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## **Competitive effects of the Tied Houses**

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Candidate:  
**Carlo Angelini Rota**  
**186851**

Thesis coordinator:  
**Gian Luigi Albano**



# Contents

<b>1</b>	<b>Introduction</b>	<b>5</b>
1.1	Exclusive Dealing . . . . .	6
<b>2</b>	<b>History 1989-2014</b>	<b>11</b>
2.0.1	The Beer Orders and the "Pubcos" . . . . .	12
2.0.2	The reports until 2014 . . . . .	14
<b>3</b>	<b>Economic analysis</b>	<b>23</b>
3.0.1	Mathematical Notations: . . . . .	27
3.0.2	Monopolistic brewer selling to free tenants . . . . .	27
3.0.3	Brewer-tenants with exclusive agreements . . . . .	28
3.0.4	Pubcos . . . . .	30
3.0.5	Complications . . . . .	32
<b>4</b>	<b>The CAMRA super complaint</b>	<b>37</b>
4.0.1	Inquiry on Prices . . . . .	41
4.0.2	Discounts and Rents . . . . .	44
4.0.3	Foreclosure and Restrictive covenants . . . . .	47
<b>5</b>	<b>Conclusion</b>	<b>49</b>



# Chapter 1

## Introduction

My purpose is to analyse both the effects that vertical restraints such as exclusive dealing have on competition, and its causes which can be linked to the vertical integration structure within an industry. The market taken into consideration is the beer distribution in premises for the sale and consumption of drinks at national level, the geographical scope is large since we consider whether these types of vertical restraints and relationships foreclose the UK market to small and foreign investors. Over a temporal period of twenty-five years, there has been many debates regarding the structure and the resulting allocation of bargaining power of this particular market, indeed many critiques believed them to be the reason for increasing pub closures and harm over consumers and tenants. The questions on the legitimacy or illegitimacy of this particular industry framework arose in 1989 with the report on Beer published by the UK Monopolies and Mergers Commission and an answer by the Government was given in 2015 when the "Small Business, Enterprise and Employment Act"<sup>1</sup> was enforced. Over the years though, many

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<sup>1</sup>Small Business, Enterprise and Employment Act (2015), Part 4: "The Pubs Code Adjudicator and The Pubs Code.

courts, competition authority and consumer bodies researched the effects that these exclusive agreements had on competition and on consumers, and there was never a collective opinion between the parties. Therefore i am going to explain the practices that takes place in this particular market structure, the legal and historical context in which they are situated and the different views that overlapped each other during the years, hoping to make a bit clearer the benefit and cons they have on competition. I will do so, fist by introducing how the industry is structured, including its history and the mutations that took place from 1989 to 2015. Then i will show theoretically the differences in prices available to the market, which are dependent on the type of vertical relationship, and i will do it through a model developed by Slade(1998). At last i will try to integrate this theoretical model to a "Real Market situation", through the analysis of a report on the competitive consequences of the vertical integration in this market, which was published by a consumer organization in 2009 and responded by the OFT, "Office of Fair Trading" in the same year.

## 1.1 Exclusive Dealing

Exclusive dealing is an arrangement where a retailer is generally tied by a contract to buy predetermined goods only by a specific supplier. Even though it is common and generally lawful, it is in other cases considered an anti-competitive practice, for example when the improved distribution is off-set by a reduction in competition, which can be a consequence of preventing competitors from supplying to the same retailer. Since the effect of exclusive dealing agreements on competition are always dependent on the context in which they are enforced, the legislation differs

from country to country. For example the Competition and Consumer Act<sup>2</sup> in Australia, prohibit corporations to enter into exclusive dealing contracts in many instances, while Australian competition authority Australian Competition e Consumer Commission (ACCC), allows them to apply for an authorization, granted in cases in which public benefits stemming from the arrangement outweigh public costs; corporations are therefore given legal protection on a case by case basis. Differently, the Sherman Act<sup>3</sup> in the USA, makes clear that exclusive dealing arrangements are not di per se or presumptively illegal but, any agreement which may substantially lessen competition or create a monopoly is prohibited. In order to ascertain whether particular arrangement between retailers and suppliers may operate as restraints on trade, courts often use as a benchmark the reasoning applied by the lawyer Louis Brandeis articulated in the case law “Trade of City of Chicago v. U.S. 246 U.S. 231 (1918)”, which states: “The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. to determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts”. The conclusions we can obtain from this speech clearly ties U.S.A. law to Australia, it in fact clearly suggests that a correct judgement concerning competitive fairness in a commercial trade agreement shall be attained, as usual

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<sup>2</sup>Competition and Consumer Act (2010), sect 47: Exclusive Dealing

<sup>3</sup>Sherman Antitrust Act 15 U.S.C. 1-7 (passed in 1890)

in common law countries, on a case by case basis. It can be therefore harmful to have too heavy and strict regulations.

Similarly, the "Competition and Market Authority (CMA)" in the UK, deals with exclusive agreement on a case by case basis. Such agreements are regulated by the "Competition Act"<sup>4</sup>, which stated generically: "agreements between undertakings, decisions by associations of undertakings or concerted practices which, may affect trade within the United Kingdom, and have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom, are prohibited unless they are exempt in accordance with the provisions of this Part... ". The difference with respect to the previous mentioned jurisdictions, lies in the fact that every EU member state has to comply with the articles of the EC Treaty, which means that not only every commercial activity has to act in accordance with the antitrust laws of the state in which it resides, but in also has to observe Article 81 of the EC Treaty (ex Article 85). The Article aim at those agreements who could negatively affect trade between member states of the European Community, as it stipulate: "The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market". Even so, the EU Treaty spell out some instances in which a block exemption may be granted, the Article distinguish between those agreements that contributes to "improving the production or distribution of goods or to promoting technical or

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<sup>4</sup>Competition Act (1998), Chapter 1: Agreements etc, preventing, restricting and distorting competition.



economic progress, while allowing consumers a fair share of the resulting benefit”, and those who do not. This double legislation may serve as a safe harbour for many commercial activities, given that those who fall under the block exception will be also exempt from the chapter I prohibition, but it could also lengthen times and increase costs during litigations.



# Chapter 2

## History 1989-2014

In the United Kingdom, the terminology "Tied House" refer to a pub, or public house, that is bound by a contract or agreement of any sort, to be supplied of all or at least some of its beers by the brewery or pub company with which it is bound. The "Free House" instead, due to not generally being bound by any exclusive contract, can choose freely its suppliers and stocks of beer. During the 18th century, the pub industry started experiencing a circumstance that in the following two hundred years became a widespread trend, in opposition to public houses freely owned and supplied, many pubs started tying themselves to breweries in contracts through which both parties could benefit. The trend grew at a fast pace becoming more and more common, giving life to the phenomenon of the Tied Houses. Different types of arrangement took place in this system, the most common called for the pub owned by the breweries to be rented to private individuals, who ran it as separate commercial activities and were required by the contract terms to be supplied of beer solely by the brewery in exchange for low rent fees. In another type of agreement, the breweries offered mortgage loans

to private individuals who owned the properties and needed them to finance or renovate the pubs, the terms of the loan had a similar exclusive supply agreement as in the previous case. Later in the 20th century, the breweries started managing directly the pubs through salaried employees that, depending on the circumstances, were given bonuses for motivational reasons. Finally at the end of 1980s, the basic models of tied houses started changing over time in order to adapt to new legislations and retain power in the beer industry.

### **2.0.1 The Beer Orders and the "Pubcos"**

At that particular point in time, the wholesale and supply of beer industry in the UK, was an oligopoly in which six big national players divided by themselves nearly the whole share of the market, these were: Bass, Grand Metropolitan, Allied, Courage, Whitbread and Scottish e Newcastle. This market situation led the competition authorities to be deeply concerned about the consequences that the lack of competition could bring to consumers and small brewers. Finally in 1989 the competition commission published the report titled: "The Supply of Beer: A report on the supply of beer for retail sale in the United Kingdom". The content of this research was related to the vertical relationships that took place between brewers and retailers in the market of beer distribution. The findings of the report exposed the Tied houses system as having negative effects on competition, since they raised the barriers to entry. The commission made therefore a set of recommendation aimed at loosening the tie between suppliers and retailers as a prerequisite for an increase in competition between breweries, thus increasing consumer choices and facilitating entry in the industry. In December of the same

year, the United Kingdom Secretary of State for Trade and Industry launched the "Beer Orders"<sup>5</sup>, two statutory instruments who restricted the power of tied houses. They required large breweries owning more than 2,000 pubs to release from the tie half of the surplus over 2,000, thus creating some 11,000 more free houses in the UK. Furthermore, the government also required that all brewers had to permit their tied pubs to be supplied and to sell at least one draught cask-conditioned guest beer, other than being allowed to have complete freedom in buying non-beer drinks from any sources. The sell-off of their estates led large ties-holder breweries to spin-off purely pub owning companies. This event was the cause of the emergence of a new business model in this sector: the pub company, or "Pubco". In this model, the corporation itself is in the majority of the cases purely pub-owning and controls a series of pub that, in the same way as in the previous models, either manage itself or lease to tenants. Nearly every Pubco pub is tied by exclusive contracts, the terms of the agreement oblige them to buy products and be supplied (of beer for the major part) by the pub company itself. The typical behaviour of the Pubcos, was to negotiate further exclusive agreements with brewers for the supply of certain branded beers or other products, then they tied those commodities to the orders made by their tenants. The newborn pubco model and their ties have generated a great deal of criticisms, the general concern was about the distortional effects they could have on prices and thus on competition, furthermore by taking the role that breweries had in the pub-ownership model, they also made the Beer Orders less effective. One conjecture among critics was that the inflated price of tied beers, combined with the price of rents, constituted a cost too high to provide

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<sup>5</sup>The Supply of Beer (Tied Estate) Order 1989 , The Supply of Beer (Loan Ties, Licensed Premises and Wholesale Prices) Order 1989

a sustainable business for pub landlords. The argument that the Pubcos used to defend themselves from this particular assessment was that the inflated cost of their supplied beer was partly off-set by the lower rents and the further serviced they provided to tenanted pubs. The increasing concern of the public opinion on the condition of the market of beer distribution for sale and consumption, led to many inquiries and legislative revisions in the years following 1989. One of the most relevant took place in 2003, when the rise of the Pubcos, and the belief that the problems which the Beer Orders were introduced to address no longer existed<sup>6</sup>, led the authorities to entirely revoke them.

### **2.0.2 The reports until 2014**

In 2004, concerned about the concentration of ownership in the hands of a small number of Pubcos and its subsequent effects on tenants, the "Federation of Small Businesses" requested an inquiry of the industry to the Trade and Industry Select Committee of the House of Commons. The concern was about the greater commercial strength that pub companies possessed with respect to free tenants, and stemming from it the disadvantageous agreements that tied tenants were forced to enter into. Later on, a report by the committee was published, it provided a review of the economic aspects of the ties with the principal focus on pub companies, it then recommended the Government and the OFT to protect tied tenants through a code of practice as the fairness of these agreements had been lacking in many cases. The OFT did not respond, while the Government agreed that a voluntary Code of Conduct, if developed by the participants of the industry themselves, could have been a way to partly resolve problems of the contractual

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<sup>6</sup>if brewers were able to prevent proper competition between pubs and restrict consumer choice

relationships in which tied tenants were into. Even so, it did not want to force a Code as there was evidence demonstrating that the conditions of tenants in the industry varied "from excellent to dire", thus it would have been too harsh to impose a statutory Code of Practice which would prescribe the terms and conditions for the commercial arrangements.

The debate kept going since there was disparity of opinions of different parties concerning the competition in the beer industry and the conditions of tenants. The successor of the Trade and Industry Committee, the Business and Enterprise Committee, launched a new inquiry in June 2008 to establish whether the conclusions of the predecessors still stood. The report was completed on May 2009, which was also a period in which the pub industry was declining, many pubs of every type were closing all over the UK. The committee had to carefully establish whether closures of pubs were more common in the Pubcos system compared to the free houses, and also to calculate if the tough conditions of tied tenants was a consequence of the industry model or was given by the unfavourable situation of the overall market.

Regarding the closure of pubs there were discordant opinions, the pub companies attributed the tenants financial difficulties to the general trading environment and argued that tied pubs were less likely to close as a consequence of the offsetting of high beer price through low rents. Tied tenants instead, argued that their difficulties stemmed from the high rents and beer price charged by the Pubcos. The statistics taken into consideration by the committee supported pub companies as they showed that tied houses were doing relatively well, even though they didn't take into attention situations in which a Pubco lessee had failed and gone out of business only to be replaced by the pub companies with a new lessee.

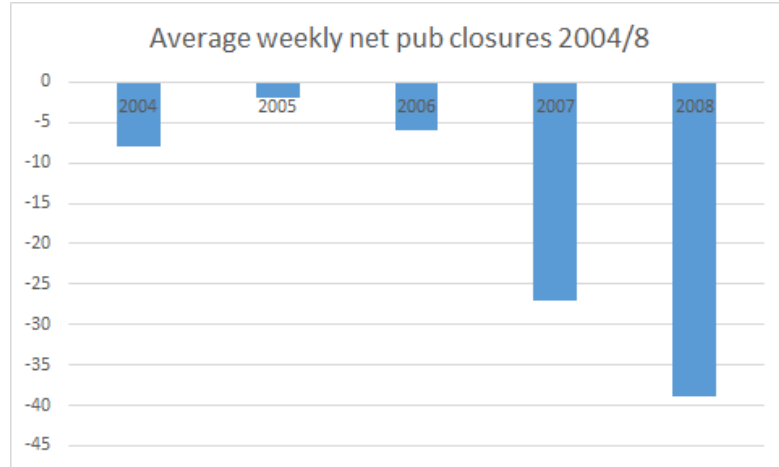


Figure 2.1:

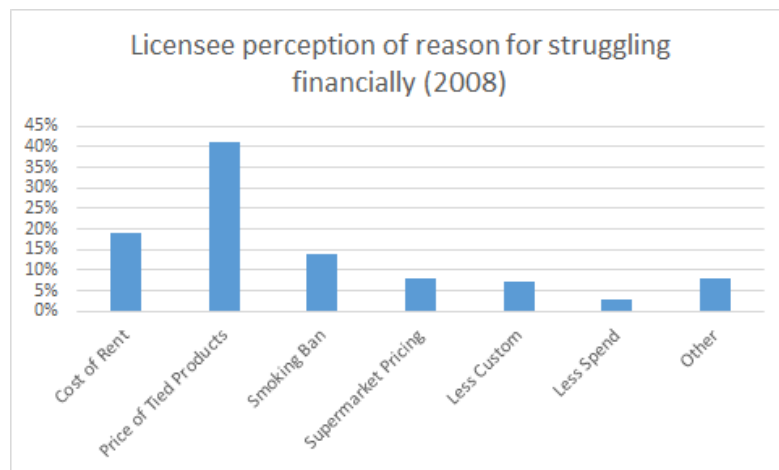


Figure 2.2:



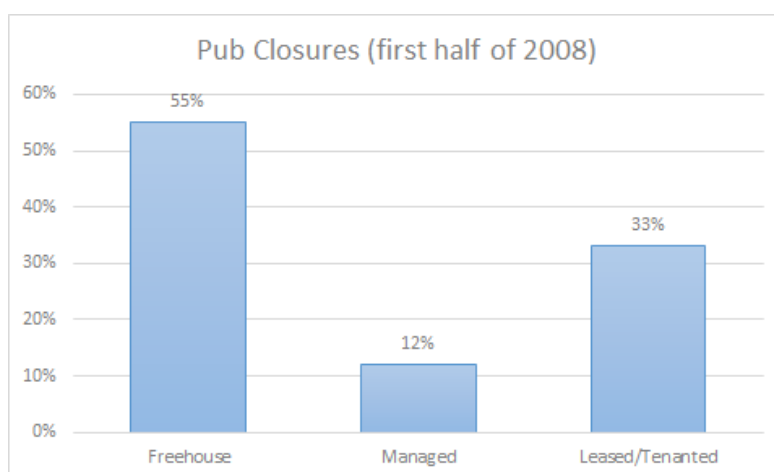


Figure 2.3:

Again and principally as a form of mediation between consumers organizations and industry bodies, the Committee issued a report in March of 2010, in light of the fact that the tied houses model seemed to put bound lessee into unfavourable trading conditions with respect to free tenants. Over the same year was also published by the BBPA a new code of practice, "Framework Code of Practice", as a new standard to be used in contractual relationships between lessors and lessee, with the aim of improving the conditions of tied tenants in a period in which the industry was facing financial difficulties. Following these events, the Committee also concluded that it would recommend the Government statutory regulations in the case in which these problems were not resolved. The concern of pressure groups was not only directed at the shape of contractual relationships in the tied houses system, since part of their attention was again directed at issues regarding the extent of competition in the industry. The report included claims and data taken from investigations made by different consumer organizations such as The Fair Pint Campaign, CAMRA and SIBA; that were still convinced that the competi-

tive effects of the Tied Houses model and the damage upon consumers stemming from it, required further studies from the Competition Commission. These concerns were particularly raised in the "CAMRA super complaint", a memorandum to the "Office of Fair Trading", in this document the evidence of data demonstrated that the price of beer in the pubs from 1998 to 2008 increased faster than brewery beer prices. According to the investigation, the widening gap given by the faster-than-inflation increase in pub beer prices, was possibly due to the influence and bargaining power of big Pubcos. The reasoning was that given their strong market shares, they could possibly set high beer prices that were later taken as a norm by the rest of the industry. Furthermore, those consumer bodies believed that the inability of tied tenants to respond the market given their list of Pubcos approved products, was also detrimental to the consumers by lessening their variety of choices. In short, the whole report by the Business and Enterprise Committee, contained recommendation on how to treat issues extensively debated over the years but left untouched, however it did not prescribe a clear path to be followed as was still uncertain if perhaps many of the before-mentioned issues could be solved by leaving them to the market, or if maybe a stronger legislation and law enforcement would have caused an improvement. Nevertheless, it strongly urged the Government to assume responsibility since the OFT failed to take on the issue properly. The committee wanted the Government to ensure that the legal framework around the industry was adequate and that the competition issues around the problem were fairly investigated.

In 2011 the committee launched again an inquiry to establish whether the problem raised in the previous years regarding the protection of tied tenants had been resolved or if a new statutory regulation was needed. Overall the commit-

tee found high levels of acrimony within the industry and the implementation of the framework code of practice by pub companies to be proceeding very slow. In the published report of August 2011, new data showed that the financial pressure on tied tenants compared to free tenants was worsening and tied pubs were closing at a faster rate. Given those findings, the committee concluded that the previous attempt at reform had failed and that they had to change path of action. In this scenario the industry was slowly being changed not on the ground of competitive issues but rather to protect the fairness of agreements by which tied tenants were bind. In this course of events, the OFT kept taking the view that the competition effects of the tied houses were not detrimental to competition. In the previous response to the CAMRA super complaint, it indeed responded of not having found evidence of competition issues having a significant impact on costumers which could justify a further investigation. Finally, seeing no other alternatives in improving the conditions of the market, the Committee finally recommended the Coalitional Government to take institutional proceedings. In responding the Committee recommendation in November 2011, the Government had to take into consideration what had been the response of the OFT to the CAMRA super complaint of an year before, regarding the harm on consumers and the effect on competition. Even though it had agreed to consult on the recommendations of the Committee regarding the institutional proceedings, the Government announced a new self-regulatory package. It decided to take this direction keeping in mind two principles:”the OFT has found no evidence of competition problems that are having a significant adverse impact on consumers and therefore the Government is not minded to intervene in setting the terms of commercial, contractual relationships”and that ”legally binding self-regulation can be introduced far more

quickly than any statutory solution and can, if devised correctly, be equally effective". The new code particularly aimed at strengthening leases conditions and was made legally binding, which had the same function as making it statutory, as it would have been enforceable through the courts. This course of action brought to debates inside the House and with the committee, the latter strongly criticized this decision as their belief was that only by pursuing statutory regulations could any objectives be achieved, and that they were being too cautious and moderate. These proceedings were probably motivated by the fact that the CAMRA had not taken out arguments or evidence after the response of the OFT, and the Government certainly did not want to challenge it any further, as it would have been a serious matter requiring certain evidence. Even so, the departments 2012 annual report provided by the secretary of state to the committee shook off every doubt of what would have been the next step to take in relation to the legislation of the industry. It was indeed the case that the previous year actions did not have the expected results, many tied tenants were still facing operational problems and hardships. Given the "non-optimal" conditions of the market, it was finally decided by the Government to have a consultation about the proposals previously submitted by the committee. The justification was that even though many pub companies were not having an unfair conduct with respect to their lessee, across a big part of the industry could still be seen exploitation of lessee, unfair dealing and lack of transparency. Those behaviours increased the risk of further damages to the industry in a situation in which pubs were already financially distressed. The consultation document was published on April 23 of 2013, with the main proposal of establishing a statutory regulation and an adjudicator. Furthermore since the majority of complains came from lessee of the seven bigger pub companies, the

statutory code of practice would have been binding upon companies holding more than 500 pubs. The other central issue was about the role of the adjudicator, it was supposed to have the role of investigating the complaints coming from lessee and impose sanctions according to the statutory code. The result of the consultation was only seen on June 25 of 2014, when the government published the "Small Business, Enterprise and Employment Bill", which introduced a statutory code of practice and an adjudicator to enforce it. During this period of time after the consultation, the Committee had been strongly critical for the amount of time taken by the government to decide upon the specification of the Bill, and the concern arose from the increasing worsening conditions of the industry. The Government acknowledged the Committees regret but went on to argue, "it was important for the Government to give the industry time to change before proposing a statutory solution, which should always be a last resort".



## Chapter 3

# Economic analysis

As we have seen, the period from 1989 to 2014, was a span of time full of debates between authorities and other industry actors in the UK, the reason being the uncertainty of the effects on competition of the different form of ties, and the possible harm on consumers/tenants. Some believed that the tied houses provided a more efficient form of distribution to final consumers, leading to the view that they should not be restrained as they improved social welfare. Others have viewed this system with much more suspicion, believing that big pub companies maximized profits without leaving any surplus to retailers, furthermore they caused high inflated prices that put tenanted pubs in an impossible state to face competition, which caused them to be distressed and to eventually close. After the beer orders in 1989, the competition authorities and the government never reached a conclusion regarding the competitive effects and the possible harm of this model on consumers, but instead acted on the ground of fairness for the tied retailers, which has been shown facing more hardship than free tenants. This clearly shows the extend of the complexity of a system in which the abounding variables at

stakes such as the many types of contracts and the different actors that comes into play, make the industry response difficult to predict. In 1989, the authorities had predicted that following the closure of public houses tied to brewers, the same number of free houses would have been created. This would have caused an increase in competition that would have led to lower retail prices and a wider variety of choice for consumers. What they didn't predict is that instead the industry would respond by creating the Pubcos, a vertical system even more complex, which led to exactly the opposite results expected by the authorities; higher prices and lower consumer choices. It is clear that the forms and types of linkage relationships within an industry shape its response to external influence, and that failing to fully understand them may even bring to a worsening of the industry condition. Before analysing the specific effects that the different tie models exert on competition, it is important to get familiar with the more general externalities associated with vertical linkage relationships in industrial organization. In "Industrial Organization: A Strategic Approach" of Church and Ware (2000), the vertical externalities in these relationships are of two types ; the first being called the "vertical Pricing Externality", while the second being the "Vertical Service Externality". The first describes the case in which a firm in a monopoly or oligopoly charges a mark up over marginal costs to appropriate more of the surplus; the increased price leads to an increase in social inefficiency, that is due to a decrease in quantity demanded for goods. The latter is in some proportion related to the first, it describes the situation at the downstream level of competition; due to the retailer margin not including the margin on each sale accruing to the manufacturer, the retailer will have no incentive to decrease to a price that would improve social welfare, often instead, a further mark up is added. Marginalization and horizontal competition



act in opposed ways, as the first tends to rise prices too high while the second decrease them by too much, at one point those externalities will cancel each other out, leading to a choice in equilibrium of the retail price that is the optimal choice to maximize the joint profit of retailers and wholesalers, given their vertical relationship constraints. In reality however, considering the complexity of an industry and the possible further externalities and differences in interests of the party involved in vertical relationships, is not always possible to have the function of the joint profits maximized. It may be that a retailer will not set a price that would maximize wholesaler profit function on which he based the price; for example, given the mark up of a wholesaler, a retailer may decide to marginalize again. This action would lead to a decrease in demand and a subsequent drop in profit for the supplier if compared to the case with no further marginalization; retailer's profit instead would increase/decrease according to Price elasticity of demand. The wholesaler has therefore incentives in trying to keep retailer's price up or down according to his profit function and, in the case in which he has some bargain power, he may be able to do so through artificial instruments such as exclusive agreements. To make an example in the market of distribution of beer for consumption, in order to restrain the retailer power on price variations, the supplier may attach to the contract a pre-defined number of barrels of beer to be bought over a period of time; as a result the pub owner would probably face a loss if he increased the price of beer, as by doing so he would not be able to sell the whole stock of beer. According to the degree of bargain power that the various actors of the industry possess, there are other types of vertical restraints that may be enforced through contracts, for example the supplier could be able to set a price ceiling or price floor "resale price maintenance", or may diversify his activities by requiring the

retailer to be supplied of other products or an entire product range "tie-in-sales". Through agreements in practice, the wholesaler is able to constraint the behaviour of the retailer and specify him to do or not to do certain things. Many of the vertical restraints considered, depending on the effects and context in which they are in, are anti-competitive, while other can be considered pro-competitive if they improve distribution of goods and increase social welfare.

The aim of the Beer Orders was to modify a market situation in which after many years, the power of a small number of firms had improved too much, and resulted in consequences out of the expectations. In order to understand whether the cause in the worsening of the beer industry condition is related to the rise of the Pubcos, and thus to the Beer Orders, it would be useful to comprehend whether the industry would have followed the same path of steep increase in prices even without them or if it would have ended in a different way.

In 1998, Slade published an article in the *Economics Journal* whose purpose was to provide an answer to this doubt. His model was based on a paper of Rey and Stiglitz of 1995 on exclusive territory. It included only the essential features of the market in order to built a base onto which to add variables according to the tie model taken into consideration. In this way he was able to show the dynamics behind the variations of prices of the different form of ties in the UK.

His paper consider different types of contractual agreements that takes place in the pub industry in UK and examine how prices are shaped depending on the vertical linkage relationship. The intuition behind it, link an alteration of the producer's demand curve to the type of vertical restrain, which should results in a price increase given by the belief of a less elastic demand curve. For simplicity we are going to consider only beer as the product, and we are going to reduce

the number of forms of linkage relationships to three: The first being the case in which a monopoly producer of beer, supply to many pub owners. In the second case instead, the brewer is vertically integrated with his pub chain. The third case consider the variation of the industry structure after the introduction of the beer orders in 1989, when the Pubcos emerged. In this scenario the brewer sell his product to the Pubco which will supply to pub owners.

### 3.0.1 Mathematical Notations:

Given that we have prices both at the wholesaler and retail level, we distinguish using upper case letters to define upstream values and lower case letters for downstream values. P is used for price, c for Marginal Cost,  $\varepsilon$  for elasticity and  $\Pi$  to define profit, furthermore as a benchmark case we consider direct producer competition with the demand function facing each player of  $D^i(p^i, p^j)$ . In this case the profit function that brewers have to maximize through price choice is:

$$\Pi^i = (p^i - c)D^i(p^i, p^j)$$

### 3.0.2 Monopolistic brewer selling to free tenants

In this case, the monopolistic brewer adds to the cost of production a mark up which results in an appropriation of monopoly profit at the upstream level of production. Retailers are therefore supplied expensively and competition at the downstream level, leads to the inability of retailers to set a high price. In a real market context though, it is common for them to have the power to reduce the profit of wholesalers, for example they could have the possibility to substitute to

cheaper drinks at the downstream level, action the would result in a reduction of monopoly quantity and thus profit. In a case like this the producer would likely impose other vertical restraints such as a pre-determined quantity of barrels of beer. In this scenario though, we assume that the retailer is not able in any case to appropriate surplus. The essential economic modelling given the mark up that the producer seeks to maximize is given as follows:

Where M stands for monopoly and P=p. Given that the retailer is not able to set a mark up, wholesale price is market price.

$$\frac{p^M - c}{p^M} = \frac{1}{\varepsilon^i(p^M, p^M)}$$

$\varepsilon(p^M, p^M)$  measures the percentage change in quantity due to a 1% variation in p of the producer. The difference from a monopoly to a duopoly situation is that retail margin are lower in the second case. The discrepancy is due to the partial own price elasticity of demand, that is necessarily higher in the case of a duopoly with respect to a monopoly.

### 3.0.3 Brewer-tenants with exclusive agreements

Here we consider the case in which a brewer is vertically integrated with his pub chain through exclusive dealing contracts. When the brewer has control over retailers "Managed Houses", he is able to take monopoly profit at the downstream level of production. It supply his own pubs at marginal costs pricing while the mark up is reflected on the price list given to consumers. When considering this scenario there is the necessity of drawing a distinction from managed to tenanted houses. The previous considerations holds only in the case of Managed Pubs,

indeed managers who works for a brewer have no price discretion. It follow that the resulting price to consumers in this case is similar if non identical to the price considered in the first scenario, and it is only a matter of where the mark up is set, if downstream or upstream. The situation is instead different if we consider tenanted pubs; depending on the level of competition that he face, a tied tenant that has freedom in making pricing choices, may decide to add a further mark up on the price list, resulting in a reduction of quantity sold and brewer profits. When making his pricing choices, the brewer has to consider whether to set a high mark-up over price that would result in lower sales, or to have a lower mark-up and higher sales. The optimal decision is as always dependent upon the elasticity of demand:

The notation R stands for retailer. The brewer in this case seeks to maximize through the price  $P^i$ , the profit function:

$$\Pi^i = (P^i - c)D^i(p^{iR}(P^i, P^j), p^{jR}(P^i, P^j))$$

Given that J has the same profit function, it becomes:

$$D^i \frac{dp^i}{dP^i} + (p^i - c) \left[ D^i \frac{dp^i}{dP^i} + D^i \frac{dp^j}{dP^i} \right] = 0$$

We have now two different mark up formulas, one for tenants and the other for wholesalers, the first one mimic the results of the previous model, as for retailers the choice of price is dependent only upon the elasticity of consumers demand and the cost (price set by the wholesaler):

$$\frac{p^i - P^i}{p^i} = \frac{1}{\varepsilon^i(p^i, p^{i-or-j})}$$

The mark up for the wholesaler instead, is dependent upon the price agreed with the tenant, denominated  $p^T$ :

$$\frac{p^T - c}{p^T} = \frac{1}{\varepsilon^i + \varepsilon^{ij}r^{ji}}$$

Where:  $\varepsilon^{ij}$  is the partial cross price elasticity of demand, while  $r^{ji}$  is the elasticity or rival reaction function.

The brewer mark up is slightly more complex and can be explained assuming that the brewer anticipate how the retail price will be set, it follows that wholesalers price will be dependent upon the behaviour of the tenant. The final price to consumers becomes a variable which determines the one set by the brewer. The first part of the denominator in the brewer mark-up measures a percentage change in own quantity due to a 1% variation in own price. The second instead, measures the effects that retail price has on brewers, it is the percentage change in own quantity due to a 1% variation in rival price, times the percentage change in rival quantity given a 1% variation in own price.

### 3.0.4 Pubcos

The final analysis consider the Pubco tie model that took the prevalence after the Beer Orders came out in 1989. Here two consecutive relationships takes place, first between the brewer and the pub companies, then between the latter and the tenant. As we will see, to determine the price consequences of this model, we can think of the previous analysis(brewer-tenants with exclusive contracts) as the benchmark case onto which we have to add another margin, caused by the introduction of the pub chains in the model. This brings to the highest prices

available to the market of the three models that are a consequence of double marginalization. Since in this case the brewer cannot make profit downstream, he rises price above marginal cost when selling beer to the Pubcos, that again adds another margin to the price of barrels. Retailers under this model will find it more difficult to meet consumers demand given the higher prices, furthermore they will have a competitive disadvantage with respect to the other models if we leave aside other possible externalities through which they could benefit.

By assumption every pub chain has monopolistic power over some fraction of the market and make exclusive contracts with the pubs under his control, thus it can charge a mark up over the price of beer set by the producer. The final price  $p^i$  of the retailer will be dependent also upon the barrel price set by the brewer, where:

$$\frac{p^{iE} - P^{iE}}{p^{iE}} = \frac{-1}{\varepsilon^i}$$

The subscript E stands for exclusive contracts, while the brewer price at the upstream stage is chosen to maximize the profit function:

$$\Pi^i = (P^i - c)D^i(p^{iE}(P^i, P^j), p^{jE}(P^i, P^j))$$

The same applies for J, thus:

$$D^i + (P^i - c) \left[ D^i \frac{dp^{iE}}{dP^i} + D^i \frac{dp^{jE}}{dP^i} \right] = 0$$

The mark up of brewers differs from the previous case as it also incorporate the effects of double marginalization:

$$\frac{P^i - c}{P^i} = \frac{1}{\alpha^i} \left[ \frac{-1}{\varepsilon^i + \varepsilon_{ij} r^j} \right]$$

Where:

$$0 < \alpha^i < 1$$

The new variable  $\alpha^i$  is the elasticity of the retail price with respect to the price of the wholesaler, by the time it is positive but less than 1, it makes the mark up be greater than the case in which brewer and pubs were directly and vertically integrated. The reason being that the double marginalization which occurs increase the price available to costumers, allocating the surplus to brewers and Pubcos.

### 3.0.5 Complications

The aim of the model that Slade developed(1998), is to show the general level of prices that retailers and wholesalers will set depending on the model of linkage relationship taken into consideration. Even so, it does not take into account other possible externalities that have an impact on the balance between bargaining powers in the industry. The conclusions regarding the level of prices of retailer and wholesalers between the different models of ties are as follows: Prices will be higher in pub chains and leased pubs, to be followed by tenanted houses and then free houses, unambiguously lower are the prices in managed pubs:

$$p^{pubco} \approx p^{leased} > p^{tenanted} > p^{free} > p^{managed} > c$$

The previous analysis assumes that the equilibrium states found do not appear in the market simultaneously, they are unique and do not interfere with each other



or any actors of the industry, and it constitute an untrue statement. Even so, by building a model which roughly outlines the simplest situations, is possible to give shapes to more complicated dynamics by adding more variables. Consider an example in which there is a market composed of two players, which are two pubs selling only beer. They face the same demand, but one of them is a free house and the other is a tenanted house, the latter face a higher wholesaling price produced by the mark-up of the brewer, which implies that reducing price of beer below a certain degree would bring a loss to the tenant. By the time the demand is symmetric, the free house has obviously a cost advantage since by reducing the price of beer it can increase his own share of the market, and the tied tenant would face a reduction of the demand. In order too make the market situation more credible, we can introduce the off-setting benefit of lower rents offered to tied tenants, in this way the loss experienced as a cause of competition would be reduced or eliminated through the lower rent. In reality, conditions that in a purely theoretical situation would have brought a competitive disadvantage upon a participant of the industry, might be attenuated or eliminated through clauses in supply agreements. Regarding the previous situation, a pub who has to choose among lower sales and lower rents or higher sales and higher rents, might even decide to opt for the first as a method to reduce risks.

When making his model, Slade (1998) relied on several simplifying assumption, but in a "Real market context" there are many factors to be taken into considerations as they might alter the allocation of bargaining power between the actors of the industry. In analysing the Pub chains model, he assumed that Pubcos manages by themselves their pubs, eliminating in this way the possibility of a further mark up by the retailer. However it is common for pub chains to employ tenants

to manage their pub, furthermore depending on the agreements with the chains, retailers may have the decisional power to rise price again. Adding another layer of distribution to the model reinforce the determination of the level of prices made by Slade(1998). Furthermore it is likely that pub chains may be able to obtain wholesale discounts from brewers due to their large volume of purchases, and It is possible to expect that these discounts would not be reflected on the price paid by tenants, but instead would be appropriated by the pub chains in the form of profits. In this case we would see a movement of surplus from the brewer to the pub chain and the relation  $p^{chain} > p^{tenanted}$  would still hold. Slade also assumed that in every model the industry participants faced the same costs and when deriving the level of prices was pretended constant return to scale. The brewing industry in reality is characterized by increasing return to scale, which means that marginal cost decrease as output increase and this variable reinforce the inequalities found on the price levels of the industry actors. The final assumption is symmetry of contracts in the industry. It is common to have mixtures of arrangements that can shape the level of prices according to the content of contracts, in this case though it would be too misleading to model them. However if we take into consideration small geographic or demographic area, it is credible that the model would be a rough guide for price levels, since the same types of pub structures tends to be concentrated in the same areas.

Finally leaving aside the free houses, Slade draw a conclusion which states that in an industry with the presence of Pubcos, prices should be higher. He assumed that in a situation like the one that was facing the beer industry before the Beer orders in 1989, the average price of beer for tied houses could be calculated by summing all the managed and tenanted houses multiplied by the prices in the

contracts, and dividing them by the same number of tied estates. If the same calculation was to be made after 1989, period in which occurred a movement of ownership from tenanted/leased houses to pub chains, we should be able to see an increase in the level of prices.

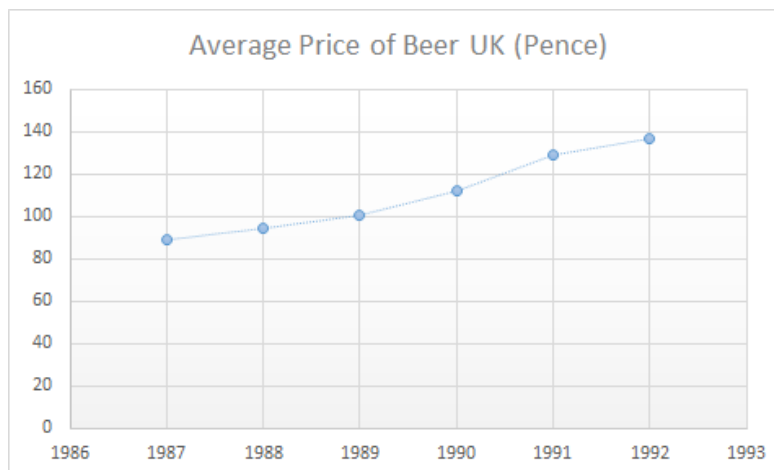


Figure 3.1:



## Chapter 4

# The CAMRA super complaint

The model set out by Slade can be an helpful tool in order to understand the basic dynamics and consequences deriving from different vertical linkage relationship in the Uk beer industry. Even so, it was not possible for him to include too many variables of the market. In order to better connect the model to a "real market situation", it can be of aid to deepen the understanding on the main causes of discussions regarding the tie, by analysing a real litigation between industry actors. During the years, the effects of the Tied Houses phenomenon has been debated on many grounds and not only on competition, the proof is that in 2014 the tie system have been restrained by the Small Business,Enterprise and Employment Act (2015), on the unfairness of contracts stemming from the industry conditions. Nevertheless, its competitive effects and subsequent harm on consumers has been the content of many disputes between consumer organizations, competition authorities and the Government. One of the most relevant and richest study centralized around these matters is the CAMRA Super Complaint of the 24 July of 2009 and the response by the Office of Fair Trading that came thereafter. The CAMRA,

"Campaign for Real Ale" is an independent consumer organization which campaign for Ales Beers, Pubs and buyers rights, it is also the bigger of these organizations whose concern is for a single product, and counted more than 175000 members in 2015. A Super Complaint instead, is defined under section 11 of the "Enterprise Act 2002" of UK , as a complaint by a consumers body submitted in cases in which there is doubt about the harm on buyers deriving from a certain condition of a market; it is described in the act as:"any feature, or combination of features, of a market in the UK for goods or services is or appears to be significantly harming the interests of consumers". Following the submission of a super complaint, the authority at which it is aimed has the duty to respond in a period of 90 days, the Office of Fair Trading response came out in October 2009.

The Beer Orders were published in 1989 with the aim of increasing competition in the UK pub industry, they required brewers who owned more than 2000 pubs to divest half of them. These expectations were not met since many of the freed pubs were bought from entrepreneurs and owners of other activities as a result of the lucrative opportunity they saw in the creation of pub chains. The main purpose of the Super Complaint was to denunciate the relatively new Pubcos who have exploited the market to the detriment of customers after 1989, and asked for further inquiries and reforms. According to the CAMRA, the prevention, restriction and distortion of competition in the industry could be explained by supporting evidence which showed that nearly 54% of pub estates were tied and managed according to one of the tie models. The operation of exclusive agreements in such a large share of the market, meant that access of new entrants to the industry was denied to the same percentage of the UK pubs, and it constituted a huge barrier to entry. Furthermore, entering in the industry through tying contracts

with pub companies was much easier than negotiating individual agreement with wholesalers, and the low bargaining power of new tied tenants could lead to exclusive contracts with unfavorable conditions for retailers, that often resulted in the exploitation of mark-ups by the pub chains. Therefore, the CAMRA suggested that the tied system should fall within the EC treaty Article 81, whose aim is to prohibit agreements which distort, restrict or prevent competition. In the cases in which there is the possibility that specific market practices could damage trade activities between member states of the European Community, the Treaty allows for the Community to scrutinise them and decide if to apply the article. Still, there are some agreements that even though apparently are harmful for competition, they offset the damage to the industry by providing specific benefits, in these cases a block exemption is provided. For an agreement to be suitable for the block some conditions must be met: "improve the production or distribution of goods or promote technical or economic progress, while allowing consumers a fair share of the resulting benefit", which is also the reason why after the formation of the European Union the ties were never prevented. The articles also states that the "regulation should not exempt vertical agreements containing restrictions which are not indispensable to the attainment of the positive effects mentioned", and the OFT has the discretion and the power to decide those who should not be exempted from the vertical block. By showing the negative effects that the tie had on competition and the supporting evidence, the CAMRA aimed at protecting the interests of consumers and tied retailers by moving the OFT into a deeper inquiry on the tie. It also hoped both for a possible removal from the block exemption of these exclusive agreements, and for the prevention of the negative effects on the market by making legally binding certain measures. The main focal points of the

research were:

- An Inquiry on the effects that exclusive agreements undertaken under the "Tied Houses" model had on market prices.
- Inquiry on discounts and rents on tied tenants.
- Inquiry on market foreclosure and the use of restrictive covenants as a barrier to entry.



### 4.0.1 Inquiry on Prices

In this case, the concern of the CAMRA was directed at the matter of whether tenants under exclusive agreements were able to be supplied or not of beer at a competitive price, since the latter claim could have been the reason for which tenanted house prices were higher. We have seen the calculations regarding pricing differences in various vertical linkage relationships in "chapter 2" model (2) and (3), now we will confirm whether the price differentials found by Slade(1998) applies also in the context of a "real market condition". The following data are provided by the "Fair Pint Campaign", a consumers body whose major concern is the protection of tenants. The FPC estimates that the difference in cost per pint paid by a tied retailer compared to a free house, Which is appropriated by the supplier in form of profit, was of 73 pence in May 2009, the estimates is based on the prices of one brewer of the UK industry, Coors, while the pub company taken into consideration is Enterprise Inn.

	Price of beer when the brewer sells directly to free tenants.	Price of beer when the "Pubco" sell to tied tenants.	Price paid by the "Pubco" to the brewer.
<b>Keg</b>	£63.11	£128	£45
<b>Pint</b>	£0.72	£1.45	£0.51
<b>Duty</b>	£0.36	£0.36	£0.36
<b>Gross profit to supplier</b>	£0.36	£1.09	
<b>Differential</b>	£(1.09-0.36)=£0.73		

Figure 4.1: Difference in Gross profit to supplier

The difference in costs is reflected on prices to the detriment both of consumers and tenants, the first ones who buys at higher market prices, while the latter face a reduction in profit due to lower sales. Regarding pub companies, it is possible that they prefer to make profit by higher margins on wholesale prices rather than

by an increase of the volume of sales at the downstream level of competition. An explanation could be that they are able to retain the entire price margin, while they have difficulties in matching the profit in the other case. According to the CAMRA, the data provided by the Fair Pint Campaign shows evidence that through the Tied Houses system, pub companies have been artificially rising retail prices of beer. This statement is supported by data showing that inflation on consumption of general goods has increased by less than the price increase of beer on the on-trade channel during the period 1998-2008, 62% against 105%. Furthermore the retail price index of beer has increased by 39,4%<sup>7</sup> over the same period of time, whereas the producer price index only by 31,8%, demonstrating that the inflation of prices occurs at the downstream level of competition, that is, as a consequence of pressure by the pub chains. The data collected by the CAMRA on a survey of 2009 shows the market prices according to tie model:

	Average price of ales	Average price of lagers	Mean
<b>Tenanted</b>	£2,67	£2,88	£2,775
<b>Freehouse</b>	£2.60	£2.78	£2,69
<b>Managed</b>	£2.44	£2.70	£2.57

Figure 4.2: Average prices of beer in UK (2009).

Given that prices in tied tenanted pubs tends to increase faster than prices under other industry models, and given also their widespread presence, they have huge influence over the market prices. The high share of the market(54% pubs in 2009 were tenanted) brings to low price competition, furthermore similar commercial activities in contained geographical/demographical regions tends to follow

<sup>7</sup>British Beer and Pub Association Statistical Handbook 2008

analogous pricing policies. There is also another reason that could turn out to be an important factor contributing in the higher prices of tied pubs, and is the method by which rents that tied tenants pay are calculated. Often the calculation of rent is based on the quantities of the product sold, but the price considered remains fixed even if the tenant increased sales by reducing price, thus he has a high disincentive in doing so. As seen in "Chapter 1", the position maintained by the OFT in the response to the Super Complaint remained the same of the preceding years, there was not enough evidence of detriment to consumers or competition as a result of the tied houses system. In this particular instance, the argument held by the OFT in its response to the CAMRA, was that it did not find any evidence of concentration on particular geographical/demographical areas of the same pub chain, which could have given the latter the power to rise prices at his advantage. Instead it responded that given the fragmentation of competition inside small areas, there is no pub chain in particular that could have the ability to artificially affect prices and damage competition. Furthermore a customer could always decide to change pub if prices are not in his favour, a chain thus would not want to force his tenants in agreements which would pressure them too much. The position rebated many times by the competition authority held that any action, for example rising prices too much, which would bring detriment to consumers, would then result in harm the pub chains, so it should not be in their interest to engage in such practices. Another common argument in the Super Complaint Response, which was used to justify higher prices in tenanted pubs, held that consumers not only look at the cost of products they are offered, but the whole service they experience is an important part of their evaluation. It is indeed true that in exclusive contracts of tied tenants a whole range of products is usually offered, which could

result in a pub offering a different experience compared to free houses, the proper price paid by tenants becomes hence only a matter of perception.

#### 4.0.2 Discounts and Rents

Lower than market rents are usually used by pub chains to offset the high prices that tenants are forced to list. We have also seen that the methods used for rental calculation can represent an instrument used by wholesalers to limit price discretion of retailers, we examined how if used in a controlled way, it can prevent retailers from decreasing price available to customers. Furthermore one of the market variables discussed in the second chapter was the discount that pub chains are able to get from breweries given the scale of their operations, which becomes of relative importance when discussing rents available to tied tenants. One of the method by which pub companies are able to benefit from rents, is through discounts obtained from breweries. The principle behind this statement is connected to the fact that pub chains are able to get greater discounts from brewers than free-of-tie pubs; in the vast majority of cases these reduction in costs are not passed onto retailers in the form of lower rent, and instead are retained by the Pubcos as profit, this practice put the retailers in the position of not being able to diminish prices. The following data<sup>8</sup>, that dates back to 2009, shows the gap in discounts that industry participants are able to get. The ALMR is the "Association of Licensed Multiple Retailer", from which the data was taken.

In the cases in which the Pubcos appropriate all the surplus coming from discounts, Tied tenants will be worse off in relation to other types of retailer, since not only pub chains but also free houses are able to obtain reduction in

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<sup>8</sup>Business and Enterprise Committee Report Pub Companies 80

	<b>ALMR estimates (barrel)</b>
<b>Listing Price</b>	<b>£450-£480</b>
<b>Pubco Discount</b>	<b>£210-£280</b>
<b>Free House discount</b>	<b>£140-£150</b>

Figure 4.3: Discounts, February 2009

costs in a smaller scale. The Super Complaint support the idea that not many tied retailers are able to benefit from discounts, while the Business and Enterprise Committee made clear that some tenants are not able at all to benefit from them. The following example could make more clear the dynamics behind the discounts and the subsequent benefit appropriation in the Pubcos model. We first assume that one barrel of beer contains 36 gallons and sells for £450. A pint is 1/8 of a gallon, which means that 288 pints are contained in one of them, furthermore to simplify our calculations we rely on the wrong assumption that pints in tied and free houses are sold at the same price of  $P = £2.67$ , which is the average between the three prices found by the "British and Pub Association" in 2009. The discount from the brewer is of £150 both for free houses and tenanted houses, although pub chains appropriate £110 of the discount as profit, while £40 is left to the retailer. The balance remaining after the costs have been deducted is equally divided between rent to the leaser and profit to the retailer. We also rely on the fact that rents in tied houses are lower than rents in free houses, assumed that they have to offset the reduction in tied retailer's profit due to double marginalization. The results from the calculations are as follows:

From the graphs, it looks like that in the Tied houses case, both the Pubco

<b>Free House</b>	
<b>Revenue</b>	<b>£2.67×288≈770</b>
<b>Cost of barrel</b>	<b>£450-£150=£300</b>
<b>Balance</b>	<b>£770-£300=£470</b>
<b>Leaser Rent</b>	<b>£235</b>
<b>Lessee profit</b>	<b>£235</b>

Figure 4.4: Effects of discounts on Free Houses

<b>Tied House</b>	
<b>Revenue</b>	<b>£2.67×288≈£770</b>
<b>Cost of barrel</b>	<b>£450-£40=£410</b>
<b>Balance</b>	<b>£770-£410=£360</b>
<b>Pubco rent</b>	<b>£180</b>
<b>Lessee profit</b>	<b>£180</b>

Figure 4.5: Effects of discounts on Tied Houses

and the tenants gains are lower. Even so, to show what the pub chain is really able to obtain, we should add to the rent the profit obtained from the discount:

$$£180 + £110 = £290$$

The result shows that while the chain revenue increases, tenant income decreases. The concern about these issues, led the CAMRA to ask in the Super Complaint for further investigation about the rent system and to apply a no-worse-off than free-house principle; for which the competition authority should look at, and establish rules, regarding the distribution of benefit between tenant

and pub chain. When assessing the problem, the OFT found not much evidence supporting the CAMRA's concern, furthermore it responded equivalently as in the price inquiry, by assuming that detriment to tenants brought by higher prices as a result of excessive rents, would bring harm also to the pub chains.

### **4.0.3 Foreclosure and Restrictive covenants**

The main reason for which, according to CAMRA, the Beer Ties should not have fallen under the block exemption of Article 81 of the EC treaty, is that they foreclosed market to small brewers and new entrants, even foreign. According to the consumer organization, the difficulty in entering the market was a consequence of the fact that large pub chains detained a high share of the estates available for pubs use. The data shows that over 50% of pubs were tenanted in 2009, while 16% managed. Foreclosure was also strengthened by the lack of independent technical services and equipment suppliers, the major part of them engaged in big scale contracts with pub chains with which they had strong relationship and, given the measure of their operations, new entrants and small brewers were often unable to engage in contracts with them.

It is not only the structural characteristics of the industry that foreclosed the market to small brewers and new entrants. The concern of the CAMRA was further deepened by the fact that the barrier to entry was artificially reinforced through the use of restrictive covenants. When a pub tenanted under a chain was forced to close and the estate was sold, the new owner was required to engage in a covenant restricting him to use the estate as a commercial activity different from a pub. This practice reduced the number of premises that were available

to be run as pubs in the market, leading to a diminishing of competition that would bring detriment to consumers. The CAMRA and other consumer bodies wanted to move the OFT into preventing the use of new restrictive covenants and eliminate the existing ones. In the response to the Super Complaint, the competition authority declared that it is true that when covenants were used in a certain context they resulted in bringing detriment to customers given by lower level of competition, but since in that period(2009) there was over-capacity of pubs in small geographic/demographic areas, the use of covenants did not reduce competition and instead allowed remaining pubs to survive. Furthermore given that those contracts had not been used in a large scales, the OFT believed that they could not cause significant harm to competition.



# Chapter 5

## Conclusion

From the various market situations that we have analysed in the Uk beer distribution in premises for sale and consumption of drinks, given the different contexts and time periods taken into consideration, it is not an easy task to draw a conclusion about the effects on competition of the Tied Houses, since it has to incorporate every different variable and aspect of the industry. On one hand, those who criticized this market structure, relied on theoretical models and data that showed the differences in prices and its causes according to the model taken into consideration, their concern was also directed at the power exercised by chains through exclusive contracts with tenants and their relationships with suppliers. On the other hand, the authorities defending the ties, relied on many externalities that together allowed a stable industry condition, from the great geographical fragmentation of the pub chains to the improved distribution that they provided, as well as the specific traits of exclusive agreements that were used as a means to offset the greater prices and allowed to bring benefit both to tenants and consumers. At the theoretical level though, it is true that an increased marginalization like in the

case of the Pubcos, inevitably leads to increased prices available to the market. It is also clear that pub chains relationships with suppliers, exclusive agreements and the extent of their presence in the market gives them some power in terms of foreclosure, and even though it was the focus of the debate whether they actually did it or not, it would be normal for them to have the incentives to limit entry once they have the power to do so. The influence they detain is exceptionally clear when we consider the relationships with their tenants, they have the power to impose tied products and other vertical restraints, furthermore through the rents and discounts system, they can decide over market prices and distribution of profits. Even so, the fact that they have powerful instruments does not mean that they do engage in practices detrimental to retailers and consumers; as argued by the OFT indeed, too much detriment to their tenants would probably make them worse off. Nevertheless, the necessity for authorities to enforce the Small Business, Enterprise and Employment act 2015, whose aim was also the protection of tied tenants and restrained the Tied houses, demonstrates that in a non-optimal condition of the market, pub companies could have the ability and power to shift the burden of distress to their tenants. The fact that they have the power and even did so, makes clear that in moments in which the market is non-optimal, they could have the incentives to safeguard themselves by engaging in those so called practices that are able to damage tenants and consumers. An industry in which a player has the power to do so, is probably reflected in an unstable and unsustainable market condition.

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