

## **CRA COMPETITION POLICY DISCUSSION PAPERS 3**

### **The importance of market conduct in the economic analysis of mergers - The Interbrew saga**

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## The importance of market conduct in the economic analysis of mergers - The Interbrew saga

### Abstract

*The view of this discussion paper is that too often regulators tend to assess a merger only by reference to the analysis of post-merger market structure. This "structural" analysis is important, but it does not take into account the form of competition and rivalry between firms (or, in economic terms, conduct) and the corresponding effects on market outcomes (such as resulting prices and the quality of goods and services). We believe that the analysis of post-merger market structure should be only a preliminary step in the regulatory review of a merger. Empirical assessment of conduct in the market is also needed. Understanding the conduct of firms and overall market performance are fundamental issues that need to be resolved before effective judgement can be made as to whether firms are able to exercise market power and thereby adversely affect competition in the market. It is simply not enough to point to evidence that market shares are high and that there are barriers to entry to determine that competition and market performance will be detrimentally affected by a merger taking place. We illustrate this by reference to the recent Interbrew case and argue that, in a number of critical respects, the Competition Commission has not sufficiently accounted for empirical evidence on conduct and rivalry between firms. We conclude by recommending that regulatory scrutiny of future mergers, instead of relying mainly on a simple but sometimes misleading analysis of market structure, also addresses more fully the nature of competition and rivalry between firms and gives these aspects the importance they deserve.*

In January 2001 the UK's Secretary of State for Trade and Industry, in accordance with the recommendations of the Competition Commission, requested that Interbrew SA should divest the brewing interests of Bass Plc ("Bass Brewers") in the UK, effectively blocking their merger. The Secretary of State accepted the Commission's view that the merger would have created an effective duopoly in the UK brewing industry (with Interbrew UK Ltd and Scottish & Newcastle PLC allegedly holding a joint dominant position) and that this would have been against the public interest. The decision was eventually overturned by the High Court in May 2001, following Interbrew's successful application for judicial review. The ruling held that Interbrew was not given the opportunity to comment on all possible effective remedies. Subsequent to this, agreement with the UK authorities has allowed Interbrew to retain part of the brewing interests acquired but divest certain brewing capacity and key brands (including the UK's leading brand "Carling").

The Interbrew case is remarkable in several respects. It has made legal history in that for the first time the High Court overturned a merger decision made by the Secretary of State. It has probably set the record for the longest merger review process, as it passed more than one year from the initial notification in July 2000 to September 2001 when, after the High Court ruling, the Office of the Fair Trading (OFT) advised the Secretary of State on appropriate remedies. It also was the first time that joint dominance concerns were coupled with portfolio power arguments, and the first time these arguments and concerns were made explicit in the UK.

Many lessons can be drawn from this case. Not least, the High Court ruling and the ensuing OFT review proved to the antitrust community that a variety of remedies short of outright blocking can be devised to remedy adverse joint dominance concerns. In this paper, though, we would like to draw attention to another aspect of the case.

Interbrew focused its appeal on the procedures adopted by the Competition Commission for considering remedies rather than the conclusions reached on the prospective joint dominant position. We believe, however, that the Competition Commission's economic analysis was flawed because it ignored crucial evidence and its conclusion was not justified. More specifically, we believe that the Competition Commission, although it formally analysed a number of market characteristics, or market *structure*,<sup>1</sup> did not give sufficient weight to strong evidence provided on the nature of competition in the market, or, in economic terms, *conduct*. This evidence fundamentally undermines the argument that jointly dominant behaviour would arise to harm competition in this market.

As is clear from reading the Competition Commission's market examination (Chapter 4 of the Report), its analysis relies mostly on measures of market concentration - market shares - and on other aspects of market structure - such as barriers to entry - to support its claims that consolidation in the market through the merger of Bass Brewers and Interbrew would be detrimental to the public interest by adversely affecting competition. The nature of competition is considered in a very brief and partial manner, and more importantly, no inference is drawn from it. The substance of the conclusions is derived from the analysis of post-merger market structure. This "structural" analysis is important, but it does not take into account the form of competition (i.e. how the firms behave in the market, whether they compete intensively or not) or how the market is performing in terms of the resulting prices and the quality of goods and services.

Understanding the conduct of firms and overall market performance are fundamental issues that need to be resolved before effective judgement can be made as to whether firms are able to exercise market power and thereby adversely affect competition in

the market. It is simply not enough to point to evidence that market shares are high and that there are barriers to entry to prove that competition and market performance will be detrimentally affected by a merger taking place.

The central point of this discussion paper is that the analysis of post-merger market structure is only a preliminary analysis in the assessment of a merger. Empirical assessment of conduct or effective competition in the market is also needed.

### **The Competition Commission's argument**

The economic analysis of the Competition Commission relies on market share analysis and their assessment of other market characteristics. Essentially, the Competition Commission's conclusions take the view that pre-merger there is only one scale monopolist (Scottish & Newcastle with a market share of 28%) and a number of viable competitors to prevent this scale monopolist abusing any market power it might have. But post-merger there would have been two scale monopolists who, although not significant in their own right (and thus not raising concerns about single-firm dominance), jointly would give rise to serious concern that competition would be adversely affected.

The two duopolists, the Competition Commission argued, would (presumably by tacit collusion) shift from price competition to non-price competition (i.e. advertising and marketing) that would lead to an increase in net wholesale prices, and ultimately in retail prices. This increase in non-price competition would also lead to an increase in barriers to entry to new brands and in barriers to expansion for existing, competing brands.

In the Competition Commission investigation there are three serious flaws in its economic analysis:

1. The Competition Commission largely ignored the effect on competition and brewers' conduct

spurred by the emergence of public house companies ("pubcos") after the 1989 Beer Orders.<sup>2</sup>

2. The Competition Commission did not empirically address, nor take into account empirical evidence on, conduct and in particular on the nature of pricing, which is particularly pertinent to claims about likely "parallel pricing" and joint dominance.

3. There is no empirical analysis by the Competition Commission to indicate whether market practices such as using advertising to promote brands are anti-competitive and whether they would have increased as a result of the merger.

To make judgements on these aspects it is important to consider firms' conduct, that is, the actual nature of competition in the market.

### **Retail concentration and wholesale competition**

Unlike the OFT in its December 2000 review of the Beer Orders,<sup>3</sup> the Competition Commission did not seem to attach much importance to the stark industry trend of reduced vertical integration and greater concentration at the retail level. The 1990s were characterised by a long process by which many formerly integrated brewer/retailers divested their brewing interests to concentrate on the more lucrative aspect of retailing. This, compounded by the falling level of beer sales, led to a consolidation of the brewing sector.

With the substantial weakening of vertical integration and brewer-pub ties, the nature of competition has changed substantially. From a vertically integrated structure with limited direct head-to-head brewer competition, the brewing industry has rapidly evolved into a much more openly competitive structure. With the sale of Whitbread's and Bass's pub estates, vertical ties in the industry have been further reduced. At the same time, consolidation at the retail level has continued to the point that recently pub chains owned 52% of the UK pubs.<sup>4</sup> Brewers are now faced with considerable buying power at both

the on-trade level (pubcos) and the off-trade level (the major supermarket groups).

These changes in the structure of brewing and retailing have thereby tended to have a pro-competitive effect, witnessed by continuously falling wholesale beer prices. In essence, as brewing concentration has increased so efficiency has increased (operating and distribution costs have been lowered and inefficient excess capacity has been reduced). At the same time, retailers have been better placed to assert their bargaining power over brewers and extract lower wholesale prices, which have been possible as a consequence of the increased efficiency of brewers flowing from the consolidation and rationalisation process.

With less vertical integration and increased retail concentration brewers face intense bidding competition to win contracts from unaffiliated pubcos and obtain shelf space in off-trade retailers. The trading behaviour of the multiple pub groups is now very much in line with the multiple grocers and off-licences in the off-trade, with purchasers buying in bulk and becoming increasingly price sensitive. The decision as to which beers to stock is often the result of a tender process with the retail group selecting beers on the basis of a range of criteria, including price, brand position and service levels. The size of each of the independent pub groups is such that each brewer is incentivised to compete strongly to retain or win a supply contract. The possible loss of a supply contract is a sufficient threat to ensure re-negotiation on terms favourable to the retail customer. This is particularly so in view of the fact that there is a high proportion of fixed costs associated with brewing, and the loss of a significant volume of sales therefore results in a substantial reduction in cost recovery.

Direct head-to-head competition between brewers arises not only in bidding situations to win supply contracts but also in-pub as choice to the consumer

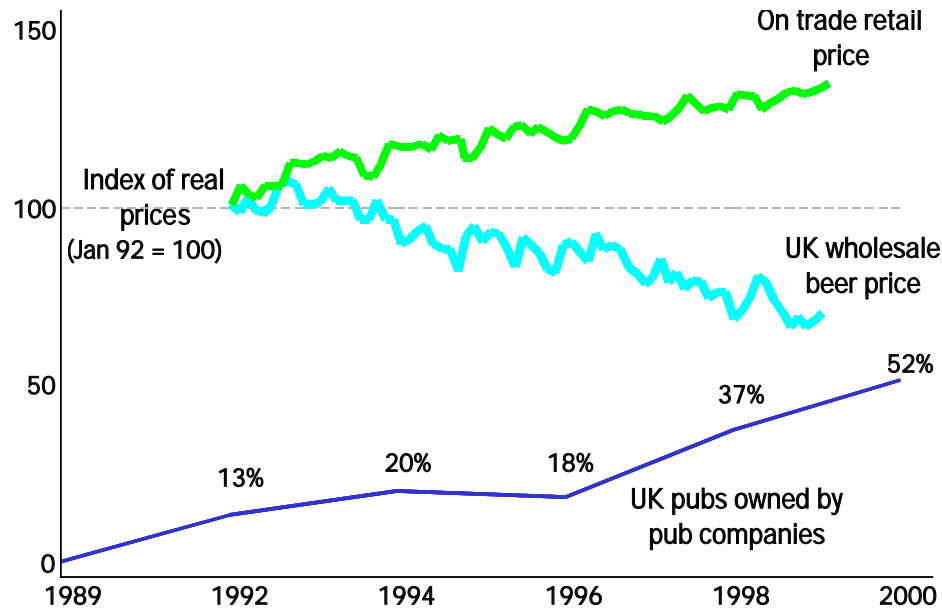
has risen with the ending of exclusive dealing and in-store as brands line up against each on the shelves of the major supermarket and off-license chains. Consumers are now much less likely than they were in the past to restrict their beer purchases to one single brand. Retailers in the on-trade and the off-trade have reacted to this and now stock an increasingly large range of brands. Younger customers in particular are affected by brand innovation. This can be seen from the high growth rate of premium bottled lager. Brewers have had to react to this increase in brand promiscuity and have had to compete more intensely in order to sell their products to retail outlets.

As a result of the more open market a greater emphasis is placed on brand-by-brand competition and retail customers may accordingly take beers from a number of brewers. In such situations, bidding may be expected to be intense. The pubco will tend to hold the upper hand in such situations since its greater freedom in choosing suppliers (switching costs are low to non-existent) will encourage competitive bidding from brewers who have no other immediate options for increasing sales. This difference in relative bargaining positions allows even small pubcos controlling small market shares to play off major brewers against one another. While the losses of beer volumes have a direct impact on brewers' profitability, pubcos can afford not to stock a certain brand of beer, given that the beer offered in a pub ranks only seventh amongst the reasons given by consumers for choosing a particular pub.<sup>5</sup>

Similarly in the off-trade, competition for limited shelf space is placing brewers under increasing pressure given that as retail concentration increases fewer but larger contracts come up for tender while de-listing threats remain credible even against the very largest brewers.

As evidenced by Figure 1 below, it is also apparent that as wholesale prices have been falling and retail

Figure 1: Average wholesale and retail prices vs Pubco concentration



Source: *Pub Industry Handbook*, BLRA

concentration increasing, retail beer prices in the on-trade have continued to rise indicating that pubcos have been simultaneously able to exercise buyer as well as seller power. Statistical analysis shows that the wholesale prices are significantly negatively correlated with on-trade retail concentration and, it seems, also with brewing concentration. In fact, the 1995 merger between Scottish & Newcastle and Courage did not reduce the rate of decline in wholesale prices, which, if anything, increased after 1995. Indeed, if brewers were able to exercise market power it might be expected that if concentration at that level increased then it would be positively related to wholesale prices. In fact a simple statistical analysis shows the effect to be negative. This suggests that increasing brewing concentration could have a pro-competitive effect, possibly since it allowed for increased efficiency, which in turn reduced the cost base for brewers allowing retailers to negotiate prices down. All these factors suggest that the merger would not have reversed the downward trend in wholesale prices, given that apparently

this had been driven by changes in the structure of the retail sector, over which the merger had no effect.

#### The problems with the parallel pricing argument

The credibility of the Competition Commission's view that conscious parallel pricing behaviour (essentially tacit collusion and devising means to avoid intense price competition) would emerge in this market rests on their interpretation of the market conditions

favouring such behaviour. Based on previous cases and economic theory, it is accepted that there are a number of market conditions that, when simultaneously arising, strengthen the possibility or feasibility that such behaviour might occur. However, critical to this line of argument is that the parties concerned should be able to focus on a set of prices which they independently understand to be appropriate, which they would then gravitate towards and that once they reach that point and set common prices they do not deviate from this position.

The two most important conditions are that (i) prices are transparent, i.e. all parties can see all prices in the market (to enable them to see what is going on in the market and particularly how rivals price), and (ii) a market-wide or segment-wide price (or equivalent parity of prices which reflect accepted quality differences in the products) can emerge. In many situations, this is indeed the case: firms tend to charge similar prices to every customer in the same class as their competitors and these can be observed by their

competitors. This is absolutely essential in order for parallel pricing to occur, as rival firms need a price to focus on and coordinate around. Yet this is clearly not possible in this market which is characterised by bidding competition and strong buyer power and where all negotiations with customers are private and terms not publicly disclosed. As the chart below shows, there is a large dispersion of net wholesale prices, even when different volumes are taken into consideration.<sup>6</sup>

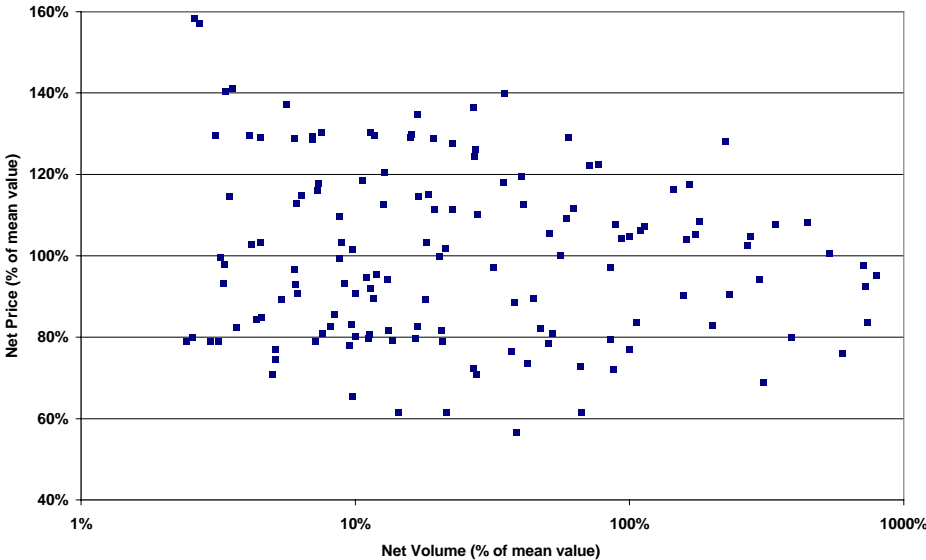
The chart unambiguously shows that that brewers have no clear way of predicting the price of their competitors on the basis of volume taken (as one would expect in a market with homogenous client needs that would be susceptible to price coordination). The Competition Commission took the view that, notwithstanding all the various discounts and service elements bundled in to wholesale prices, ultimately the net price per barrel could be measured and be seen in the industry allowing key brewer rivals to determine focal price points around which to coordinate and in so doing avoid undercutting

each other. This evidence dispels that view. There is no single price rule and prices are set in a series of heterogeneous bidding processes.

This evidence of price dispersion indicates how buyers choose to bargain and the extent to which they would be seriously willing to consider shifting to another supplier and thereby seek to play off different brewers against each other. Moreover, there is no that simple segmentation of the market that brewers could undertake. It is clear from Figure 2 that there is no clear separation into two, three or even four groups for which “pricing rules” could be devised.

Note that this evidence does not imply that we are in the presence of price discrimination indicating that brewers are exploiting their market power: there are many reasons why this may be happening in an effectively competitive market. Suffice it to say that price dispersion in wholesale prices is something that the OFT investigated and reported on only a few years back. Its conclusion then was that there was no unfair price discrimination in the market (or none that at least warranted remedies).<sup>7</sup> The OFT looked

Figure 2: Net wholesale price vs net volume for one brand



Source: One of the Parties.

at price discrimination very thoroughly again in its recent review of the Beer Orders and found no need to impose any remedy to the current situation.

Again, as in the case of the industry trends previously described, the merger would not have had any impact on price dispersion and the change in market structure brought about by it, and analysed by the Competition Commission, could not have made coordination easier. This

is because the nature of competition (or conduct) in the market is such that tacit coordination is extremely difficult to achieve.

The Parties put clear evidence on the extent of price dispersion before the Commission - this has been ignored. In fact, the Competition Commission admits that the price is not transparent, but it does not address price dispersion. In its argument about whether a market price exists, it addresses the “related argument” of the multiple dimensions of competition but not the central argument of the large price dispersion.<sup>8</sup> Hence, in our view, the Competition Commission did not address the single most important piece of evidence relevant to the issue of parallel pricing and it failed to show how brewers could coordinate on a market price if there is no such thing as a market price.

### **The nature of non-price competition**

Finally, contrary to what is assumed by the Commission, it is not established that a rise in non-price competition will necessarily be adverse to competition, or consumers, overall. There is no evidence produced to suggest that increasing intensity of non-price competition is damaging. Over the last decade marketing intensity has increased while prices have fallen. According to the Competition Commission’s logic we should already be seeing ineffective competition (prices rising, etc.). There is no evidence for this. Indeed, the opposite is happening - prices have been falling while advertising has been increasing. After all, non-price competition is still a form of competition and it is surprising that a regulator should take such a negative view of it. Or, as the OFT puts it: “Increased advertising expenditure is a sign of enhanced inter-brand competition in the on-trade”.<sup>9</sup>

Interestingly, the theory of advertising as an endogenous barrier to entry (that is a barrier generated by the conduct of the players) referred to by the Commission is inconsistent with the Commission’s view that the merger would have resulted in tacit collusion. First, brand promotion and the intensifying advertising escalation to promote product differentiation and build customer/consumer loyalty would result in heterogeneous and differentiated products and hence reduce the possibility of adopting a conscious parallel behaviour for which the homogeneous nature of the products is a favourable condition. Second, central to the economics of endogenous barriers to entry or expansion is the fact that these are an expensive way (as advertising is costly) for firms to escape too strong head-to-head price competition. Economic studies in this area show how the escalation in advertising expenditure is often brought about by an increase in price competition. Increased advertising is undertaken to allow a brand-owner to raise its price above that of its competitors. Then it is clear that, if price competition were softened by conscious parallel behaviour, there would be very little incentive to increase advertising, as the price that could be charged to consumer would depend only on the tacitly coordinated industry price, which is largely independent from the specific firm’s amount of advertising.

### **Conclusion**

The reality of the recent events in the UK beer market is that Whitbread’s and Bass’s decision to divest their brewing interests marked a key point in a long process by which the continuing pressure on wholesale prices has left brewers with the choice between consolidating and rationalising their operations or exiting the market altogether. Many formerly integrated brewer/retailers have voluntarily divested their brewing interests to concentrate on the more

lucrative aspect of retailing. The pressure on prices exerted by the emergence of pub chains has resulted in some concentration, albeit far less than that experienced by any other significant national market (with the only exception of Germany), and probably not enough, given that brewers' profits account for only 4p in the price of a £2.04 pint.<sup>10</sup>

In a number of critical respects outlined above, the Competition Commission has not undertaken sufficient empirical analysis nor sufficiently accounted for empirical evidence put before it in reaching its conclusions about the economic effects of the merger and possible remedies. In the absence of these considerations, the Competition Commission's conclusions and proposals lack strength as they rely mainly on a structural analysis of the market and abstract from the evidence of conduct and rivalry between firms. We would recommend that regulatory scrutiny of future mergers, instead of relying mainly on a simple but sometimes misleading analysis of market structure, also considers the nature of competition and rivalry between firms and gives these aspects of the analysis the importance they deserve.

1 And, although this is not the subject of this paper, we respectfully disagree with the Commission on various aspects of its analysis.

2 Following a MMC enquiry into the supply of beer, and the resulting implementation of the Beer Orders in 1989, restrictions on the number of pubs that a brewer can own or

have an exclusive beer supply agreement let to the leading brewers selling off thousands of pubs. The Beer Orders were designed to cut beer prices and improve consumer choice by increasing competition between pub operators.

3 OFT 317; *The Supply of Beer*; December 2000. See, for instance, paragraphs 2.11; 2.15; 2.16; 4.4; 4.6; 4.12; 5.4.

4 *Pub Industry Handbook*.

5 Competition Commission; *Interbrew SA and Bass Plc*; January 2001; page 61; table 4.2.

6 Note that the data have been scaled in such a way as to ensure confidentiality. Moreover, the brand selected was not unique in terms of the extent of price dispersion. The degree of price dispersion exhibited here appears to be a common feature in the market.

7 The 1995 OFT enquiry into the wholesale price of beer focused on the question whether tenants of tied pubs pay more for beer than their competitors in the free trade, and, if so, whether any action was justified under UK competition legislation. The outcome of the investigation was that the Director General did not consider that there were sufficient grounds to refer the issue to the Monopolies and Mergers Commission nor, consequently, to seek undertakings in lieu of a reference (Source: OFT Press Release; *Carlsberg Announces Results Of Enquiry Into Brewers' Wholesale Pricing Policy*; May 27, 1997).

8 See Competition Commission; *Interbrew SA and Bass PLC*; January 2001; page 26; paragraph 2.116.

9 OFT 317; *The Supply of Beer*; page 35; paragraph E.45.

10. "Interbrew may have to unpick Bass deal", *Financial Times*, 25 October 2000.

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**The authors acted on behalf of Interbrew SA throughout the merger review. The views expressed herein represent those of the authors and are not necessarily shared by the parties involved.**



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