[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*C/Cs6 cs fb.1585fm485(ent of)]TJ-35.9418.2131 TD0.001

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.

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

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

[5] The mere fact that a product is highly differentiated does not mean that coordination is

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.