# Strategy and Policy in the Food System: Emerging Issues

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PART TWO: Measurement of Market Power

## 8. Evaluating Mergers in Food Industries Under Procedures for Litigation or Regulation

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# Evaluating Mergers in Food Industries Under Procedures for Litigation or Regulation

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## Evaluating Mergers in Food Industries Under Procedures for Litigation or Regulation

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### Introduction

In the 1990's, antitrust enforcement tends to follow a dual track analysis, one for litigation and the other for settlement. The litigation track is based on the case law and applies to mergers likely to go to court, while the settlement track is based on the U.S. Department of Justice and Federal Trade Commission Merger Guidelines and applies to mergers in which institutional realities transform either the DOJ or the FTC into a regulatory agency (Coate 1996).[2] Based on FTC data (Coate et al. 1995), proposed mergers that involve relatively small competitive overlaps, small absolute transactions or unusually large companies tend to face regulatory enforcement, while a clean acquisition of a direct horizontal competitor by a mid-sized rival likely faces rules based on the litigated case law. While most cases follow the regulatory route, the litigated cases may obtain the lion's share of the publicity.

### Court Decisions

To understand how the courts apply the antitrust laws, it is necessary to review enforcement actions. Table 8.1 highlights relevant information on six litigated cases in the food industry. They all share narrow markets, relatively high Herfindahls, and generally focus on branded products, but differ with respect to the findings on ease of entry and buyer power. Four cases (Coke, Coke SW, Bigelow, and Tasty Baking) involved some type of injunction, while two cases (Country Lake Foods and Kraft) were dismissed. Moreover, two cases (Bigelow and Tasty Baking) involved preliminary injunctions with relatively narrow markets that may not have been upheld in a full trial on the merits.

These cases all involved oligopolistic industries, with one reaching the level of a dominant firm. All but one (Kraft) involved the acquisition of a significant rival and even in the Kraft case both firms were large in a niche product line. Abstracting from the questions of market definition and entry, these cases generally offer strong structural foundations. Moreover, efficiency considerations are rarely mentioned in the decisions. Thus, an evaluation of a proposed merger in an oligopolistic food business would tend to focus on issues of market definition, entry, and maybe efficiencies.

Case law on market definition is confused at best. Some cases with relatively narrow markets exist (see Bigelow and Tasty Baking discussed above), although in other cases, broad markets are accepted after the respondents produced evidence suggesting some type of switching among the products occurred (see Calmar and Donnelley cases). While econometric studies may be particularly insightful on market definition grounds, it is possible or even probable that both parties to the litigation will present models that generate conflicting results. Courts would likely have great difficulty in resolving the technical

TABLE 8.1 Selected Merger Decisions in the Food Industry

| Case | Market | Herfindahl (Change) | Strong Brand | Entry Barrier | Buyer Power |
|---|---|---|---|---|---|
| FTC v. Coca Cola Company | Carbonated Soft Drinks | 2651 (344) | Yes | Yes | No |
| Bigelow v. Unilever | Herbal Tea | 7228 (3328) | Yes | No | No |
| FTC v. Coke SouthWest | Branded Carbonated Soft Drinks | 3421 (614) | Yes | Yes | No |
| Tasty Baking v. Ralston | Snack Cakes and Pies | 4077 (1685) | Yes | Yes | No |
| DOJ v. CountryLake Foods | Fluid Milk | 2832 (646) | No | No | Yes |
| New York v. Kraft | Ready to Eat Cereal | 2281 (66) | Yes | Yes | Yes |

Source: Coate (1992) and the author's review of court decisions. The Coke Southwest decision was reversed and returned to the FTC for further review. Coca-Cola Bottling Company of the Southwest v. FTC, 5th Circuit Court of Appeals, June 10, 1996, No. 94-41224.

disputes associated with the parameter estimation. In contrast, documentary and testimonial evidence is likely to have more impact on the outcome of a market definition dispute than econometric evidence, because it is easier for the court to understand.

The case law approach to entry is better defined. With Waste Management and later Baker Hughes, courts have found entry arguments offsetting the competitive concerns caused by concentration. In Baker Hughes, Judge, now Supreme Court Justice Thomas explicitly rejected the DOJ's proposed "quick and effective" standard, noting that even the threat of entry can maintain competitive performance. Thus, the law is clear that actual entrants need not be identified. For example, if one could list a few firms with a chance to enter, the combined probability of at least one entrant is likely to meet the court test. In effect, the court seems to be demanding evidence on some type of entry barrier before concluding entry is not likely to offset an anticompetitive price increase.[3]

Efficiency considerations probably require a precedent-setting decision before they rise to the level of entry in immunizing a merger. While efficiencies are cited favorably in some court decisions, the level of quantification falls short of what might be expected in a full efficiency defense.[4] It is unlikely a food industry merger will serve as an efficiency test case.

## FTC Enforcement Decisions

While the Merger Guidelines purport to define enforcement policy, it is also useful to review the limited information on enforcement priorities. Table 8.2 lists the products involved in three Hart-Scott-Rodino (HSR)-reportable food industry mergers (Coke, KKR, and McCormick) challenged by the FTC

TABLE 8.2 Selected FTC Enforcement Actions in the Food Industry

| Products in HSR Cases | Pre-merger Market Structure | Entry Possibilities |
|---|---|---|
| Carbonated Soda | Duopoly and Fringe | Limited (Brand Name) |
| Ketchup | Oligopoly | Possible (Shelf Space) |
| Packaged Nuts | Oligopoly | Possible (Shelf Space) |
| Shelf Stable Chinese Foods | Duopoly and Fringe | Possible (Shelf Space) |
| Spices | Dominant Firm | Limited (Shelf Space) |

Sources: F.T.C. v. Coca-Cola Company, D. 9207; F.T.C. v. Kohlberg, Kravis & Roberts, C. 3253; F.T.C. v. McCormick, 1988-1 Trade Cas. (CHH) ¶ 67,976; and publicly available information.

in the mid-to-late 1980's. The Coke case resulted in both a federal court and FTC decision against the merger, the KKR investigation ended in a settlement and divestiture of three product lines, and the McCormick/Spice Island merger was abandoned after an investigation including a federal court decision enforcing the second request. A few other food industry mergers were allowed to proceed after internal investigations.

In these matters, the food products of concern (Coke—carbonated soda; KKR—ketchup, packaged nuts, and shelf-stable Chinese foods; and McCormick—spices) were branded and faced limited competition. The spice case involved a dominant firm, while the soda and Chinese food case affected markets best described as duopolies, and the remaining markets could be described as concentrated oligopolies. In the soda and spice cases, the target could be best described as a fringe firm, while the others involved branded rivals. Thus, it is fair to say that all the matters involved strong structural cases on the merits, abstracting from questions of market definition and entry. Efficiency issues are more difficult to explore without compromising the confidential nature of the case files. Overall, a regulatory analysis of a food merger is likely to be strongly influenced by the outcome of a Guidelines evaluation of market definition, entry, and efficiencies.

In general, it is relatively easy to confuse Guidelines issues and generate inappropriate policy recommendations. A naive Guidelines analysis could support an aggressive enforcement program with markets limited to niche products and entry considered blocked by the need to brand products and acquire shelf space. On the other hand, one could argue for broad markets based on the assumption that foods are all substitutes and conclude that entry is always easy based on a count of the number of new food products introduced each year. This would generally preclude antitrust enforcement in the food industry.

A sophisticated Guidelines analysis would attempt to define realistic markets in which a hypothetical monopolist could profitably impose a significant and nontransitory price increase. In some markets, a five percent price test may be appropriate. However, it seems reasonable to validate the five percent price test by determining if enough consumers would switch from the product of the acquiring (or acquired) party to defeat a unilateral pre-merger price increase. If not, the use of the five-percent test will artificially guarantee a narrow market.

In grocery retailing, interbrand competition may involve relatively large promotions (either in-store specials or coupons) instead of small reductions in list price.[5] Thus, instead of focusing on list price changes to define markets, one might look at the effects of promotions on sales. If a firm regularly

promoted its brand-name product and gained sales from generics or low quality brands, a broader market must be seriously considered. This approach would have the added advantage of focusing the analysis on the responses of the marginal customers. A class of products dependant on promotions or coupons to move output is unlikely to survive a realistic hypothetical monopolist test and hence a broader market would be required.

In some cases, maybe branded cola, even a broad market would be concentrated, while in others the addition of a generic product or a close substitute might eliminate the competitive concern. Any statistical analysis of a grocery market should address the promotion issue either directly through the price data or indirectly through a study of coupons. It is likely that a statistical analysis would prove useful in the regulatory procedure. Of course, it is doubtful that the regulators will accept black box methods for predicting economic effects, instead they will insist on complete disclosure and replicability of the relevant results.

The Guidelines entry analysis focuses on timeliness, likelihood, and sufficiency of entry (Coate and Langenfeld 1993). In general, the timeliness standard of two years can be easily met and the sufficiency concerns are likely to be limited to assuring the entry under study addresses the competitive effect of concern.[6] Thus, the analysis concentrates on the more theoretical question of likelihood of entry. It is important to note that the analysis does not involve a survey of the hypothetical entry decisions, instead it requires an analytical study of the entry incentives created by a noncompetitive price increase.

Two general approaches to the likelihood of entry merit attention. First, it is possible that noncompetitive behavior will attract "premium store brands" as entrants. In effect, these products leverage the retailer's reputation for quality into new niches and almost automatically obtain the recognition of a branded high-quality product without a new investment in sunk costs. This retailer branding may be more efficient than manufacturer branding, because the retailer can use the quasi-rents from its entire portfolio of premium products to assure the quality of each product. (For a discussion of quality assurance, see Klein and Leffler (1981).) In practice, industry experts should be able to differentiate between grocery items that can be easily co-packed as private label and those that cannot. Examples of easily co-packed products probably could include nuts and shelf stable Chinese foods, while co-packing a high quality product is likely to be difficult for colas, ready-to-eat breakfast cereals, and soft cookies produced through patented technologies. Overall, some food product markets are unlikely to be monopolized given the growing trend to retailer branding. However, food markets which exhibit production processes protected by patents or trade-secrets are likely to remain difficult to enter without an investment in new facilities and brand name capital.[7]

Second, it is possible for a firm to enter most food products with a new branded product. This entry analysis is more complicated, because the entrant likely faces some sunk costs to branding (hence scale is important) and is unlikely to choose a "me-too" product. The scale concern appears manageable. First, sunk costs associated with entry need to be identified to ensure that they are significant.[8] Next, data on sales generated by recent successful entrants in similar markets must be collected. These sales would be compared to the market universe associated with the product under study. The Guidelines hypothesize a five percent share as sufficient to infer likely entry in response to a noncompetitive price increase and note other figures can be considered. For example, if the market was growing, it would be reasonable to conclude that a new product could profitably obtain an output level greater than five percent of the current market in response to a noncompetitive price increase. Alternatively, if the level of sales required for a successful entry mandates a very large share, the Guidelines suggest entry is not likely.

At least two generalizations of the basic Guideline likelihood analysis should be considered to adjust for the differentiated nature of likely entry into food markets. First, the addition of a new product offers consumers more choice in food consumption and such choice should be worth slightly higher prices. Thus, one could assume entry would be profitable even if market share did not rise to the level anticipated in the Guidelines. Second, most entrants in the food industry are likely to be able to exploit

economies of scope with their other food products. Thus, they could have lower costs than the incumbents or obtain some benefit from their investment in sunk costs for their other food product lines. Again, another adjustment could be made in the Guidelines analysis. While both of these changes are likely to be small, it does seem entry should be presumed likely in marginal cases.

Efficiency analysis is also possible under the Guidelines (Stockum 1993). While the basic approach to measuring efficiencies is relatively well understood (focusing on real cost savings unavailable through alternative reorganizations), less time has been spent on balancing competitive and efficiency concerns. One approach would attempt to show efficiencies are relatively certain, while adverse effects are speculative. (For a qualitative analysis of this point, see Pitofsky (1992).) Thus, the scenario in which price falls could be compared to one in which it rises, with the balancing determined by the magnitudes and expected probabilities of the two scenarios. Alternatively, an efficiency analysis could focus on the dynamics of the marketplace with short-run anticompetitive effects compared to long-run price declines due to efficiencies. A third approach would integrate efficiencies into the competitive analysis with efficiencies that lead to structural changes that lower price being considered procompetitive.

## Conclusion

Competitive analysis in the food industry should focus on the key issues of market definition and entry under either a litigation or regulation framework. While the analytical techniques are likely to differ, the conclusions on market definition and entry go a long way to determining the outcome of the competitive investigation. Although issues associated with how competition occurs in the market are important (for one approach to evaluating competitive effects, see Werden and Froeb (1994)), these questions are secondary to market definition (and thus concentration) and entry. Of course, a complete analysis would identify how the underlying competitive structure of the market is adversely affected by the merger, before blocking a transaction with the analysis simultaneously considering issues of market definition, concentration, competitive effects, and entry. Efficiency considerations, while interesting, await a change in case law and/or policy before becoming fully relevant.

## Notes

[1]Malcolm B. Coate is a Deputy Assistant Director for Antitrust in the Bureau of Economics, Federal Trade Commission. The analysis and conclusions set forth in this paper are those of the author and do not necessarily reflect the views of the Federal Trade Commission, the Commissioners, or any Commission Bureau.

[2]Coate presents a model of the merger settlement process that predicts one side will generally "win" in settlement negotiations and obtain its goals. Thus, when the government holds the more powerful negotiating position, it will be able to obtain settlements sufficient to maintain regulatory power in merger enforcement.

[3]As noted later in the text, the 1992 Merger Guidelines advance a three part test of timeliness, likelihood, and sufficiency for evaluating ease of entry. While one could argue this simply restates the rejected "quick and effective" standard, other interpretations are possible. The detailed discussion in the Guidelines allows for a broad interpretation of timeliness such that the definition could be customized to the facts under study, instead of limited to some vague understanding of "quick." Likewise, the concepts of likelihood and sufficiency, taken together, address the issue of "effective" entry. However, both concepts are developed in detail and implicitly allow for case-by-case customization of the analysis. Thus, under the Guidelines structure, it may be possible to point to some type of barrier to entry.

[4]In Country Lake Foods, the court cited efficiencies as one of the reasons why the merger is unlikely to lead to an anticompetitive effect. Since the transaction made the acquiring firm a stronger competitor, prices were likely to be competed down.

[5]Promotions and coupons may be considered forms of price discrimination. A firm may regularly discount or coupon its product to capture sales from marginal customers, while at the same time selling the product at full price to inframarginal customers the remainder of the time. The higher the share of the firm's sales on special, the more important the marginal customers become in the analysis. Promotions and coupons can also be considered a type of introductory offer. The firm heavily discounts its product to induce consumers to try the product in the hopes of obtaining full price business. One would expect introductory offers to be infrequent and of limited duration, hence most of the product would trade at full price.

[6]For example, a new generic entry may not eliminate unilateral competitive concerns associated with the loss of a branded competitor.

[7]It is unlikely the Guidelines concern with scale is relevant, because the retailer does not face significant sunk costs.

[8]The Guidelines note sunk costs can be considered significant if they cannot be recovered by charging a price five percent above the competitive level for one year.

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