying TS with minimal outlay if the demand were to grow and there were insufficient suppliers available. These would include businesses which already had the necessary infrastructure and technicians in a related field, and soft drinks suppliers. It seemed to us, however, that these arguments did not apply to large scale entrants seeking a critical mass in order to compete effectively with SDEL. The parties themselves estimated that the total cost of entering and providing TS for one year on a national scale would amount to a little over £6 million—an amount in excess of the annual turnover of all but the largest independent TS providers. Around three-quarters of this cost would be associated with providing a workforce of 150

technicians, with the remaining cost associated with resource planning, supply chain management and setting up a dedicated call centre.<sup>49</sup>

5.59 We concluded, therefore, that there were barriers to entry on a national scale in both TSE and TS before the proposed merger. We return to the effects of the proposed merger on entry in paragraphs 5.78 and 5.89.

### ***Counterfactual***

5.60 We next assessed what would be likely to happen in the absence of the proposed merger (the counterfactual). We considered what might happen to Coors's TSE and TS business and the future of Coors as a competitive force in TSE and TS if the proposed merger did not occur. We have focused on those factors that we consider to be the most important for the purposes of identifying a counterfactual for each relevant market. We have taken into account a strategic options paper put together by Coors prior to the decision to proceed with the proposed merger with SDEL,<sup>50</sup> as well as evidence provided subsequently.

5.61 We considered that, in the absence of the proposed merger, SDEL/Innserve would continue to operate with SDEL as a JV between the two SDEL brewers. We also assumed that the national brewers would continue to participate in the FBI. The parties agreed.

5.62 Coors told us that, since November 2003, it had not sought to provide TSE or TS to outlets other than with the provision of beer, and would not do so in the future. It would therefore not compete directly with SDEL or other brewers in the markets for

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<sup>49</sup>The parties also proposed a smaller scale entry model, based on a one-stop shop operation with 48 technicians servicing about 6,000 outlets belonging to one or two pubcos. However, based on our discussions with TS suppliers and pubcos, we

TS and TSE. Coors also told us that it would like to remove its TSE assets from its balance sheet, provided it continued to ensure the quality of its beer.

5.63 Given Coors's strategic model, the options for Coors in the absence of the proposed merger fall into two broad categories:

(a) Retain the TSE and TS business. Do not compete in the markets directly but provide TSE and TS only with the supply of beer.

(b) Sell the TSE and TS business either through the creation of a JV or to a third party.

5.64 We believed that there could be several potential partners for a JV or a sale as proposed in option paragraph 5.63(b). Possibilities might include a deal with the remaining national brewer, Interbrew, to create a model similar to the SDEL/Innserve model. Whilst we have had regard to submissions from Coors that no such transaction is envisaged we are satisfied that this would be among the strategic options for Coors to consider in the absence of the proposed merger. There might also be the option to create a JV or sell Coors's TSE/TS business to one of the two potential entrants that were identified at the time of the creation of SDEL or to another third party, for example a national TS provider or a manufacturer. Evidence we received from various parties confirmed that there would be interest in joining forces with Coors to create a competitor to SDEL/Innserve.

5.65 We note that option (b) would be more likely to create a strong competitor to SDEL/Innserve (one with an asset base comparable to SDEL's and a national TS operation on the same scale as Innserve) than option (a), resulting in more competition in the market for TSE/TS in the absence of the proposed merger. If

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thought it unlikely that such an operation was realistic as a national competitor to SDEL/Innserve. SDEL also told us that many of these requirements could also be subcontracted or outsourced.

<sup>50</sup>Presentation to the board of Coors, November 2003.

option (a) prevailed, the major player in the TSE/TS market would be SDEL, and market shares would be more asymmetric than would be case were option (b) to occur.

5.66 Whilst one of several variants of option (b) might be the likely outcome, we have decided to assess the proposed merger against the plausible but more conservative outcome as set out in paragraph 5.63(a). It would follow that if the proposed merger gave rise to an SLC compared to option (a), it must do so compared to option (b). Option (a) is therefore the more demanding test, and we have regard to it in our assessment of the effects of the proposed merger.

5.67 We therefore adopted the assumption that, in the absence of the proposed merger, Coors's TSE and TS business would remain in the market in the short to medium term providing TSE and TS only in conjunction with beer supply.

### ***Effects of the proposed merger***

5.68 The next section of the report assesses the possible effects of the proposed merger compared with the counterfactual, in the context of the existing competitive situation and any competitive constraints imposed by market entry. We also take into account the features of the market listed in paragraph 5.18 and the impact of the proposed merger on these market features.

5.69 The major concerns that were put to us focused on the increased ability of the SDEL brewers/Coors and SDEL/Innserve to act independently and exploit their market power as a result of the large increase in SDEL's market share following the proposed merger. The effects arising from the use of this increased market power are commonly referred to as unilateral effects. We have looked at the possible effects of the proposed merger in each of the three markets—the supply of TS, TSE

and beer. Given the size of SDEL's market share following the proposed merger, our analysis focused on unilateral effects, and did not consider coordinated effects.

5.70 In assessing the effects of SDEL/Innserve's increased market power, we considered whether or not any benefits associated with more efficient purchasing or the realization of synergies might be passed through to the end consumer. The extent of pass-through of any benefits will depend on the relative bargaining power of the SDEL brewers/Coors and the retailers. The parties told us that a fair share of the resulting benefits would be to the ultimate benefit of the end consumer. However, Coors also put it to us that the increasing strength of the larger pubcos in particular might force them to pass benefits on to the most powerful retailers which might not, in turn, pass the benefits on to the end consumer, although SDEL did not believe that the pass-through of cost savings would differ between large and small pubcos, and independents. It was not clear to us that the benefits would be passed through in full to all the retailers, and that, even if they were, that they would be shared between the different types of retailers.

5.71 We considered that some of the larger pubcos had started to drive competition in the markets for TSE and TS by requesting unbundled pricing. However, this has only been the first step. For competition to develop and to exert a competitive pressure on TSE/TS quality standards and price, it would be necessary for credible alternative suppliers to be available, with the ability either to take ownership of TSE, or to have assured and sufficient access to TSE, not only for brewers, but also for retailers, third party TS providers or others. We considered whether the increased size of SDEL/Innserve following the merger might perpetuate the present pattern of ownership and stifle the opportunity for competition to develop, removing the incentive to pubcos to seek a competitive solution to their TSE/TS supply.

## *TS market*

- 5.72 We considered whether the increase in SDEL's market power as a result of the proposed merger would lead to a reduction in competition in the TS market compared to the counterfactual. We then considered how any reduction in competition might manifest itself in terms of adverse effects in the TS market.
- 5.73 In the absence of the proposed merger, the two SDEL brewers would be using the SDEL/Innserve arrangements to provide TS to retailers, while Coors and Interbrew would be providing TS through a mix of in-house staff and subcontractors. However, after the proposed merger, Coors would also use SDEL/Innserve to deliver TS. SDEL has contracted with Innserve to be the exclusive provider of TS to SDEL, and therefore Innserve would provide TS via SDEL for three of the four national brewers.
- 5.74 We believe that competition for the provision of TS in the absence of the proposed merger is relatively limited. Both Coors and Interbrew told us that, despite sometimes competing in the recent past to provide single supplier contracts, they would now only provide TS if linked directly to beer supply. In our counterfactual, they would not compete directly to provide TS to a retailer on a single supplier basis. Although we do not dismiss entirely the theoretical mechanism for indirect competition (ie switching principal supplier—see paragraph 5.37), we do not believe that it provides effective competition.
- 5.75 A retailer looking for an alternative TS provider would therefore be likely to need to contract directly with a third party TS provider. We considered whether, following the proposed merger, there would be sufficient competitive pressure on SDEL/Innserve to prevent them from exercising their market power. We also considered the likelihood of an existing smaller-scale third party TS provider expanding to provide more direct competition for the provision of TS on a national scale. This has

occurred on one occasion in the past—we were told that City’s contract with Spirit enabled City to develop a national offering. However, we considered that following the proposed merger, SDEL/Innserve would have the ability and incentive to organize its third party TS subcontracting strategically to ensure that no subcontractor developed a sufficiently strong presence to become a national competitor. SDEL/ Innserve’s ability and incentive to do this would be strengthened by the proposed merger.

5.76 SDEL/Innserve’s increased market power as a result of the proposed merger would give Innserve a strong negotiating position with third party subcontractors and it appears to us that a tightening in subcontractor rates is one logical way of achieving cost reduction targets. Innserve could demand substantially improved terms from the subcontractors, which would be highly dependent on Innserve for business. Given the lack of alternative buyers for their TS services, the subcontractors might well have no alternative but to accept reduced terms. This would put pressure on the margins of the subcontractors, reducing the possibility of any such third parties having the necessary funds and levels of profitability to grow to compete on a national scale. Although they might have the opportunity to switch some of their business away from the provision of TS on beer dispense equipment, we received no evidence which allowed us to assume that the subcontractors could successfully diversify, nor that this would be cost free. Innserve would also have the ability and incentive to restrict the level of business with any subcontractors who chose to compete head-to-head as principal suppliers.

5.77 The parties told us that it was in their interest to nurture the subcontractor base. At a late stage in the inquiry, they told us that SDEL had agreed with Innserve to amend the Services Sub Contract to include a code of conduct to encourage the maintenance of a healthy subcontractor market. This would include a requirement

that Innserve did not impose any restriction on its subcontractors working freely for any other customer, and Innserve managing its resources so that external subcontractors accounted for at least a small proportion [X] per cent of SDEL's TS requirements.<sup>51</sup> We recognized that it would be important for there to continue to be a vibrant sub-contractor market to enable Innserve to retain flexibility, but did not believe this to be inconsistent with the policies described in paragraphs 5.75 and 5.76.

5.78 We also considered whether a new entrant was likely to provide retailers with alternatives in terms of TS provision. Given the nascent nature of the market, we considered this to be critical to our assessment of the effects of the proposed merger. As discussed in paragraphs 5.53 and 5.54, it was clear to us from the evidence that we received from potential entrants that the options for entry would be significantly reduced or removed as a result of the proposed merger. We believe that this would be likely to be true for other potential new entrants.

5.79 Given that credible third party TS providers with a national capability would be less likely to emerge and would struggle to compete on level terms with SDEL/Innserve, retailers' incentives and ability to find alternatives to their existing TS provider would be much reduced compared to the counterfactual. The retailers told us that they had to have a credible alternative in order to put pressure on the national brewers to offer unbundled prices. We do not believe that it would be in the interests of the brewers to offer unbundled prices unless they were asked to do so by the retailers. However efficiently a competing service might be organized, we believed that the competitive nature of its offering would be affected by the level of discount for unbundling that the brewers would offer (see paragraph 5.22). This would be in addition to the levels of

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<sup>51</sup>Coors told us that it expected the share of external subcontractors to be rather higher (around [X] per cent).

inertia which would in any case present a barrier to a retailer seeking to switch TS provider.

5.80 The SDEL brewers and Coors told us that they would always provide separate TS prices upon request. They told us that, following the proposed merger, they would have less incentive than they had had historically to promote their own in-house TS operations. The potential loss of sales and profits through offering unrealistically low discounts for beer supplied without TS would be more than any potential gain arising from a share in Innsolve's profits. Hence they argued that, following the proposed merger, it would always be in the interests of the SDEL brewers and Coors to offer realistic discounts for retailers looking for independent TS provision.

5.81 The SDEL brewers already have the incentive and ability strategically to foreclose their portion of the TS market to new entrants, and this would be strengthened by the proposed merger. The parties told us that they would have improved knowledge of the costs associated with TS provision as a result of the creation of SDEL/Innsolve, which would make it easier to assess the gains or losses from unbundling prices. We agreed. However, given the lack of credible alternatives for TS provision to retailers, we believed that the proposed merger would reduce the prospects of discounts being offered at a level which would allow viable competing bids for independent TS provision.

5.82 Overall we considered that there would be a reduction in competition as a result of the proposed merger. However, the adverse effects of such a reduction in competition are difficult to predict in view of the nascent nature of the market. We looked at the possible impact on quality of service. We have been told that in general the national brewers' service contracts with the retailers do not specify service levels to any degree of detail. In addition, even in cases where targets have

been specified, there is no penalty for non-achievement of targets. It has, however, been a feature of the emerging competition that well managed pubcos have been able to use the competitive operation of the market to negotiate contractual service terms to reflect their requirements. We considered that because of the foreclosure effect of the proposed merger, and the diminished level of prospective competition in this market, it would be more difficult after the proposed merger for retailers to force the SDEL brewers and Coors to adhere to demanding service levels.

5.83 We noted two features of the contract between SDEL and Innserve. First, the long-term nature of the contract (ten years) would give an inherent advantage to Innserve over any rival service provider because the contestable market would be restricted for a long time. The duration of the contract also has an impact upon the ability of SDEL, as customer, to use the sanction of termination, or the implicit sanction of non-renewal, of the contract as a means of controlling standards. Second, it was not clear how effectively service standards would be monitored. SDEL does not have the resources to carry out any monitoring. It would either be done through Innserve on behalf of SDEL (in which case Innserve would be monitoring its own performance), or by the SDEL brewers/Coors, but it was not clear that either mechanism would provide a strong check on service standards. In addition to these two contract features, we noted that SDEL/Innserve have entered into contractual commitments without agreeing the per-event ratecard (see paragraph 3.5), reflecting a lack of competitive pressure in bidding for this contract.

5.84 The parties have told us that they would not wish to risk damaging their brands by poor dispense quality. They told us that quality would be safeguarded by SDEL's contract with Innserve, which, they said, contained demanding performance targets which Innserve must satisfy if it is to keep its contract. However, it is not clear to us that there is an alternative TS provider capable of providing the service that Innserve

will be contracted to provide, and so it seemed to us that the threat of termination was not real.<sup>52</sup> The TS employees of the SDEL brewers and Coors would have been transferred to SDEL and then to Innserve, and, although TUPE might operate if Innserve lost its contract, we were not certain that a sufficient workforce would be readily available to any other service provider. Innserve has been set up to make a profit, with a focus on achieving cost reductions. Whilst some of these cost reductions will be achieved through synergies, there will be an incentive on the part of Innserve to cut costs at the expense of service standards. We therefore believed that the incentives to standardize at a lower level of service—one which, in the words of one of the national brewers, is ‘adequate’—were high.

5.85 In addition, retailers told us that standards provided by the brewers are not as high as those provided by third party service providers (see Appendix F). Despite the perception among some retailers that the brewers’ TS employees have better knowledge and provide a better quality service than third party TS providers, we understand that in at least one example third parties agreed, and delivered, significantly higher levels of service. In particular, we were told that City has a better response rate for four-hour call-outs, with more than 95 per cent of high priority calls answered in four hours. This compares to a proposed level of [X] per cent in Innserve’s contract with SDEL. We believed that, despite the parties’ argument that quality was fundamental to ensuring brand success, it was more likely that the first reaction of consumers would be to switch outlet rather than to switch brand in response to a poor quality product delivered through poorly serviced TSE.

5.86 There might also be an adverse effect on price as a result of the reduction in competition outlined. Given the size of SDEL/Innserve, the relative lack of

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<sup>52</sup>The parties told us that SDEL had the option to change the management team. However, we were not persuaded that this

competitive constraints or benchmark prices, and the fact that some TS costs would be common between the SDEL brewers/Coors, there would be little to restrain SDEL/Innserve, and their customers, the SDEL brewers/Coors, from allowing the price of TS to rise, at least over the longer term. Since any price increase (or cost decrease) would generally be reflected in the bundled price for the supply of beer, and TS represents a small percentage of the total beer price, such price rises (or cost reductions) may not be apparent to retailers (or may not be passed on to retailers—see paragraph 5.70). In practice this might mean that prices stayed level despite the achievement of cost reductions. Further, as SDEL/Innserve would have a very large market share following the proposed merger, their prices may well become the market rate, adversely affecting even those retailers who do not receive their TS directly from SDEL/Innserve.

#### *TSE market*

5.87 Given the interdependence of the TSE and TS markets, the possible effects in the TSE market are similar to those already identified in the TS market. We considered whether the increase in SDEL's market power as a result of the proposed merger would lead to a reduction in competition in the TSE market compared to the counterfactual. We then considered how any reduction in competition might manifest itself in terms of adverse effects in the TSE market. Once again, our focus was on generic rather than branded TSE.

5.88 At present the majority of retailers could be supplied with generic TSE owned by SDEL (for the two SDEL brewers), by Coors or by Interbrew. Neither Coors nor Interbrew has any interest in supplying TSE outside their respective beer supply obligations. There is no well-developed third party provision of TSE. As a result of

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was an effective sanction, and moreover thought that this might, in effect, terminate the contract between SDEL and Innserve.

the proposed merger, the TSE required by Coors would also be provided to Coors by SDEL.

5.89 Given the lack of effectiveness of the indirect competition mechanism, there are limited options available in the TSE market in the counterfactual. It is therefore even more important in this market to consider the impact of the proposed merger on entry. Paragraph 5.47 outlined the various mechanisms through which entry into the TSE market might occur in principle, and paragraphs 5.48 to 5.51 discussed entry into the supply of generic TSE in the absence of the merger. We believed that incentives for retailers to seek alternatives to their existing TSE owner would be reduced as a result of the proposed merger, due to the difficulty that alternative providers would have in competing with the enlarged SDEL (see paragraphs 5.78 to 5.81). Moreover, the SDEL policies on asset valuation and sale would be likely to deter individual pubcos from purchasing the TSE in their cellars (see paragraph 5.49).

5.90 In addition, both of the potential large-scale entrants that we spoke to told us that they would prefer to purchase some or all of the brewers' TSE assets, although their business models were based primarily around providing TS.<sup>53</sup> The reduction in the headroom available in the market after the proposed merger makes this less likely (see paragraph 5.51).

5.91 We therefore considered that there would be a reduction in competition as a result of the proposed merger. However, in the case of the TSE market, this was focused in particular on the reduction in future competition that would otherwise have emerged.

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<sup>53</sup>We were told by one potential entrant that while contractual agreements on fair access to assets and replacement of assets would be possible, and would eliminate the need for asset ownership, such contracts would be costly and time consuming to negotiate.

- 5.92 We considered the possible adverse effects of such a reduction in competition following the proposed merger. In terms of asset quality, one third party put it to us that it would be in the interests of the SDEL brewers and Coors to 'sweat' their assets, saving money on replacement costs. In addition, we believe that SDEL would have incentives to standardize TSE in order to benefit from economies of scale in purchasing, and simplicity in terms of TS. We have seen that the KPIs in the Innserv contract relating to timescales for installations of non-standard TSE are [X] days compared with [X] days for standard TSE, which is likely to provide a strong incentive to retailers to use standard TSE. It is not clear that such a differential would have emerged if the market were to be more competitive.
- 5.93 We also believed it possible that there would be an adverse effect on prices in the TSE market. The increased market power of SDEL could provide SDEL, and hence the SDEL brewers and Coors, with the incentive and ability to allow prices to increase for TSE over time within the bundled beer price or fail to pass on any cost savings (see paragraphs 5.70 and 5.86).
- 5.94 SDEL's increased market power would give it a strong negotiating position with manufacturers of generic TSE. Its ability to rationalize the supply chain and minimize inventory levels could benefit customers, depending on whether or not the savings were passed on (see paragraph 5.70). However, pressure could be put on manufacturers by the enlarged SDEL such that manufacturers' margins were reduced, potentially restricting the development of the TSE manufacturers market, or even forcing some to exit the TSE market in Great Britain. The BFBi told us that this was the view of most of its members. Any negative impact on the TSE manufacturing base supplying SDEL/Coors would be likely to have a knock-on effect on Interbrew and the regional brewers which purchase generic TSE.

5.95 We heard conflicting evidence on the importance of innovation in the TSE market. We agreed with the parties that the incentives and ability to innovate on branded TSE would be unchanged as a result of the proposed merger. With regard to generic TSE, many third parties told us that there was no potential for significant innovation in generic TSE, although several of the respondents to our TSE questionnaire did not agree. The parties argued that the proposed merger would increase incentives to innovate in generic TSE, because it would be less likely that brand switching would lead to a change in principal supplier outside the SDEL brewers or Coors, given that three of the four national brewers would be inside the arrangement. We believed, however, that there might be more incentive to standardize than innovate in generic TSE due to the reduction in competition, possibly leading to a reduction in quality (see paragraph 5.92).

5.96 We also considered the longer-term future of the FBI as a result of the proposed merger. Several third parties said that the SDEL brewers and Coors might try to gain a competitive advantage after the proposed merger by withdrawing from the FBI. They told us that there was a lack of commercial incentive for the SDEL brewers and Coors to remain as part of the FBI, since the common ownership of assets reduced their need to rely on the FBI to avoid unnecessary switching costs. The SDEL brewers and Coors, on the other hand, told us that they had no intention of withdrawing from the FBI arrangements since they had been effective in the past and would continue to be necessary in the future. We were also told that the SDEL brewers shared a common interest in seeing the FBI continue, and it would remain important for relations with non-SDEL brewers/Coors. On the evidence available, we were unable to form a view as to whether the FBI arrangements would cease to operate or would be substantially changed as a result of the proposed merger.

## *Beer market*

5.97 Finally we considered the impact that the enhanced market power of SDEL, and hence the SDEL brewers/Coors, following the proposed merger, might have on the beer market. We note that in the beer market, the relative importance of the quality and price of TSE and TS is low compared with issues associated with the provision of beer itself (see page 16 in CC buyer survey). Nevertheless, we considered whether the opportunities for greater collaboration and exchange of information between the SDEL brewers and Coors would be significantly enhanced as a result of the proposed merger. We also took account of the fact that the SDEL brewers and Coors, despite having other opportunities available to them, chose to keep a controlling interest in TSE and TS through ownership of SDEL. Other brewers outlined potential issues regarding future installation costs and quality of TSE, particularly with regard to cask ale. The increased market power of SDEL following the proposed merger might affect the ability of the independent brewers to supply outlets with beer.

5.98 We considered whether it would also be possible for the SDEL brewers and Coors to exploit the market power of SDEL/Innserve to take measures to impose disadvantages on brewers that are not members of SDEL from getting their brands on to the bar. This could be achieved by raising the rental charge associated with a line, raising the annual TS fee, or simply by making the logistics difficult. This would only be possible if an alternative to the FBI charging structure were introduced.<sup>54</sup> However, we did not consider this to be in the interest of the SDEL brewers and Coors, at least in terms of their relationships with the regional brewers. The regional brewers are substantial customers of the national brewers and would be in a position

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<sup>54</sup>We undertook an exercise to compare the FBI one-off line charge to the per annum line charging mechanism used by SDEL to charge the SDEL brewers and Coors. However, our analysis was inconclusive due to methodological difficulties associated with comparing two structurally different charging mechanisms.

to retaliate should the SDEL brewers and Coors seek to disadvantage them in any way.

5.99 We were told of concerns that outlets might find it easier in any case after the merger to switch between the SDEL brewers'/Coors's brands, rather than to switch to other brands, to the detriment of other brewers (in particular Interbrew and foreign entrants), although it was not clear what difficulties might arise in practice. Some third parties also told us that, in the past, TS technicians had been viewed to some extent as salespeople. They would have had the ability to influence retailers on the placement of brands on the bar. However, the creation of SDEL meant that Scotco and Carlsberg had already chosen to give up any such opportunities by sharing TS technicians. In addition, the parties told us that they had several other ways of influencing retailers as to brand selection, and the TS technicians did not play an important sales role.

## **6. Provisional conclusions on SLC test**

6.1 Paragraphs 5.72 to 5.99 set out our analysis of the possible effects in the TS, TSE and beer markets that might arise from the enhanced power of SDEL/Innserve, or by the SDEL brewers and Coors, as a result of the proposed merger.

6.2 We provisionally concluded that the increment in market power resulting from the proposed merger was significant enough to constitute an SLC in the TS market for the reasons set out in paragraphs 5.73 to 5.80. We expected that the increased market share of SDEL/Innserve would lead to a reduced platform for entry, resulting in a reduction in the level of competition compared to the counterfactual, with likely adverse effects on service quality and/or price of TS provision.

- 6.3 We further provisionally concluded that the increment in market power resulting from the proposed merger was significant enough to constitute an SLC in the generic TSE market for the reasons set out in paragraphs 5.87 to 5.91. We expected that the increased market share of SDEL/Innserve would lead to a reduced platform for entry, resulting in a reduction in the level of competition compared with the counterfactual, with likely adverse effects on the quality and/or price of generic TSE.
- 6.4 Finally, we provisionally concluded that the arguments set out in paragraphs 5.97 to 5.99 did not carry enough weight to lead us to form an expectation of an SLC in the beer market.