STATEMENT OF THE FEDERAL TRADE COMMISSION

RJ Reynolds Tobacco Holdings, Inc./British American Tobacco p.l.c.,
File No. 041 0017

The Federal Trade Commission has closed its investigation of RJ Reynolds Tobacco Holdings, Inc.'s ("RJR") proposed merger with British American Tobacco p.l.c. (referred to as "Brown & Williamson" for its U.S. subsidiary). As part of the Commission's continuing effort to provide transparency to its decision-making process,[1] and to provide guidance about the application of the antitrust laws to mergers in this market, this statement outlines the reasons for our decision.

The proposed merger would combine two of the larger marketers of cigarettes in the United States. Based on an intensive investigation, however, we do not believe that the transaction is likely substantially to lessen competition in the U.S. market for cigarettes. First, Brown & Williamson plays an increasingly minor role in the U.S. market for cigarettes. The company's market share greatly overstates its competitive significance. Brown & Williamson lost more than one-third of its market share in the last seven years, and there is no reason to believe it can reverse or even slow this trend. (RJR lost one-fifth of its share during the same time.) Second, there is no market in which, and there are no brands for which, Brown & Williamson and RJR are each other's closest competitors. Nor is there any other basis for a case based on a theory of unilateral effects. Third, this transaction is unlikely to facilitate or enhance coordination among the major manufacturers in the U.S. cigarette market. Accordingly, we have concluded that this transaction is unlikely to harm consumers.

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[1] *See*, *e.g*., Statement of the Federal Trade Commission, *AmeriSource Health Corporation/Bergen Brunswig Corporation* (Aug. 24, 2001), available at www.ftc.gov/os/2001/08/amerisourcestatement.pdf; Concurring Statement of Commissioner Mozelle W. Thompson, *AmeriSource Health Corporation/Bergen Brunswig Corporation* (Aug. 24, 2001), available at www.ftc.gov/os/2001/08/amerisourcethompsonstatement.pdf; Statement of the Federal Trade Commission Concerning *Royal Caribbean Cruises, Ltd./P&O Princess Cruises plc* and *Carnival Corporation//P&O Princess Cruises plc* (Oct. 4, 2002), available at www.ftc.gov/os/2002/10/cruisestatement.htm; Dissenting Statement of Commissioners Sheila F. Anthony and Mozelle W. Thompson, *Royal Caribbean/Princess* and *Carnival/Princess* (Oct. 4, 2002), available at www.ftc.gov/os/2002/10/cruisedissent.htm; DOJ and FTC Merger Challenges Data, Fiscal Years 1999-2003 (Dec. 18, 2003), available at www.ftc.gov/opa/2003/12/mergereffects.htm; Statement of the Commission, *Sunoco Inc./Coastal Eagle Point Oil Co.* (Dec. 29, 2003), available at www.ftc.gov/os/caselist/0310139/031229stmt0310139.pdf; Statement of Chairman Timothy J. Muris, *Genzyme Corporation/Novazyme Pharmaceuticals, Inc.* (Jan. 13, 2004), available at www.ftc.gov/os/2004/01/murisgenzymestmt.pdf; Dissenting Statement of Commissioner Mozelle W. Thompson, *Genzyme Corporation/Novazyme Pharmaceuticals, Inc*. (Jan. 13, 2004), available at www.ftc.gov/os/2004/01/thompsongenzymestmt.pdf; Statement of Commissioner Pamela Jones Harbour, *Genzyme Corporation/Novazyme Pharmaceuticals, Inc*. (Jan. 13, 2004), available at www.ftc.gov/os/2004/01/harbourgenzymestmt.pdf; FTC Horizontal Merger Investigation Data, Fiscal Years 1996-2003 (Feb. 2, 2004), available at www.ftc.gov/opa/2004/02/horizmerger.htm; Statement of the Federal Trade Commission, *Caremark Rx, Inc./AdvancePCS* (Feb. 11, 2004), available at www.ftc.gov/os/caselist/0310239040211ftcstatement0310239.pdf.

Competition Among Firms for the Sale of Cigarettes

The proposed merger between RJR and Brown & Williamson would combine the second- and third-largest firms in the sale of cigarettes in the United States. Philip Morris is the largest firm and Lorillard is number four in size (only slightly smaller than Brown & Williamson). Together, Philip Morris, RJR, Brown & Williamson, and Lorillard are sometimes referred to as the "Big Four." The next largest firms in the industry are Commonwealth and Liggett, each with roughly a 3 percent market share. Dozens of smaller domestic and foreign firms also sell cigarettes in the United States. The market share of firms outside the Big Four (sometimes referred to as the "non-Big Four" or "NB4") grew from around 2 percent in 1997 to well over 10 percent in 2003.

We did not find evidence during our investigation from which to conclude that the market is narrower than all cigarettes, although, as noted below, we considered several theories regarding potential reduction in localized competition within the all cigarettes market. Within the market for all cigarettes, the merger will increase concentration as measured by the Herfindahl-Hirschman Index ("HHI") from 2735 to 3113, resulting in a change of 378. Since 1996 the Commission has challenged roughly half of the mergers that it has reviewed within this HHI range.

Competition in the cigarette industry reflects the special characteristics of consumer demand for these products. To begin with, cigarettes are highly differentiated, and producers compete across a number of dimensions. For each brand of cigarette that it introduces, a producer chooses physical characteristics, including taste and packaging; selects an image for marketing purposes; and determines how much to spend on advertising and promotions. These activities are designed largely to increase demand for the brand and to discourage smokers of the brand from switching to others. The expenditures that a cigarette company makes to increase the demand for a brand are known as the "brand equity investment." A producer also determines how much to spend on the sales personnel who visit retailers.

The price dimension of competition among firms is also complex. Indeed, cigarette companies not only set the prices they charge to wholesalers but also use a number of promotional tools – such as "buy-some-get-some-free" – to influence the retail prices of their brands. Far from being independent, a manufacturer's decisions on levels of brand equity and prices involve a trade-off. For each brand, a cigarette company has some freedom to choose between (1) investing less in brand equity and charging a lower price (and earning a lower margin over costs other than brand equity investments) and (2) investing more and charging a higher price (and earning a higher margin over other costs). Each major cigarette company sells a variety of cigarette brands with different levels of brand equity and different average prices.

Age is an important determinant of purchasing behavior. Smokers under 30 are much more likely than smokers over 30 to pay a substantial premium for cigarettes with high brand

equity.[2] Specifically, the most heavily promoted, largest selling brands account for a considerably higher share of smokers under 30 than of smokers over 30. Moreover, the price elasticity of demand for these premium cigarettes is substantially lower for smokers under 30 than for older smokers.

At the same time, the percentage of smokers under 30 who switch among major brands and have not yet settled on a usual brand is higher than for older smokers.[3] Almost all smokers beyond the age of 30 have settled on a usual brand and exhibit rates of brand loyalty that are unusually high (in comparison to the loyalty consumers accord to brands of other products). For that reason, a smoker lost to another brand is likely to be lost for years into the future. Given such behavior by smokers, cigarette companies must consider the longer-term effects of their current competitive decisions.

To understand the current competitive landscape, it is sufficient to distinguish among three categories of brands owned by RJR and Brown & Williamson. First, each of the Big Four cigarette producers has at least one premium brand in which it makes substantial brand equity investments, including various types of price promotions. A producer makes these investments principally to attract smokers under 30 to adopt its brand. These "equity" brands include Philip Morris's Marlboro, Lorillard's Newport, and RJR's Camel. While their sales are much lower, Brown & Williamson's Kool and RJR's Salem are also in this category.

Second, like the other Big Four producers, Brown & Williamson and RJR sell other premium brands that were once popular but no longer receive substantial brand equity investments, including the price promotions. These "legacy" brands, which commonly sell at relatively high retail prices, include Benson & Hedges, Kent, and Tareyton. Smokers of legacy brands are older, and the market shares of these brands fall as consumers who prefer them die or switch to discount brands. Individual legacy brands have little competitive interaction with other premium brands.

Third, RJR and Brown & Williamson also produce "discount" (or "savings") brands that have relatively low levels of brand equity and thus carry lower prices. Other discount and "deep discount" brands are sold by Commonwealth, Liggett, and numerous smaller cigarette companies.

Our investigation revealed that RJR and Brown & Williamson face two principal sources of competition: (1) price competition from NB4 discount cigarettes; and (2) competition among premium brands in the form of brand equity investments, including various types of price

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[2] The share of smoking accounted for by discount cigarettes increases substantially with the age of smokers.

[3] In 2002, substantially more smokers under 30 who switched brands switched to a premium brand rather than to a discount brand, as compared to smokers over 30.

discounts and promotions such as buy-some-get-some-free and direct mail coupons.

There are both supply and demand explanations for recent increases in price competition from smaller companies. On the supply side, the late-1998 Master Settlement Agreement ("MSA") between the Big Four and 46 states imposed substantially higher costs on the Big Four than on many smaller companies, and thus conferred a cost advantage on smaller companies that sell deep discount cigarettes. On the demand side, the price of cigarettes increased during 1997-2001 primarily because of the pass-through of MSA costs of higher excise taxes. The cost of smoking relative to incomes increased substantially, and a significant number of smokers switched from Big Four cigarettes to NB4 discount cigarettes. Discount brands sold by the Big Four faced greater switching than did the Big Four's premium brands, but the NB4 competition had some effect on all Big Four brands.

Beginning with Brown & Williamson in 2000, the Big Four responded to this increase in competition and loss of share in three ways. First, they placed greater emphasis on the growth of a small number of premium brands – the segment in which they face the least direct competition from the NB4. Second, the Big Four took steps to mute the increase in, and then to reduce, retail transaction prices for their cigarettes (net of MSA payments and excise taxes). They stopped raising the wholesale list prices of their premium brands and substantially increased price promotions for those brands, cutting into their own manufacturer margins. Third, the Big Four undertook major efforts to reduce costs, to free up internal funds that would allow them to make the aforementioned changes while still providing dividends to shareholders.

On net, these changes by the Big Four substantially invigorated competition during 2002-2004, not only between Big Four and NB4 companies but also among the Big Four themselves, who have responded to each other's competitive moves.

Brown & Williamson's Competitive Significance

Although Brown & Williamson has the third largest share of the overall cigarette market, we believe that its market share (of slightly under 10 percent) substantially overstates its pre-merger significance because most of Brown & Williamson's sales are accounted for by discount and (to a lesser extent) legacy brands. Discount and legacy brands account for a much smaller share of sales for Philip Morris and Lorillard. (RJR has the second highest proportion of discount cigarettes among the Big Four.) Because discount cigarettes account for a large share of Brown & Williamson's sales, increased competition in discount cigarettes has resulted in a sharp decline in recent years in the company's market share. Thus, Brown & Williamson's market share declined from 15 percent in 1998 to under 10 percent today. (RJR's market share decline has been significant as well, although somewhat less steep, from 24 percent in 1998 to slightly under 20 percent today.) Because a considerable portion of Brown & Williamson's portfolio is still in discount cigarette brands that it no longer actively supports, this decline can be expected to continue absent the merger.

As noted above, a premium brand's long term competitive significance depends heavily on its ability to attract smokers who have not yet settled on a usual brand, because a premium brand is unlikely to attract new customers among older smokers. Brown & Williamson's share among smokers under 30, however, trails considerably behind the other Big Four. Based on sales of equity brands, Brown & Williamson (Kool) is far behind both Lorillard (Newport) and RJR (Camel, Salem), and the latter two companies in turn are far behind Philip Morris (Marlboro).

The Transaction's Competitive Implications

Although Brown & Williamson's very small share among smokers under 30 is a far more accurate gauge of the company's long-term competitive significance than is its share of the total cigarette market, we carefully evaluated Brown & Williamson's potential to play a meaningful competitive role in the market for cigarettes and analyzed whether the merger is likely significantly to reduce competition under either a unilateral effects or a coordinated interaction theory.

Unilateral Effects

One theory of unilateral effects is based on the existence of a dominant firm. The theory is implausible for this merger, regardless of whether one focuses on all cigarettes or only equity brands. In a market for all cigarettes, the merged firm's share would be approximately 30 percent, and entry is easy. On the other hand, if one were to focus on equity brands, the merged firm would have a share of approximately 20 percent.

Another theory predicts unilateral effects in a differentiated products market if the merging firms have substantial market shares and are uniquely close competitors, so long as other firms would not reposition themselves to divert enough sales from the merged firm to defeat an anticompetitive price increase. The clearest potential overlap between RJR and Brown & Williamson is between the parties' menthol cigarettes, Salem and Kool, which are respectively the fourth- and third-largest premium menthol brands (behind Newport and Marlboro Menthol).[4] Both are particularly weak among smokers under 30, the segment with the most significant competition among equity brands.

The evidence reviewed in our investigation led us to conclude that Salem and Kool are not close substitutes for a substantial share of the smokers of either brand. The two brands have different tastes and are smoked by different demographic groups. Moreover, the investigation did not find evidence of significant head-to-head competition between them. As a result, we concluded that the merger would not eliminate localized competition. The merged firm may support both brands as they would have been supported absent the merger. If the merged firm

[4] Menthol accounts for approximately 25 percent of all cigarette sales.

were to deviate from that course, it would likely stem from a decision to throw its resources behind one of the menthol brands in an effort to create a strong third competitor against Newport and Marlboro Menthol. Therefore, as far as unilateral effects are concerned, the merger is likely to be competitively neutral or even procompetitive in the menthol segment.

Coordinated Effects

In assessing whether the cigarette market is susceptible to coordination, one must consider the likelihood that the Big Four would successfully reach, monitor, and enforce a consensus on how to reduce competition. The market for cigarettes is subject to many complexities, continual changes, and uncertainties that would severely complicate the tasks of reaching and monitoring a consensus among the Big Four.

To begin with, cigarette brands are highly differentiated.[5] Firm sizes, product portfolios, and market positions vary substantially among the Big Four. Price competition and non-price competition among the Big Four are complex and multidimensional. And there is substantial price competition not only among the Big Four but from NB4 companies. In part because of differences in demographics and state taxes, market shares and competitive activities vary significantly from state to state and between urban and rural areas. Significant changes have occurred (and continue to occur) in the cost structures of the Big Four and in the market shares of many of their brands.

Furthermore, because smoking is addictive and brand loyalty is high, the competitive decisions of the Big Four are heavily influenced by long-term considerations. This fact complicates the decision-making of the cigarette companies, because there is considerable uncertainty about the future of market institutions and individual brands. There is uncertainty about potential changes in state taxes, regulation, and the effect of the MSA, as well as about potential FDA regulation. In large part because of these potential changes, there are uncertainties about the future competitive role of the sellers of deep discount cigarettes. RJR and Brown & Williamson now place greater emphasis on investments in a smaller set of equity brands. There is uncertainty about the results of these strategic changes. Uncertainties of these types greatly increase the difficulty of engaging in coordinated behavior.

The conditions that would make coordination difficult in the market for cigarettes are strikingly different from conditions in some other markets. For example, the FTC's district court complaint in *Arch Coal* alleges that a coal market with features "including a small number of

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[5] The mere fact that a product is highly differentiated does not mean that coordination is impossible. *See, e.g.*, *Nestle Holdings/Dreyer's Grand Ice Cream* (superpremium ice cream) (complaint) Docket No. C-4082 (June 25, 2003), available at www.ftc.gov/os/2003/06/dreyercomplaint.htm; *Diageo/Vivendi* (various alcoholic beverages) (complaint) Docket No. C-4032 (Dec. 19, 2001), available at www.ftc.gov/os/2001/12/diageocomplaint.pdf.

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competitors, high barriers to entry, homogeneity of the relevant product, relatively inelastic demand, availability of substantial market and competitor information, and close geographic proximity of competitors" is susceptible to coordination.[6]

In principle, evidence of recent successful coordination could overcome evidence suggesting that coordination would be difficult. We did not, however, find evidence suggesting recent coordination. From 1997 to 2001, average retail transaction prices for premium cigarettes (net of MSA payments and excise taxes) increased substantially, followed by two years of reductions. We considered whether the price changes from 1997 to 2001 might constitute evidence of coordination but concluded that another explanation is more likely – that it was in the unilateral interest of each of the other Big Four companies to follow the price increases of the largest firm, Philip Morris.[7]

In addition to looking for evidence of past coordination, we considered whether and how the merger would affect the likelihood of post-merger coordination. For example, in principle a merger might make coordination more likely by increasing the similarity among firms and their corresponding incentives, by reducing the size of the competitive fringe and thereby making coordination more profitable, or by eliminating a maverick. Even if one were to assume, however, that the cigarette market is more susceptible to coordination than the preceding discussion indicates, we did not find evidence that the merger would affect the likelihood of coordination. Competition in the market is driven by discount brands and by Big Four equity investment in select premium brands, and there is little evidence that Brown & Williamson's continued autonomy is critical to the preservation of either form of competition. Brown & Williamson has been reducing, not increasing, its commitment in the discount segment. As for equity brands, Brown & Williamson is a very small factor. Finally, as noted earlier, there is reason to believe that the merged firm will maintain heavy investment in the menthol segment, where Brown & Williamson has pursued strategies to increase Kool's market share.

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[6] *Federal Trade Commission v. Arch Coal, Inc.* (complaint) (D.D.C. April 1, 2004), available at www.ftc.gov/os/2004/04/archcoalcmp.pdf.

[7] The separate statement of Commissioner Thompson suggests that "there is evidence that members of the Big Four in the past have reacted in parallel fashion to price increases by Philip Morris." We believe that the specific example he cites, the so-called "Marlboro Friday" event, could just as easily support the opposite conclusion. An example of failed coordination in 1993 – if that is what it was – does not demonstrate that the industry was prone to coordination then, much less that it is susceptible in the less stable environment that exists today.

Distribution Foreclosure

We received complaints from industry participants about the effects of current promotional and incentive programs. We do not believe, however, that these incentive programs provide a reason for challenging the merger. The evidence does not indicate that RJR has market power, nor is the merger likely to facilitate coordination between RJR and Philip Morris. We have uncovered no evidence that RJR's promotional incentives and discount program have had exclusionary effects that the merger would exacerbate. On the contrary, the discount brands have dramatically expanded their market shares while this program has been in effect.

Conclusion

The Horizontal Merger Guidelines (§ 2.0) state that "market share and concentration data provide only the starting point for analyzing the competitive impact of a merger." Although the United States market for cigarettes is highly concentrated, we have concluded that the RJR/Brown & Williamson merger is unlikely to create or enhance market power or to facilitate its exercise.

Fundamentally, the facts do not support the conclusion that Brown & Williamson is competitively significant. Indeed, the firm's competitive significance has declined in recent years. The evidence obtained in our investigation did not support the conclusion that the merged firm would be a dominant firm as a result of the merger, or that the merger would eliminate a uniquely close competitor. In addition, the facts obtained in our investigation support the conclusion that the dynamics and complexity of the market, as well as the role of Brown & Williamson and its brands, are such that the merger would not increase the likelihood that the remaining firms would engage in coordinated interaction.

Because in our view this merger is unlikely to lead to a substantial lessening of competition in any relevant market, we have closed this investigation.