

8 Views of Bass PLC

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Introduction

8.1. This chapter summarizes the views of Bass, given to the MMC in a number of written submissions and at two hearings.

Background to the merger transactions

8.2. Bass said that it had been in the brewing industry since 1777. The present company was formed to implement the merger of Bass, Mitchells & Butler Limited and Charrington United Brewers and was called Bass

Charrington Limited until 1979 when the name was changed to Bass PLC. Share ownership was now widely spread, with over 40 per cent of shareholders each having a holding of 500 shares or less; only one shareholder, the Prudential Corporation group of companies, had an interest over 3 per cent (3.6 per cent). The principal activities of the Bass group were the production, wholesaling and distribution of drinks, primarily beer and soft drinks; the ownership, management, leasing or franchising of pubs, hotels, restaurants, bingo clubs, betting shops, bowling centres and entertainment centres; and the manufacture, supply and operation of amusement and gaming machines.

8.3. On its beer industry interests, Bass said that it owned all the brands it produced with limited exceptions. A list of the beer brands owned by Bass is at Appendix 8.1. Scottish Courage and Whitbread were more reliant on licensed brands, particularly in the lager segment, while approximately one-quarter of CT's brands were licensed from third parties, with the remainder currently licensed from its shareholders (although this position would change after the proposed merger). Bass and brewers like it with significant wholesaling activities also factored a large number of brands, that is, supplied beer produced by third parties.

8.4. For the year 1995/96 Bass's final sales of beer in the UK totalled [*] million hl ([*] million barrels) against its nominal UK production capacity of [*] million hl ([*] million barrels). Bass's share of the UK beer market in 1995, on the basis of final sales, was 22 per cent. Of the total final sales, [*] million hl ([*] million barrels) or about 75 per cent were sales to the on-trade. One-third of all its on-trade sales were to Bass's tied estate of almost 4,400 (1997) on-licences (mainly pubs). The permitted maximum size of this estate under the Tied Estate Order¹ was 4,752. Bass's total tied estate constituted 2.9 per cent of total UK on-licences (150,000) and its 4,190 pubs constituted 6.5 per cent of total pubs (65,000). Bass's tied estate had reduced from 5,620 in 1991 to 4,373 outlets in January 1997. These outlets divided broadly 70:30 as between managed outlets and leased/tenanted outlets. As of 1997 2,764 of the company's tied pubs were managed, and 1,426 were leased. There were also 183 other on-trade outlets. Bass no longer owned any off-trade outlets.

The reasons for the transactions with Allied Domecq and Carlsberg/Carlsberg-Tetley

8.5. Bass said that the rationale for the merger transactions resulted from the company's long-term strategy which had benefited consumers—a competitive combination of innovation, product quality, well-supported brands, continued efficiency improvements, keen prices and good customer service. The catalyst for the events leading to this specific transaction was the decision by AD to cease brewing in the UK. At the same time CT was losing market share and was in profit only because of a favourable supply contract ([*] million hl or [*] million barrels) with ADR which was to expire in December 1997. CT's final sales share of the market in 1995 was 15 per cent. It needed to merge with another, complementary company in order to derive savings from synergies, savings which would be significantly greater than those it had already begun to procure. The only realistic alternative to a merger for CT, in Bass's view, was to reduce its business scale radically. But this would in practice result in reducing the number of CT brands and breweries and thereby reduce consumer choice and long-term prospects for employment. And even so, it would not necessarily result in a commercially viable entity.

8.6. Bass was the ideal partner for CT and there was a strong commercial logic for the merger. Bass was the only major brewing business which was complementary to CT's. Whereas Scottish Courage and Whitbread marketed major international lager brands which were strong competitors to the Carlsberg brand, Bass lacked such a brand in its portfolio. It could also further develop CT's leading ale, Tetley Bitter, as a major national brand and provide wider choice for CT's customers and its own. Its international operations, which in its view, were well ahead of other UK national brewers, offered scope for developing further activities jointly with Carlsberg, already a powerful player in the international beer market.

The terms of the transactions

8.7. Bass's description of the transactions, actual and proposed (including the fallback arrangements to come into effect should regulatory conditions not be satisfied), is at Appendix 8.2.

¹The Supply of Beer (Tied Estate) Order 1989.

*Figures omitted. See note on page iv.

8.8. In brief, however, on 25 August 1996 Bass announced that it had acquired, unconditionally, AD's interests in CT for £200 million in cash-the first stage. The purchase included principally AD's 50 per cent share of CT as well as its beer brands. Bass and Carlsberg also announced on the same day that they had reached agreement, conditional on regulatory approval, to merge CT and BBL (the brewing division of Bass)-the second stage. Carlsberg was to contribute its interests in CT and £20 million cash in exchange for a 20 per cent share of (or economic interest in) the combined BBL and CT business. This would exclude both Bass's brewing interests outside Great Britain and its export business. The new combined business, to be renamed BBL,¹ was to be controlled and managed by Bass. Following the merger, BBL's expected final sales' share of the UK beer market would be around 35 per cent by 1998. Bass's announcement expected that, within three years, Bass would achieve annual cost savings of £90 million, including the savings already announced by CT, with additional one-off cash costs of £75 million.

8.9. In the event that regulatory approval for the merger could not be obtained on terms satisfactory to Bass, it would have the option to put to Carlsberg for £110 million all of the interests acquired from AD, and AD would reimburse Bass £30 million in cash.

European Commission

8.10. The EC's Merger Task Force had confirmed to Bass that it agreed with the parties' analysis that the transactions did not fall within the scope of the EC Merger Regulation at either the first or the second stage. Bass also said that the parties had sought confirmation from the EC that the other contractual obligations accepted were ancillary to the concentration of BBL business with that of CT. The EC had indicated that it regarded the licence agreement between Carlsberg and the merged BCT business as possibly going further than an ancillary obligation in the context of the transaction. Bass and Carlsberg had, therefore, submitted a joint notification on Form A/B relating to the licence agreement on 2 December 1996.

Jurisdictional and legal issues

Number of transactions

8.11. In reaction to the MMC's indication that because the terms of reference for the inquiry required it to answer a number of specific questions, it intended to consider separately:

- (a) whether a qualifying merger had been created (that is, Bass's purchase of AD's share of CT);
- (b) whether one or more qualifying mergers were proposed or contemplated (that is, Bass's proposed acquisition of a controlling interest in CT; and the possible ability thereafter of Carlsberg materially to influence the policy of the former Bass enterprises); and
- (c) whether any such merger might be expected to operate against the public interest,

Bass said that it took the view that in business terms the arrangements were a single transaction operating in two stages, but it did not object to the MMC's approach to the analysis of the transactions for the purpose of the FTA.

Material influence over Carlsberg-Tetley by Bass (Stage 1)

8.12. Bass did not disagree with the MMC's provisional view that, notwithstanding its limited involvement in practice, Bass was currently able materially to influence the policy of CT as a result of the provisions of the merger deed and the fact that Bass would be able to block any ordinary or special resolution of CT. Bass did, however, point out that for the interim period between Stage 1 and Stage 2 considerable care had been taken to ensure that Bass's position as 50 per cent shareholder in CT should not give it the possibility of exercising joint control with Carlsberg over CT.

¹Generally, in this report, the acronym BCT is used to describe the proposed merged business.

Bass's controlling interest in Carlsberg-Tetley (Stage 2)

8.13. The company also said that it did not disagree with the MMC's view that if Bass were to acquire an 80 per cent economic interest in CT it would acquire a controlling interest in CT so that the enterprises of Bass and the enterprises previously carried on by CT would come under common control for the purposes of section 65(1) of the FTA.

Material influence over former Bass enterprises by Carlsberg (Stage 2)

8.14. Bass had considered whether the terms of the agreements with Carlsberg would confer on the latter the ability materially to influence the policy of CT so far as it concerned the enterprises now carried on by Bass and the current Bass brands. In particular, Bass had thought about the MMC's suggestion that the shareholder's deed (in particular, the agreement to make no material changes in the business, the provision of management accounts to Carlsberg, the provisions for dividend policy and Bass's restrictive covenants) together with the 20 per cent interest and the incentive on Bass and Carlsberg to co-operate in order to iron out any problems which might arise, would confer on Carlsberg the ability materially to influence the policy of CT so far as concerned the Bass brands. Bass's conclusion was that the issue was not straightforward but, when the overall effect of the contractual arrangements were analysed, Bass did not believe that any ability to exercise material influence was so conferred. In any event any influence was greatly outweighed by Bass's countervailing influence, and the overall effect of the agreements' provisions amounted to no more than the normal protection for a minority shareholder.

Public interest effects of Stages 1 and 2

8.15. Bass did not consider that the existing merger (that is, Stage 1) raised in itself the same public interest issues as the merger as a whole. The existing merger was temporary; Bass did not think it was correct to say that it gave rise to Bass acquiring a controlling interest in the merged enterprises of BBL and CT, although the company agreed that it formed part of that process. The nature and extent of Bass's influence over CT during the interim period were clearly different from that which would arise on completion. In any event, Bass did not believe that its essentially passive involvement in CT at this stage could give rise to any significant public interest concerns. On a separate point concerning the existing merger, Bass did not consider that its acquisition of the AD brands licensed to CT gave rise to any different issues from those that might arise from Bass's acquisition of the AD shareholding in CT and, indeed, considered that it was part of the same merger situation.

8.16. In response to the MMC's suggestion that the situation if the merger proceeded should be compared with a situation where there were four major brewers, Bass said that it was for the MMC to judge, as part of their assessment, how realistic it was in commercial terms to expect the continued presence of CT if the proposed merger were not to proceed. In this context, AD had already exited from the brewing market, by virtue of the completion of the first stage of the transaction. Bass agreed that the fallback arrangements might themselves be open to scrutiny under the merger control provisions of the FTA and that in theory the three parties could themselves agree to vary the terms of the relevant contracts between them (although it could see no prospect of their doing so). Bass accepted that the implementation of the fallback arrangements was only one of the possible outcomes of a decision by the Secretary of State to prohibit the merger, albeit the one that had been contractually agreed between the parties, and hence (subject to regulatory approval), the most likely outcome, and Bass did not believe it had ever suggested that the fallback arrangements should be the only point of comparison when considering what might happen in the absence of the proposed merger. It was, however, at least one point of comparison.

The fallback arrangements

8.17. Bass agreed with the MMC's view that the fallback arrangements were not included in the terms of the reference. It was also argued by the company that the MMC could and should consider whether the fallback arrangements would address any public interest concerns which the MMC might have identified as regards the merger situations which had been referred.

General market issues

Overall analysis of the market

8.18. Bass considered that the UK beer market was in transition towards forms of competition familiar in many branded goods markets.

8.19. Total demand had fallen since the 1970s, and by about 9.5 per cent between 1989 and 1995. The pub's role at the centre of the community had changed and traditional pub-visiting groups had been affected by the decline of heavy industry. Spending on beer as a percentage of consumer leisure spending had also fallen substantially. Within the overall decline, there had been partially offsetting growth in the off-trade. From 17 per cent of the total market in 1985, the off-trade now accounted for about 28 per cent.

8.20. The on-trade, however, also faced rising retailing costs. Net of duty, retail prices had risen by 6 per cent in real terms between 1992 and 1995, although wholesale prices had declined (by 8 per cent in real terms net of duty over the same period). Draught beer sales had fallen by some 19 per cent since 1989. Packaged sales had increased in the on-trade as well as off-trade overall by some 15 per cent. There had also been a trend of reduction in consumer loyalty; consumers were now much more discriminating and ready to try new beers and other drinks. For example, Bass said, Caffreys was Bass's fifth biggest selling product by value, yet it was less than three years old.

8.21. There were a number of other major pressures as well:

- (a) Wholesale buyer power had increased dramatically in the off-trade and the on-trade. The supermarkets, off-licence chains, cash-and-carries and co-ops had substantial purchasing power, as had the new retail on-trade groups (the pub chains) which had developed significant status and buying power resulting from the Beer Orders. There were now 50 of those with more than 30 pubs each and about 19,000 houses in all. These large purchasers were well informed and could easily switch substantial volumes of purchases from one supplier to another.
- (b) The single independent on-trade outlet had also gained from this overall downward pressure on wholesale prices, and competition between brewers for these accounts was intense.
- (c) At the brand level, it was notable that even the leading brands had only a small share of the total beer market. The top brand (Carling Black Label-Bass) had only 6.8 per cent. This was very low as compared with international beer markets and other fast-moving consumer goods (FMCGs) markets. Even the top three (Carling, Foster's and Guinness) had only 16 per cent of the market. The share of the top three brands in FMCG markets was typically in the 70 per cent range.
- (d) Consumers demanded new and innovative products, for example Caffreys and its imitators, or Hooper's Hooch and other FABs. This demand for variety meant that niche and/or new products were always coming on to the market putting further pressure on brewers and established brands. Between 1990 and 1994 brand choice had remained high, at around 1,400 brands. While during this period 460 brands had disappeared, their place had been taken by nearly 480 new ones. Nor was this brand churn, in Bass's view, restricted to a small fraction of peripheral brands. There had been considerable movement up and down, and in and out of, the list of the top 30 brands in recent years. Competitive pressure at the brand level was intense and growing, and branded beer was moving towards the characteristics of the FMCG sector.
- (e) Competition between the major brewers was buoyant and further consolidation would not reduce it, in Bass's view. Smaller brewers could also be strongly competitive with the majors. Their competitiveness had been strengthened by vertical integration and other factors, for example their ability to keep distribution costs low from supplying a relatively densely situated estate. Leading regional brewers (for example, Wolverhampton & Dudley, Vaux, Marston and Greene King) had maintained or had increased their market shares over the 1990 to 1995 period.
- (f) Significant tax differentials between the UK and other European countries had fuelled the growth of duty paid imports and had served to increase the competitive pressures.

- (g) Because of the increasing competition beer faced for a share of consumer's available cash (for example, from other drinks and food), beer prices were more and more sensitive to the prices of such products.
- (h) A further pressure was the lack of major barriers to entry or expansion. Access to distribution was straightforward, and advertising costs were not a high proportion of sales revenue. For Carling Black Label, for example, it was [*] per cent of net retail sales. The FMCG industry norm was about 7 per cent.
- (i) The UK market was very open by international standards. A further pressure on brewers' competitiveness was therefore that the UK was an obvious outlet for the significant spare capacity that existed in other European countries.

8.22. Taken together these factors produced and, in Bass's view, would continue to produce strong downward pressure on wholesale prices. Its own real net wholesale prices had fallen by [*] per cent over the period 1992/93 to 1995/96. And the competitive pressures faced by the industry in the wholesale market were the principal determinant of increasing concentration in brewing. Studies which Bass had commissioned from Economic and Business Policy Research provided corroboration of this conclusion. These studies had analysed share price movements of a sample of brewers and retailers on four separate occasions in 1966 when information about the merger was released to the capital market, and had shown that if there were any stock market expectation that wholesale prices would rise as a result of the merger, the relevant brewing and retailing industry share price movements would have reflected these expectations. The brewing industry was one of the best researched sectors in the UK stock market and information on it was widely available to investors. The statistical exercises had, however, shown that there had been no abnormal movements or changes in these share prices at any of the four relevant times, indicating that the capital market did not expect wholesale beer prices to increase as a result of the merger.

8.23. The industry was unlikely to reach stability in the foreseeable future due to the intense competitive pressures. Retail concentration, for example, would continue to grow, and more and larger pub chains would place brewers' margins under great pressure.

8.24. Bass believed that, as a result of normal competitive forces, of itself brand concentration would tend to increase. However, Bass considered that this was not a process that would be affected significantly by the merger. Brand choice could be high where concentration was high. There were so many brands in the UK by comparison with other countries, there was cross-entry of brands from other European countries, and much beer was sold through the on-trade sector where there was still a degree of vertical integration. Regional and local brewers could use this integration to access the market without needing to be of substantial scale. This contributed to greater brand choice and would, therefore, limit the extent of brand concentration.

8.25. Overall, Bass considered that given:

- (a) higher retail concentration;
- (b) shifts to the off-trade;

*Figures omitted. See note on page iv.

- (c) a step-down in brewer's margins; and
- (d) downward pressures on wholesale prices

the company was only going to increase its margins by producing new products which customers wanted and by further reducing its cost base. An example of the latter was the contracting out of Bass's distribution to Tradeteam (see paragraph 8.30). While others might aim at the premium sectors of the market and/or at maximizing the volume through their own estates, Bass's strategy required it to be the lowest-cost beer industry producer/supplier in the UK. It was in danger of missing this goal as a result of the Scottish Courage merger. Bass therefore needed to buy or merge with CT, or fundamentally to reassess its brewing strategy.

Public interest issues

Reorganization

8.26. The savings Bass expected as a result of the merger and consequent reorganization amounted to over £90 million a year but, after deduction of those savings already announced by CT and an allowance for contingency, the figure was closer to £[*] million, as summarized below.

TABLE 8.1 **Anticipated savings**

Production	[
Distribution	
Sales and marketing	
HQ functions, etc	
Advertising and promotions	*
Less contingency	
Less savings under way in CT	
Net savings]

Source: Bass.

8.27. Bass had high confidence that these savings were achievable. A key aim was to improve productivity in CT. In output of hl per man terms, the CT rate was [*] hl (or [*] barrels). Bass's rate was currently [*] hl ([*] barrels) and its aim was to move the merged group to over [*] hl ([*] barrels) post-merger, and to improve CT's performance on the distribution side from [*] retail tonnes per man per day to [*]. The restructuring was essential for CT. Recent brokers' reports and CT's own statements indicated that CT could not survive on its own in its present form. The projected savings from the merged group would build up over three years. Bass had every confidence that it could achieve, through communication and discussions, acceptance in CT of the need to make savings additional to those already underway in CT.

Breweries

8.28. The company had made it clear that, following the already completed closure of CT's Warrington brewery, and subject to there being no regulatory requirement to reduce the level of trade, its present intention was to retain all the breweries of the merged group including Alloa in Scotland and Wrexham in Wales. The intended policy was to concentrate the more complex and short-run production lines in breweries such as those, leaving the larger breweries to deal with longer run, more straightforward production, and hence to maximize unit cost reduction potential.

Employment

8.29. Bass confirmed that the employment reduction from the reorganization would be some [*] on the assumptions that the merger proceeded as planned. The merger would, however, allow Bass to create further

*Figures omitted. See note on page iv.

jobs as it continued to expand its export sales, as well as the very significant opportunities for employment being created in other parts of the Bass group.

Market issues

Distribution

8.30. Bass said that Tradeteam, which was set up to handle Bass's contracted-out distribution requirements, was jointly owned by Exel Logistics, a subsidiary of NFC, and Bass which held a 49.9 per cent interest. It was Tradeteam's objective that after three years, Bass would account for no more than [*] per cent of its trade. One of the options for Bass would be to move distribution of all CT's beer volume to Tradeteam, which could generate approximately £[*] million savings for Bass. If CT was to move distribution to an independent contractor such as Tradeteam independently, Bass estimated that it could benefit from savings of £[*] million to £[*] million; the additional savings which Bass could generate would arise from synergies in the distribution network. [

Details omitted. See note on page iv.

]

8.31. [

Details omitted. See note on page iv.

]

Concentration

8.32. The level of concentration in the UK market today was low by international standards for the industry. The HHI ratio was 1,715. After the proposed merger it would be 2,400, still below the average for major developed beer markets. While the merger would clearly increase the share of UK final beer sales held by Bass and the share of production capacity, it was not clear that these headline increases were in themselves likely to damage the public interest, given the dynamic nature of the market and the continued strength of the competitive pressures in the market summarized in paragraph 8.21. Bass would not regard the beer market in Australia, which had been mentioned as a possible comparison, as having sufficient features in common with Great Britain to offer any reliable parallel. Unlike Australia, which was geographically independent, and comprised a number of regional markets, Great Britain was part of the European regional market. Concentration was and would remain lower than in Australia. Also, unlike Australia, it was a large market in volume terms, its transport costs were modest, and entry strategies existed which required minimal capital costs (for example, direct exports from the Continent). Finally, the Australian market was subject to a kind of price regulation that could be expected materially to affect company behaviour.

8.33. It had been said that the merger would lead to a duopoly in certain parts of Great Britain, for example between Bass and Scottish Courage in Scotland. In Bass's view, however, the implications for competition in such situations were heavily influenced by a number of other characteristics, including brand competition, the threat of cross-entry and the presence of other wholesalers. In any event, no retailer was nowadays going to feel confined to one or two brewer's wholesale lists. If it was a pub-chain it would pick and choose. Smaller retailers would continue to have access to other national brewers, regional brewers, independent wholesalers and importers.

Regional brewers

8.34. In Bass's view, the merger would not mean additional difficulties for regional and local brewers. It would not be more difficult for them to get their products to markets, including those outside their own areas. They would still have the opportunity of buying pubs; and they would drive their brands successfully, as now, on a wholesale basis. Bass was carrying 71 of its own brands and was carrying or factoring 102 that it did not own, many of which were regional products because this choice was what customers wanted. The new post-

*Figures omitted. See note on page iv.

1980s beer market would continue to put pressure on regional brewers, but Bass considered that those which were well-managed would prosper.

Wholesale market

8.35. With greater retail concentration it was, according to Bass, inevitable that the retailers would tend to go direct to the producers. This would cut out some wholesalers. It was not, however, a feature of the merger. Independent wholesalers, especially the bigger ones with high-volume purchases, would still command substantial discounts. Bass's policy on discounts was based primarily on volume and quality brand distribution.

Loan ties and exclusivity

8.36. Bass rejected the notion of 'ties' from loans made to the free on-trade in this area because it was open to the loan recipient to terminate it within three months. Bass's own free trade loans, in line with its policy, were reducing, from £[*] million in 1992/93 to £[*] million in 1995/96, and from 9,378 free houses to 8,175 over the same period. There were other financial institutions in this market now, although brewers did still compete to buy out others' loans. As to exclusivity of supply, Bass said that 40 to 50 per cent of its loan agreements currently involved an exclusive purchasing commitment (subject to the right to buy a guest beer), but that this had been declining and was forecast to decline further. For pubs released from the tie to Bass under the Beer Orders the situation was that, while it was true that initially most pub purchasers made arrangements that resulted in continuity of supply of Bass brands, with the passage of time most retail group owners of these pubs had moved to dual or multiple sourcing.

Prices, choice and innovation

Prices: general

8.37. Bass considered that the proposed merger's effects on prices, if any, would be in relation to wholesale prices rather than retail prices; movements in wholesale prices were not necessarily reflected in retail prices; but in Bass's view the downward pressures on wholesale prices would continue—for example, from the consolidation of retail buying power, and from imports. Bass therefore maintained that after the merger the downward pressures on average real wholesale prices (net of duty and discounts) would continue. It did not accept that there was any evidence to support an argument that wholesale prices in the on-trade in areas of higher concentration tended to be higher than elsewhere with the possible exception of ale in Scotland, which exhibited strong regional characteristics in terms of consumer preference. In any event purchasing was increasingly done on a national basis. Over 70 per cent of beer market purchases were purchases made nationally (including the off-trade). And, on this issue, it was relevant that with the untying of the 4,000 ADR outlets there would be a large new national purchasing organization.

Prices: discounts

8.38. Bass had a standard national discount policy which offered discounts based on overall volumes which would be adjusted where appropriate to reflect the provision of any loan support, and on the basis of outlet-specific variables such as choice of brands, volume, risk, brand/container complexity and size, nature of outlet drop, cost of technical services equipment etc. For retail groups Bass offered higher discounts to gain access to the retail chains because of their volume and brand distribution.

8.39. Bass typically gave larger discounts to the bigger retailers than to independent wholesalers, because of both the higher volumes purchased and the marketing and consumer access benefits from supplying pub chains. Bass's largest discounts were generally to Bass Taverns. This was simply an internal arrangement, but was so structured for three reasons: it was BBL's largest customer ([*] per cent of Bass's on-trade sales); it put pressure on BBL to lower its costs; and gave Bass Taverns an incentive to increase beer sales. Discounts were

*Figures omitted. See note on page iv.

nonetheless rarely so large as to be at marginal price levels because they could result in a level of demand that would exhaust brewing capacity. Nor did Bass provide discounts that would result in charging less than cost.

Choice and innovation

8.40. The proposed merger would not restrict consumer choice. In Bass's view, it was likely to enhance it. This would be first through the retention and development of CT brands that might otherwise disappear, or that might be subject to reduced distribution, second through the maintenance of brewing capacity, wholesaling opportunities and national coverage and third, through a greater choice for all customers of the merged group, including Bass's own outlets. However, there had, separately from the merger, been decisions within the two companies to stop production of [*] minor brands ([*] Bass and [*] CT). This was in the normal course of business as new brands replaced less popular ones.

8.41. If lower discounts resulted from the merger, which Bass did not predict, it would not necessarily result in less choice and higher prices for the consumer. It would all depend on the strategy of the on-trade or off-trade retailer. As far as consumers were concerned, it was not so much a matter of whether they were more sensitive to price in the off-trade or in the on-trade; they were looking for different occasions. The fact that the BCT business would dominate the relatively small super-strength lager sector (up to 95 per cent) would not, in Bass's view, reduce the significant buying power of the off-trade retailers nor the choice available to them. Virtually all of the sales of the two products in question were in the off-trade.

8.42. From the choice angle, Bass considered that it needed the merger with CT because it did not have a major international premium lager in its portfolio, and the Carlsberg brand had an international image in the minds of UK consumers and it could be developed further as a premium brand. Nor was there any need for concern that competition between Carling and Tennent's (Bass) on the one hand and the Carlsberg and Castlemaine brands (CT) on the other would result in rationalization between them, as the latter two were international lagers with different brand positioning and hence complementary to Bass's brands rather than direct competitors.

Vertical links and barriers to entry/expansion

Vertical links

8.43. Bass considered that such links were progressively weakening. Only some 40 to 50 per cent of its loans to the free on-trade had any exclusivity of supply commitment attached (subject to the right to buy a guest beer). This percentage was declining and Bass's policy for the last three years had been not to enter into any more exclusive agreements. In addition the merger would reduce vertical integration in another respect, because AD's 4,000 houses would be free of a tie to a brewer. Bass did, however, believe that vertical integration was a pro-competitive force that had contributed to higher on-trade volumes, lower on-trade prices, greater choice and larger numbers of competitors and that this view was well supported by available evidence, including evidence on the links between variations in vertical integration and in on-trade prices. Vertical integration was of particular value to medium-sized and smaller brewers who wanted to supply a range rather than just a niche product. The value was not in any protection from competition which it offered, but in its giving them a way of addressing the market by methods that did not depend heavily on the attainment of substantial scale.

Barriers to entry and expansion

8.44. In Bass's view, pressure on brewers' margins was an indication that barriers to entry were fairly low. There were a large number of imports. Overseas competitors had established themselves in the UK. Budweiser was brewing at Mortlake; Becks and Holsten Pils were being imported, Kronenbourg and Heineken were being brewed under licence and there were new overseas owners of UK beers (for example, Ruddles). 37 per cent of all brands sold in the UK were foreign-owned. There were now more micro-breweries. New entrants had a number of alternative routes: they could sell to one or more retailers; they could develop their own wholesaling

*Figures omitted. See note on page iv.

operation, or make use of an existing one. In the on-trade they had much greater volume opportunities for draught beer than in other countries.

8.45. There was no reason why the merger should make barriers to expansion more difficult. Bass itself was keen to carry new products in response to consumer demand. Some [*] per cent of its sales were of factored products it did not own ([*] of which was Guinness). Bass would only draw the line at carrying competitors' copies of its own brands such as Caffreys.

Public interest benefits

8.46. Bass was committed to cost reduction. The merger would enable Bass to achieve significant efficiencies and reduce costs thereby enabling it to respond to competition in the market more effectively. Reduced costs would also enable margins to be improved while not reducing the downward pressure on wholesale prices, and lower unit costs would enable Bass to price more aggressively at the margin. If there were no merger, then the industry's unit costs would be significantly higher than they need be. The merger would release resources for use elsewhere and, over time, it could be expected that the benefits of lower brewing costs would be shared with others, including pub owners and final consumers of beer.

8.47. The merger would give rise to other public interest benefits by:

- (a) maintaining all of CT's breweries which would not be feasible in the absence of the merger, thus enabling Bass to continue to produce a range of brands to meet consumer needs and to develop its expanding export business;
- (b) increasing brand choice available to Bass's and CT's customers and, through cost reductions, enabling greater investment in and greater support to be given to the CT brands than would otherwise be possible; and
- (c) creating a more secure environment for CT employees in the longer term than CT as a stand-alone business and allowing Bass to create more jobs as it continued to expand export sales and through investment in other parts of the Bass group.

8.48. Bass said that it was at the forefront of export growth in the UK beer industry. In 1996 its exported beer volume had risen by [*] per cent and in the first 16 trading weeks of 1997 it had grown by [*] per cent (now standing at [*]). Bass's continued success in the export market would create additional jobs domestically and, as noted above, cost reductions and increased capacity in the UK would help Bass to expand its beer sales overseas.

Remedies

8.49. The company was asked to give its views on various possible remedies, on the hypothetical assumption that the MMC might reach the conclusion that the mergers might be expected to operate against the public interest. At an early stage Bass was asked to consider a variety of individual remedies including the matters referred to in (a) to (g) of paragraph 8.50. Subsequently its views were sought on a much more specific (albeit illustrative) package of remedial measures relating to pub disposals.

8.50. In considering the individual remedies put to it early on in the inquiry, Bass said that in principle it was very difficult to comment on the appropriateness of any particular remedies, their feasibility or acceptability etc, without first understanding the detriment they were aimed at. Moreover, it was possible that a combination of these remedies might have substantially different effects from any one of the components of that combination taken on its own. This posed a practical problem about giving a considered reaction. The company did, however, provide indicative reactions, without prejudice to its position, as follows:

- (a) *Prohibition of the merger. If Bass were required to divest its existing 50 per cent interest in CT, would this pose any practical problems?*

*Details omitted. See note on page iv.

If there were a complete prohibition, which Bass felt would certainly be disproportionate to any perceived detriment, then Bass would have to undertake a major review and reassessment of its brewing strategy.

(b) An undertaking to dispose of one or more brands and the brewing capacity required to produce them.

The acceptability of this kind of remedy would depend on the extent of brewing capacity to be disposed of, the precise brand(s) and the associated loss of economic value. While such a remedy might be acceptable at a certain economic scale, if it was such as to disrupt or destroy the economic viability of Bass's brewing operations, it would obviously not be acceptable.

(c) An undertaking to dispose of a significant number-say 3,500-of tied pubs and to accept a reduction to, say, 1,000 in the permitted maximum under the Tied Estate Order, such reductions to be concentrated in those regions (for example, the Midlands and Scotland) where Bass and CT currently together had high market share.

On this, Bass said that the level of vertical integration for the merged group would already be very low and that of itself the merger had already in effect freed the 4,000 ADR pubs from the tie. In earlier discussions with the OFT, Bass had considered the acceptability of freeing another 1,000 or possibly more if that were genuinely thought to be necessary. However, the numbers in the example above would be quite unacceptable in terms of both disposals and the reduction in Bass's permitted maximum under the Tied Estate Order. Bass also stated that there was no systematic relationship between the geographic coverage of its pubs and of its beer sales; in particular it had very few pubs in Scotland.

(d) An undertaking to limit any future supply arrangements to the ADR estate by BCT to a period of, for example, five years and to a maximum of, say, 50 per cent of AD's retail requirements.

In reply to this, and on the assumption that the proposal sought to restrict volume supplied, rather than volume committed to be supplied/purchased, Bass said that although it was not, in principle, a question that it would refuse to consider, there were serious difficulties with it. If ADR's consumers wished to buy larger volumes of Bass products, it would be unfair if they were prevented from doing so and it would amount to a restriction on competition in itself.

(e) An undertaking to ensure that at least 15 to 20 per cent of the on-trade wholesale volume of the BCT merged business should be from a range of third party brands (that is, brands which were neither owned nor brewed by BCT), that there should be a wide choice of such brands available (say, 50 per cent of the list) and that there should be no reciprocal supply arrangements in relation to those brands.

Whatever the effect on Bass of such a measure, there would, in its view, be real, practical problems of putting it into operation not least because, whilst Bass might retain a certain number of third party brands on its wholesale price list, Bass could not compel its customers to purchase them. Furthermore, Bass was not confident that it could compete in the market-place with such a remedy. It would mean the company being compelled to limit its competitiveness, and in a particularly difficult way; every time it failed to sell someone else's beer it would have to cut back on its own beer sales. It would be an almost impossible task to explain to Bass's sales force, let alone to achieve.

(f) A reduction in the level of excise duty for the first 200,000 hl of beer brewed by any producer in order to protect the position of small regional brewers which could not achieve the economies of scale of national brewers and to protect the range of brands available to the consumer.

In Bass's view this would be acceptable as long as it applied also to Bass. Otherwise it would give small producers, that is those producing at about this level, a significant cost advantage over Bass particularly in the case of a new brand from an independent supplier. Such a measure could be abused in practice and could lead to an artificial reconfiguration of production into small units simply to take advantage of the concession. It could also lead to a large increase in the number of micro-breweries.

(g) The effect of requiring, for example, the present CT wholesaling operations to be hived off to an independent business.

Bass considered that it was difficult to comment on this as a general proposition because so much would depend on the detail of any such remedy. Depending on its terms it could significantly reduce the efficiency gains to be expected from the merger and, therefore, the merger's value for Bass and the public. It could, therefore, be seen as a disproportionate remedy. If, for example, the proposed new wholesaling business were placed in a privileged commercial position for current CT brands (for example, through exclusivity of supply), this could distort competition between the merged business and other wholesalers, including other brewer-wholesalers. In addition, there already existed a sizeable independent wholesaling sector with 12 per cent of independent on-trade sales. And it was not clear to Bass what public interest detriment would be addressed by this hiving off possibility.

8.51. The package of illustrative remedies, set out in paragraph 8.53, which Bass was subsequently asked to comment on at the second hearing held with the company, was focused on the possible divestment of part of the company's estate, again on the hypothetical basis that the merger would have effects adverse to the public interest because:

- (1) it would substantially reduce the amount of competition in the production and wholesaling of beer, thus causing wholesale prices to rise; and
- (2) it would lead to a reduction in diversity of choice for the consumer.

Commenting on this, Bass said that it could not accept that the merger would reduce competition and cause a rise in wholesale prices, nor that consumer choice would suffer. The current downward pressure on wholesale prices would continue for the reasons outlined in paragraphs 8.21 and 8.22 and would be unaffected by the proposed merger. There was independent corroboration of this view; Bass cited a paper it had supplied, providing an assessment of the capital market's expectations. These were that no significant movement in wholesale prices would result from the merger. But, in any case, it was not as though the choice was between the merger and leaving things as they were. It was clear to Bass that, on its own, CT could not survive in the market as it was now, and that without a merger Carlsberg would decide to reduce the scale of its operations in the UK brewing market.

8.52. As to the suggestion that choice might suffer, there were three points to be made:

- (1) in the absence of the merger CT would be bound to reduce very substantially the brands it had on the market. The merger therefore would maintain choice;
- (2) if the MMC were concerned to maintain, in the public interest, any specific brand or a given number of BCT brands, Bass would certainly be prepared to look at such a suggestion (assuming some allowance for a balance of new entries to, and departures from, the list); and
- (3) against any MMC concern that choice would suffer because other brewers might leave the market, there was the point that this would only happen as a result of intense competition. And intense competition implied falling wholesale prices-another counter to the MMC's hypotheses on the public interest (see paragraph 8.51).

8.53. The hypothetical set of remedies on which Bass's comments were sought, was as follows:

- (a) for Bass to accept a reduction in the number of its tied houses to a maximum of 2,000, and to divest itself of the excess of its tied houses over 2,000;
- (b) to implement this divestment in accordance with a plan to be prepared by Bass within two months of the date of publication of the MMC's report and to be approved by the DGFT; such plan to incorporate the following principles:
 - (i) divestment should be made to persons approved by the DGFT and completed within one year of the date of publication of the MMC's report;
 - (ii) the number of tied houses selected for divestment in each television advertising region should be broadly proportionate to the combined share of final sales made by Bass and CT in that region in 1996. The divestment should also be such as to lead to a reduction in the volumes of beer sold by

BCT through its tied houses in each region which was broadly proportionate to the reduction in the number of tied houses in that region;

- (iii) at least 50 per cent of the tied houses selected for divestment should be sold in parcels of not more than 25 houses within a 25 mile radius of a central point. In relation to the sale of any parcel, there should be no requirement or incentive that the purchaser should buy another parcel. Regional and local brewers should be given a right of first refusal;
- (iv) there should be no requirement or incentive for the purchaser of any tied house to take any product or service from BCT or from anyone else; and
- (v) if BCT entered into an agreement with the purchaser of a tied house for the supply of any BCT product or service, there should be no requirement or incentive for the purchaser to take any other product or service from BCT or from anyone else.

8.54. Bass said that the value of its tied estate was possibly some £[*]. Disposal of the 2,400 on-licences implied in the proposal (that is, from the present actual level of nearly 4,400) could equate to a divestment of more than £[*], compared with the £200 million outlay for the merger with CT and the value of Carlsberg's 20 per cent shareholding in the merged group. The remedy would, therefore, be quite disproportionate to the public interest issue involved. Bass would not sell or dispose of 2,400 on-licences to get approval for the proposed merger. The fallback provisions would be preferable to such an outcome. Bass had discussed a level of around 1,000 disposals with the OFT which could, perhaps, go to a somewhat higher number. This represented a very substantial sum in terms of shareholder value, and it would be important that the disposal process did not prevent the company from deriving appropriate value for it.

8.55. The focus would have to be on the leased estate of 1,426 houses, as Bass saw less scope for growth in these than in the 2,764 managed houses which could be developed by Bass for other retail value added services, such as food and entertainment; and moreover, leased pubs were more reliant on beer sales, although they did not sell, per outlet, as much beer as the average in the managed estate. Bass also required the headroom it had between the actual number of managed houses and the maximum permitted number under the Tied Estate Order (the gap was currently nearly 380 overall) in order to allow room to develop the managed estate, in particular the strategic house brands such as Harvester and other leisure retailing outlets.

8.56. Commenting on the specific components of the set of possible remedies outlined in paragraph 8.53, and using the numbered references in that paragraph, Bass gave the following reactions:

Approval of DGFT

- (i) This provision could easily reduce value if it was applied in an unreasonable manner. Critical in any level of divestment would be Bass's ability to sell so as to realise maximum value. If the purchaser had to be approved by the DGFT, Bass might not know whether or not there could be a free commercial auction until it knew if the purchaser was or was not approved. And the knowledge of the need to have DGFT approval could deter some potential buyers altogether. Bass would prefer a mechanism whereby the main elements of the disposal were approved by the DGFT rather than the specific identity of every individual purchaser. In addition the timetable seemed very tight. To avoid distress sales two years, or perhaps 18 months, would be fairer and more consistent with allowing Bass to realise the full value of its disposals. It was put to Bass that half the disposals should be put through within six months. Bass said that was unacceptable, particularly as smaller purchasers would need time to raise finance.

Regional/proportional divestment

- (ii) This provision also posed great difficulties for Bass. If the divestment was based on a figure anything like the 2,400 implied, it would mean that in regions such as Scotland, where of the [*] tied pubs only [*] were leased, Bass would have to dispose not only of its leased estate but of its managed estate as well, and it would have no headroom for expansion. This would make it impracticable to drive forward

*Figures omitted. See note on page iv.

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the managed estate business in these regions. As a national retail brand Harvester, for example, would be at a disadvantage to, say, Beefeater, or another chain. There were plenty of operators in this market who were not limited as to the number of their managed premises. A more appropriate remedy in regions such as Scotland, could be for BCT to take action to reduce the scale of its loans to the free on-trade. Bass acknowledged, however, that this was already a declining part of its own activities. Bass offered to discuss this aspect further with the MMC.

Disposal groupings and conditions

- (iii) On this, Bass said that any proposal to provide a right of first refusal for certain groups, in this case regional brewers, would be bound to detract from the overall potential value of any sale. For a start it was not at all certain that there were as many potential purchasers among the regional brewers as this provision implied. Second, the existence of such a right would deter other potential purchasers from participating at all. Bass made it clear that giving particular classes of purchasers an express right to bid would not create problems. Third, Bass did not understand why the MMC were seeking to benefit regional brewers over pub companies given that the MMC had previously sought to establish pub companies as a countervailing force to the brewers. Indeed, if regional brewers wanted to expand their tied estates there were many opportunities already for them to do so. Finally, the 25 house-25 mile radius element was an unnecessary constraint, in principle, on the way Bass might need to market the properties to maximize value.

Conditions and incentives for purchasers

- (iv) Bass did not have any major problem with the idea that it should not, as part of the pub disposal process, impose any simultaneous requirement or provide any incentive (for example a loan tie) to the purchaser. The company assumed, however, that it would still be free to bid and compete normally for the purchaser's business, along with other suppliers.

Conditions of supply agreements

- (v) In any case, Bass doubted that EC law permitted the kinds of condition which this part of the package was aimed at preventing. Subject to that, however, Bass did not consider that a provision of this kind would cause any difficulty.

Fallback arrangements

8.57. Asked if the proposed fallback arrangements were likely to address any potential public interest concerns, Bass's view was that if the merger was not allowed to proceed (or if Bass found the remedies so economically unacceptable that it declined to proceed), then the route would be through the fallback arrangements. In all cases of public interest aspects, however, for example efficiency, brand choice, security of employment, Bass regarded these as weighing heavily in favour of the merger going through rather than the fallback.

P H DEAN (*Chairman*)

J EVANS

A FORSTER

D M G NEWBERY

P A BOYS (*Secretary*)

24 March 1997