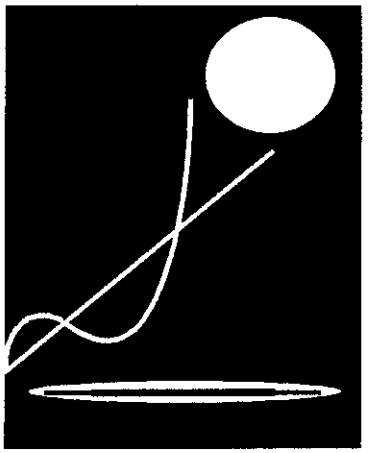

Food Marketing Policy

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Statement on the Breakfast Cereals Industry

by

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*Alfred E. Kahn is Professor Emeritus, Cornell University, Ithaca, New York. This paper was presented at the Congressional Forum, March 12, 1996, Washington, D.C.

March 11, 1996

Statement on the Breakfast Cereals Industry
by
Alfred E. Kahn[1]

I'm happy to be of such assistance to you as I can in your inquiry into the breakfast cereals industry. I must point out at the outset, however, that I am not an expert on this industry. While I have read about it occasionally, my special acquaintance with it is limited to my having served during a period of three weeks as Court-appointed advisor to the U.S. District Court in the antitrust case brought by the State of New York against Kraft General Foods in an effort to have that Company's Post Cereals Division's acquisition of the Nabisco Cereals Division of R.J. Reynolds declared in violation of Section 7 of the Clayton Act.

Moreover, while my main academic area of specialization during the first decades of my career were in the area of what economists refer to as industrial organization and antitrust, my major concentration during the last 25 years or so has been in the area of the direct regulation and deregulation of such industries as air and surface transportation, telecommunications, electric power and natural gas. This more recent work has involved completion of my two-volume *The Economics of Regulation* and service, successively, as Chairman of the New York State Public Service Commission and the Civil Aeronautics Board and as Advisor to President Carter on Inflation.

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[1]Robert Julius Thorne Professor of Political Economy, Emeritus, Cornell University and Special Consultant, National Economic Research Associates, Inc.

During the course of my previous work in industrial organization and antitrust I published a number of articles in those fields and a book, *Fair Competition, The Law and Economics of Antitrust Policy*, which I wrote in collaboration with Professor Joel B. Dirlam, and served as a member of both the Attorney General's National Committee to Study the Antitrust Laws, during the Eisenhower Administration, and the National Commission on Antitrust Laws and Procedures, under President Carter.

What I plan to do in this brief statement, after repeating the warning I've already given you about my limited professional study in this industry, is to emphasize and briefly explain the two major conclusions that I reached during my service as advisor to the District Court in the Kraft Case, which I spelled out in the testimony I gave at the end of the trial, setting forth my recommended resolution of the antitrust issue.

First, I expressed the view that there was a strong basis for public dissatisfaction with the performance of the breakfast cereals industry. But, second, I was in the evidence presented in the case, insofar as I was able to assess it, an insufficient demonstration of the likelihood—or even, indeed, possibility—that the acquisition of Nabisco by Post would further impair the effectiveness of competition in breakfast cereals to justify its reversal under the antitrust laws.

Since these two conclusions, expounded in that single piece of testimony, represent in effect the sum total of the message I have to offer this committee I take the liberty of attaching the relevant pages of the transcript of that testimony.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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STATE OF NEW YORK, by
G. OLIVER KOPPELL,
ATTORNEY GENERAL,

Plaintiff,

v.

93 Civ. 0811 (KMW)

KRAFT GENERAL FOODS, INC.,
NABISCO CEREALS, INC.,
NABISCO, INC.,
PHILIP MORRIS COMPANIES INC.,
RJR NABISCO HOLDINGS CORP., AND
RJR NABISCO INC.,

Defendants.

----------x

October 14, 1994
9:15 a.m.
New York, N.Y.

Before:

HON. KIMBA M. WOOD,

District Judge

APPEARANCES

G. OLIVER KOPPELL
Attorney General, State of New York
MARIA DEL MONACO
GARY J. MALONE
RICHARD L. SCHWARTZ
Assistant Attorneys General

ARNOLD & PORTER
Attorneys for defendants
ABE KRASH
MARCH COLEMAN
STEVE READE
DONNA PATTERSON

would do better than Post, which has, apparently --has, according to the testimony of Post witnesses, but apparently without disagreement by the plaintiffs, made very, very intense efforts in the last several years to improve its market position in all the ways that Mr. Leckie described and, as a result, succeeded in increasing its total share by only -- and I have a blank here of percentage points. It was 1. something. But it took a very, very intense effort apparently to achieve that result.

It may be, therefore, that an assumption that an independent Nabisco would go all the way back to 1978 could err on the side of generosity.

These various alternative expectations still leave us, I have the impression, with an incremental HHI in the vicinity of a hundred points. And it is an increase in an already-concentrated industry well above the 1800 index of the guidelines. And this would, therefore, require us to subject its likely competitive effect to an at least initially hostile examination.

So I turn to what is really the last major subject, which is, in a sense, the only subject, the likely effect on competition. In doing so, I do have to say something about the nature of competition as it is practiced in the ready-to-eat cereals industry.

The industry is clearly keenly competitive in

important dimensions, but I believe there is ample room for reservation or dissatisfaction with the ways in which it competes and in particular with its very heavy emphasis on advertising, product differentiation, product proliferation and variation.

This intense rivalry in developing product variations clearly caters to a genuine

consumer demand. Consumers do seek variety. They clearly do respond to the variations and innovations that the companies compete intensely in introducing. And once one concedes the legitimacy of that kind of innovation, it becomes logically very difficult to criticize the process by which an industry caters to it, to the demand for it, or even to the high profits; that is to say, the high prices that consumers pay relative to cost, including the cost of new product development that constitute the reward for successful innovation.

But consumers respond also to price. Most of us are under severe pressure to look for economy as well with the growing popularity of private brands.

Now, the industry does respond to that desire as well with the constant promotions and the very high percentage of sales with coupons, which are themselves powerfully impelled by competitive pressures. The fact remains that these methods of competition are in important

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respects, from the economic standpoint, wasteful. Competitive advertising is very costly in this industry and largely mutually offsetting.

And the record demonstrates to my satisfaction that couponing, while clearly a competitive phenomenon and a price competitive phenomenon, is in important measure an inefficient way of reducing prices to customers. They get only a proportion, high proportion, but only a proportion of the costs of competing in this way, and that doesn't include the value of consumer time spent in taking advantage of this method of competition.

There is far less emphasis in this industry on everyday low prices because in a highly-concentrated industry, as economist after economist has recognized, it is not in the interest of firms which have strong stakes in protecting and enhancing the value of their brands

to compete in this way. That is, there is a recognition on the part of each of the major players, without need for collusion, such as might be attackable under the antitrust laws, a recognition that competition of that kind would be mutually frustrating.

That's what we mean by the recognition of interdependence, or what Professor Rubinfeld refers to as strategic interaction, that confines open price rivalry directly among the firms to couponing and promotion and to

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advertising, which is not a form of price rivalry at all.

And of course the reason that it confines it to these are complicated. This is a method or competition that is much more difficult to practice price leadership and followership with. One may recognize interdependence, but there has been a lot of testimony pointing out why it is much more difficult simply to follow the leader or even to know what the leader is doing in time to do anything about it.

In this connection, having agreed with Professor Rubinfeld in one important respect, I must -- I feel it urgent to remind the Court that his demonstration or his purported demonstration of the absence of price leadership by showing the wide dispersions in the changes in the prices of individual brands, no one claims that price leadership, even a hundred percent perfect price leadership, necessitates the price of each brand or each product go up by the same percentage.

The critical aspect of the phenomenon is that brand for brand the price of competitors go up identically for each of the brands on which they compete with the price leader. And therefore, a demonstration that there is wide dispersion in price changes from brand

to brand within individual companies is irrelevant and, therefore, the demonstration that the average price changes vary widely

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from company to company is likewise of no substance whatever because those averages could diverge enormously merely by virtue of the differing composition of the bundles of brands and products sold by the several companies.

In this connection, close to finally, it is no accident that among the largest firms in the industry, the top four or five, apparently, none provides product for the private label market.

I think it is significant that the prime motivating force behind the spread of private labels, which is the closest the industry comes -- well, I mean it is very close to genuine everyday low prices, comes not from the companies directly, but from price conscious competition among retailers.

And while there has been testimony by the defendants pointing with approval in a sense to the more rapid spread of privately-owned labels in recent years, their share of the market in both volume terms and lower share in value -- and you can fill in the numbers; my impression is that we are talking about 8 percent with one and perhaps 6 percent with the other -- is much lower than their penetration in other consumer products, such as was demonstrated in one of the exhibits presented by the plaintiffs.

The reason is, of course, the high degree of

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concentration nationally on the supply side among ready-to-eat cereals, the very heavy stake of

the major suppliers in preserving the value of their own brands, and their greater success in doing so because of the strength of the brands, because of the particular ways in which they compete, and because of the barriers to entry that are constructed by this heavy advertising and heavy emphasis on brand promotion.

When I find myself confronting the strong desire expressed by Dr. Boehm of Kroger in acquiring a high-quality Shredded Wheat product, a desire still unsatisfied, and the submission by the defendants of evidence that Kellogg has a very large amount of excess shredding capacity, I find the confrontation of those two helps make my point: Kellogg has the capacity. It presumably can supply that product at prices to Kroger well in excess of marginal cost.

I am not criticizing for Kellogg not being willing to do so, but I have no difficulty interpreting that as a desire to protect its equity in the Kellogg brand, and I can only infer -- I take it that back. I can infer only in explanation a belief on the part of Kellogg that the loss of net income from cutting into its more profitable private brand sales outweighs the gain in net income that it would achieve from the higher volume at prices in excess of marginal costs and the absence of sufficient competitive

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pressure in the industry to force Kellogg to use its shredding capacity in that way.

Now I turn to the ultimate question, however. I share the belief, then, expressed by Professor Cotterill that the public would be better served by an industry whose performance contained a larger admixture of everyday low price competition in the provision of more standardized products.

But the question is whether or how the antitrust laws can or should be expected to provide the remedy. Where do they come into the picture?

Broadly, I suggest, when the market power or concentration or high degree of product differentiation or high barriers to entry that are both the source and the consequence of this intense but impure competition are extended or enhanced or buttressed by actions that the antitrust laws do encompass more or less explicit collusion, combination, merger, or what does not seem to be relevant at all in this case, unfairly exclusionary practices.

These, of course, lead us to Section 7 of the Clayton Act, as if you didn't expect it. With its prohibitions of combinations of assets that threaten to weaken or further to weaken or impair such competition, however impure or imperfect, as either previously prevailed or would prevail with its explicit intention, of course, of

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nipping any such tendencies in the bud.

And I proceed on what I take it to be the only proper assumption that the evaluation that I am called upon to offer under the Act must be confined to the possible or likely incremental consequences of the Post-Nabisco merger.

That is to say, whatever grounds I see as an economist for dissatisfaction with the previous state of competition in the industry, they are not themselves directly relevant to this appraisal.

The question is, may the merger reasonably be expected to have augmented or accentuated these characteristics of competition that I consider undesirable or interfere with tendencies that might, in the absence of the merger, have operated in the direction of diminishing

or diluting them?

First, tacit collusion, or is the term multiple lateral effects? As a general proposition, I, along, I believe, with a great majority of economists, subscribe to the proposition that the more highly concentrated a market is, the greater the likelihood sellers will avoid direct and open everyday low price competition, whether through overt collusion or conscious parallelism or mere recognition of oligopolistic interdependence, and the greater the likelihood price competition will take the form, especially in consumer goods industries of special promotions, the

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offer of coupons, both of which of course are extremely prevalent in this industry, and the greater the likelihood, also, that it will take the form of cost-inflating advertising, which of course is again very important in this industry, the form of product differentiation and the continuous offering of product variations.

That assumption is the assumption in the guidelines with its suggested application of measures of market concentration. And I have seen nothing in the record of this trial that reflects any serious questioning of that belief on the part of either of the two parties.

But the pertinent question is whether the merger of Post and Nabisco may reasonably be expected to reinforce those undesirable tendencies, or to put it another way, whether a Nabisco remaining separate from Post or hence forward separated from Post could reasonably be expected or have been expected significantly to moderate those tendencies.

Yet, another pertinent question would be whether the merger may reasonably be expected to moderate or weaken the particular kinds of competition in which the industry does

engage; that is to say, product variation, product innovation, advertising, couponing, promotions.

I think that the second of these, or the last of these questions, can be rather quickly dismissed.

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I see no serious claim by the plaintiffs that a separate Nabisco will be a more powerful or more effective product varier, advertiser, innovator than Post itself or the Post-Nabisco combination.

I found quite persuasive the testimony of Mr. Hinkes to the effect that the acquisition of Nabisco cereals seemed to Post a logical and important part of its deliberate campaign to reverse its sharp loss of market share during the 1980's and to compete more effectively than it had previously competed in the ways in which successful companies in this industry compete.

And I emphasize that because I have been at pains to express my reservations as an economist about the sufficiency of that kind of competition. But I see no basis for believing that Nabisco was particularly or unusually successful in that respect before or that there is any reason to think that it will do a better job than a combined Post-Nabisco in increasing, improving promotional efforts, extending product lines and in the case of Post acquiring a shredded cereal product for which it lacked reasonable prospect of doing so on its own.

If anything, the evidence seems to be that the acquisition contributed to the rejuvenation of Nabisco as a competitor in these ways after a period of almost deliberate withdrawal from the cereals business.

So far as the traditional way of competing is concerned, therefore, I find it difficult to assign any higher probability to its being more vigorously prosecuted by an independent successor Nabisco company than by the challenged Post-Nabisco combination. And the state has not, so far as I know, cited any evidence that the purpose of the merger was to repress that kind of competition, nor do I see statements by the plaintiffs that contradict the assertions by Post executives that their purpose, instead, was to convert Post into a more effective competitor against its much larger and more successful rivals to reverse the large losses of market share that it had suffered during the '80s or that Post has not indeed become a more vigorous competitor, partially by virtue of its acquisition of Nabisco and reversal of that company's 1989 to 1992 harvest policy.

I return, then, to the question of whether a Nabisco, independent of Post, would have competed or would hence forward be likely to compete in ways more closely resembling the pure or perfect competition model, more everyday low prices, either with offering price reductions or by offering product to retailers for sale under private label.

The state's contentions here are not frivolous. It is certainly possible that an independent Nabisco would

be a more vigorous price competitor. From the standpoint of price competition, six rivals are better than five, and a small competitor is more likely to be a price undercutter than a large one because, other things being equal, the smaller the seller's market share, the greater the elasticity of demand for its product.

The greater the likelihood, for example, that a seller with only one percent of the market might experience a doubling of its sales, a hundred percent increase of its volume, going from one half of a percent to one percent of the market, let's say, in response to a 10 or 20 percent decrease in price suggesting demand elasticities of minus 5 or minus 10. Whereas, the larger the seller, the larger the share of the market, the more closely the elasticity of demand for its products approaches the elasticity of demand for the entire product or market, because the lesser is the possibility of its increasing its sales not not by expanding total market sales, but by taking business away from other rivals.

But arguing on the other side is the absence of any evidence in the record, so far as I know, that Nabisco, when it was independent, was in fact more prone to compete directly on price than the larger manufacturers, that it was indeed a maverick in its fidelity in following price changes instituted by the acknowledged leaders, Kellogg and General

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Mills.

As for the possibility of a Nabisco independent of Post supplying shredded products for sale under private labels, in which Dr. Boehm of Kroger expressed a strong interest, the fact is Nabisco did not do so when it was independent as a matter of policy.

As Mr. Greeniaus explicitly asserted on deposition, the company was a strong believer in the importance of national brands. Like Kellogg, it was unwilling to undermine the value of the one-branded product for which it enjoyed strong consumer acceptance and an important measure of invulnerability to competition, as it had demonstrated in response to Kellogg's attempt at a direct competitive challenge, and it was unwilling to undercut that strong

market position and the prices that it justified by supplying the product to price-cutting private brand competitors.

The fact remains that the top three firms in this industry, Kellogg, General Mills and Post, as well as Nabisco itself before the merger, do not undercut their own brands by producing product for private brand distribution as a matter of policy.

Once again, I think it is impossible to deny the possibility that an independent seller of Nabisco brand, a successor company if the present merger is dissolved, might

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change that policy and be the source of intensified direct price competition to the benefit of consumers.

I see no basis in the record, either historic or otherwise, however, for raising that possibility to the level of probability. That is to say, I cannot see a basis for seeing a probability or what the law sometimes refers to as a reasonable probability that a successor company having paid presumably a high price for the value of the Nabisco brand, and specifically the Nabisco Shredded Wheat brand, would evaluate the profitability of undercutting that brand by offering Shredded Wheat products for private distribution or engaging in open price competition any differently than Nabisco itself had done previously or that Post-Nabisco does now.

In short, the fact of the undeniable possibility that a newly-independent Nabisco might, by altering the way in which it competes, measurably move this industry in the direction of more direct consumer welfare, enhancing price competition, must confront the opposing fact that this is not how firms operate in this industry.

In reaching that conclusion, I see no basis for departing from the way in which

Post evaluated its situation in the late '80's or early '90's, confronting the short loss of market share and setting about attempting to reverse it by the same methods by which firms in this industry achieve

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success; more advertising, more effective advertising, more promotion, more brand differentiation, more product variation, and more couponing.

Nor do I see any evidence in the record that a separated Nabisco would compete more intensely or effectively in these ways than Post-Nabisco has in fact done in the last few years.

I have wondered whether I should succumb to the temptation to express regret at this conclusion. I wish, indeed, and have written to the effect that I wish there were ways of stretching the antitrust laws to discourage the ways in which this industry competes and to direct its competition to what I would regard as more consumer welfare promoting channels, but I do not see any reasonable likelihood that dissolving this merger would do that.

I turn briefly to unilateral effects.

Entirely apart from its contention that this merger will tend to weaken the force of price competition in the industry and solidify tacit collusion or price leadership and followership, the state contends that it creates the likelihood of the combined company increasing the prices of Shredded Wheat and Grape-Nuts by combining the two into a single company and so removing the restraint of the direct competition between those two prices on the prices of those products from the time of the merger onward.