Unilateral Effects Analysis and Litigation Workshop

Hypothetical Merger Fact Pattern

Background

This is a consolidated preliminary/permanent injunction suit in federal district court to enjoin or otherwise redress a planned $2.6 billion corporate acquisition as violative of Section 7 of the Clayton Act. The parties to the merger are two companies both of which sell "superpremium" ice cream to the retail channel: Tressel Co. and The Higbee Corp. Tressel sells a wide range of food products, including Alice's ice cream, a superpremium brand. Higbee sells primarily ice cream products, including Longford's, Bee's, and Seattle superpremium ice cream and, through a separate division with its own P&L responsibility, premium brands such as Higbee's and Cold Slab. The only other seller of superpremium ice cream is Incline Corp. There are numerous sellers of premium and value ice cream, however. The parties stipulate that the relevant geographic market in which to examine the competitive effects of the merger is national.

The plaintiff alleges that the merger likely will injure competition in the sale of superpremium ice cream because the combined firm will be able to exercise market power without regard to the conduct of other firms, *i.e.*, unilaterally. The defendants reply that the narrowest market in which to examine the competitive impact of the acquisition is all ice cream; and that the combined share of the parties in an all ice cream market is trivial, indicating that the merger will not create a firm with market power.

The parties have asserted generally that the merger will result in production, distribution, and other cost-savings, but have not submitted evidence to prove the extent to which efficiency gains will be realized from the merger and may be balanced against any otherwise likely anticompetitive effects of the merger.

Market Structure

- Tressel has approximately a 39% share of superpremium ice cream sales, based on revenues.

- Higbee's has approximately a 16% market share of superpremium ice cream sales, based on revenues.

- The combined market share of the merged entity would be approximately 55%. As a result of the acquisition, the HHI for superpremium ice cream would increase from 3802 to 5050 (+1248). If the relevant market were as broad as premium and superpremium ice cream, the combined share of Tressel and Higbee would be measured in single digits and the post-merger market HHI would be less than 1000, quite unconcentrated.

- The parties stipulate that entry into the sale of superpremium ice cream is not likely during the next two to three years, but the defendants continuously have maintained that threatened or actual repositioning by premium ice cream sellers is sufficient to preclude any post-merger enjoyment of market power.

Superpremium, Premium, and Value Ice Cream

- Superpremium ice cream is more costly to produce than value and premium ice creams. First, it has more expensive, higher quality ingredients, such as Belgian chocolate or pure vanilla rather than domestic chocolate and artificial vanilla flavoring. Second, it uses more of those expensive ingredients. For example, the butterfat content of superpremium ice cream is 14%-18%, compared with 10% -13% for value and premium ice cream. Finally, superpremium ice cream has less air content than value and premium ice cream, giving it greater "body."

- Superpremium ice cream sellers feature unique flavors and "inclusions," mix-ins such as
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- Incline

- Alfred’s introduced its “Coffee Beans in Cream” premium ice cream product as part of its “Better and Beanier” initiative. That initiative followed a memo from Alfred’s CEO to its VPs stating: [t]he superpremiums are showing us that the way to increased sales and profits is through products showing more flair and obviously better, natural, ingredients. . . . We need to remain price-competitive with our leading premium ice cream competitors, but we can take the lead, even at a slightly higher price, by increasing our appeal to the “me, now, generation.”

- Some leading supermarkets have at least a few times negotiated increased “pay to play” and “pay to stay” payments from sellers of superpremium ice cream by threatening to reallocate shelf space among the superpremium ice cream sellers or from superpremium ice cream to premium ice cream. Higbee appears to have paid greater-than-customary fees to some leading supermarkets when first it sought to get its superpremium ice cream on store shelves. An estimated 30% of the shelf space Higbee gained in its first two years of selling superpremium ice cream previously had been allocated to premium and value ice cream.

- Premium ice cream manufacturers compete aggressively with one another on price to the retail channel. Retailers’ demand for specific premium ice cream products will drop sharply based on relative price changes among premium ice cream products of just a few pennies.

- Sellers of premium and value ice cream to the retail channel and retailers appear near uniform in believing that an increase in the price of superpremium ice cream to the retail channel would not result in any increase in the price of premium and value ice cream to the retail channel. Similarly, they believe that a moderate reduction in the price of superpremium ice cream to the retail channel would not result in any reduction in the price of premium and value ice cream to the retail channel.

<u>Summary of Plaintiff’s Economic Expert (Dr. Cassandra) Testimony</u>

- Available data does not permit direct analysis of elasticity of demand for ice cream sales to the retail channel. However, analysis of elasticity of demand by consumers is a strong and methodologically excellent proxy. Analysis of retail scanner data demonstrates that:

    - Sales of superpremium ice cream are insensitive to changes in the relative price of superpremium and value ice cream.

    - Sales of superpremium ice cream vary slightly in response to changes in the relative price of superpremium and premium ice cream.

    - Sales of specific value ice creams vary substantially in response to changes in the relative price of other value ice creams.

    - Sales of specific premium ice creams vary substantially in response to changes in the relative price of other premium ice creams.

- ▸ Sales of specific superpremium ice creams vary substantially in response to changes in the relative price of other superpremium ice creams.

- ▸ Econometric analysis of retail scanner data shows that the merger will result in an increase in superpremium ice cream prices by the combined Tressel-Higbee of between 3% and 5%.

- Analysis of third party and party documents and testimony and the economic evidence indicate that superpremium ice cream is a relevant market, *i.e.*, a hypothetical profit-maximizing sole seller of superpremium ice cream profitably would raise prices by not less than 3%, and likely by more than 5%.

- Defendants' economic expert, Dr. Pangloss, has improperly used Critical Loss analysis because his assessment of actual loss fails to account for the changed incentives of the parties post-merger. The combined Tressel-Higbee will be able to choose among a variety of price increase strategies that allow it to recapture a substantial portion of the unit sales diverted as a result of a price increase. For example, the combined firm could raise the price of The Higbee Corp. superpremium ice creams by a few percent, but maintain the price of Tressel's superpremium ice cream. If more than 5.7% of the unit sales lost as a result of a 3% post-acquisition price increase for Higbee's superpremium ice creams were captured as Tressel's superpremium ice cream sales, the price increase would be profitable. If more than 9.1% of the unit sales lost as a result of a 5% post-acquisition price increase for Higbee's superpremium ice creams were captured as Tressel's superpremium ice cream sales, the price increase would be profitable. Accordingly, Dr. Pangloss' Critical Loss analysis must be rejected.

- The analysis of retail scanner data implicitly indicates that the combined firm would employ pricing strategies under which actual loss would not exceed critical loss.

<u>Summary of Defendants' Economic Expert (Dr. Pangloss) Testimony</u>

- The Higbee Corp.'s operating margin on sales of superpremium ice cream to the retail channel is 50%.

- Critical Loss analysis indicates that if as a result of a 3% percent price increase for Higbee's superpremium ice cream unit sales dropped 5.7%, the price increase would be unprofitable.

- Critical Loss analysis indicates that if as a result of a 5% percent price increase for Higbee's superpremium ice cream unit sales dropped 9.1%, the price increase would be unprofitable.

- The Higbee's price reduction in response to the introduction of Alfred's "Coffee Beans in Cream" premium ice cream product shows, and Dr. Cassandra acknowledges, that premium and superpremium ice cream pricing is somewhat interdependent. That fact, among others, leads me to conclude that the actual loss of Higbee's unit sales from any

The Higbee Corp.
Superpremium Ice Cream Products Division
2005 Strategic Review

- Introduced superpremium ice creams (Longford’s, Bee’s, and Seattle) in late 2003 and 2004
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The Higbee Corp.

2007 Strategic Review

Superpremium Ice Cream Products Division

- Maintaining 5% discount to market leader (Incline) to gain/keep share
- And keeping “promise” to retail trade: match market leader promo pricing if passed thru to consumer
- Share = est. 15% -- $102 million of $630 million superpremium sales (vs. Tressel, $246 million (40%) and Incline, $347 million (55%)

The Higbee Corp.
2007 Strategic Review
Superpremium Ice Cream Products Division

- 2008 revenue/profit projection adjustments
  - we will take periodic temporary price reductions to blunt sampling by our customers of newly introduced, uniquely interesting premium ice cream products, particularly those with inclusions similar to our own.
  - example: in 2007 we reduced the price of “Chocolate Covered Coffee Beans in Cream” for 3 months to blunt sampling of Alfred’s new “Coffee Beans in Cream” premium ice cream product
- At the same time, having established ourselves in the marketplace, expansion of our superpremium sales no longer is fueled by experimentation and subsequent switching by premium ice cream purchasers. Our growth will not cannibalize Premium Ice Cream Products Division revenue/profit

The Higbee Corp.
2007 Strategic Review
Superpremium Ice Cream Products Division

- Continuing to compete for retail shelf space across all ice cream segments
  - supermarkets threaten to reallocate space among superpremiums <u>and</u> across segments
    - est. 30% of shelf space held at end of 2005 previously had been allocated to premium/value ice cream
  - supermarkets continue to demand “pay to play” and “pay to stay” fees
    - “Good News”: supermarkets are no longer demanding outsized fees for “new brand introduction”

From: Salvatore More, VP, Ice Cream Products, Incline Corp.
To: Richard Treat, Manager, Superpremium Ice Cream Products
cc: Norbert O. Pints, Manager Premium and Value Ice Cream Products
Date: November 12, 2007
Subject: 2008 Pricing

Sal, the Incline Executive Group has approved your sales/profit targets for 2008. Please note that we will require that you meet these targets while maintaining a roughly 3x price compared with Incline's premium ice cream products. Thanks and good luck. --Sal

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Alice’s Ice Cream
2008 Marketing Plan

- Theme: The finest and freshest ice cream indulgences; now at your neighborhood supermarket

- Price to retail channel: at price parity with Incline superpremium ice cream products, both everyday and as promoted

"Better and Beanier Initiative"

- **Building on the vision of CEO Alfred Praline:**

"We all know the problem. Premium ice cream is treated as a commodity. And so it's price, price, price. If you can't get (or keep) your price down, supermarkets will find lots of others that can and will."

"We need to break free of the commodity trap. And the superpremiums are showing us that the way to increased sales and profits is through products showing more flair and better, natural ingredients. . . . We need to remain price-competitive with our leading premium ice cream competitors, but we can take the lead, even at a slightly higher price, by increasing our appeal to the 'me, now, generation.'"

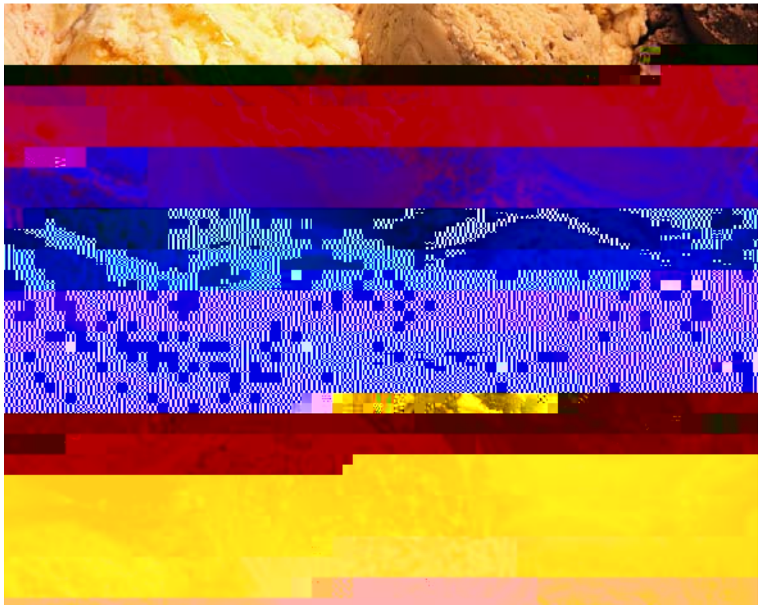
“Better and Beanier Initiative”

- Introducing Alfred’s “Coffee Beans in Cream” ice cream – first “Better and Beanier” product
  - Premium butterfat content and density
  - All natural ingredients
  - Imagination and flair
  - To be priced at 10% premium to other Alfred’s premium ice creams

THE 2007 ICE CREAM INSTITUTE FACT BOOK

Any ice cream is better than no ice cream. But ice creams vary in lots of ways, from Value ice creams that appeal to budget-minded consumers, to Premium ice creams for those willing to pay a bit more for a more "ice cream parlor" taste, to Superpremium ice creams for the most demanding and adventuresome of consumers.

Value, Premium, and Superpremium ice creams generally vary as to kinds and costliness of ingredients, butterfat content, "overrun" (the amount of air incorporated in the mix), and inventiveness of the manufacturer.



THE 2007 ICE CREAM INSTITUTE FACT BOOK

For example:

- Value ice creams tend to use artificial flavors, have butterfat content of about 10%, be “airy,” and come in just a few flavors.
- Premium ice creams use more natural flavors, have butterfat content of anywhere between 10% and 13%, have more body, and come in a greater variety of flavors, sometimes including small amounts of candies, nuts, or fruits (sometimes called “inclusions”).
- And Superpremium ice creams use the finest, often imported, natural ingredients, have butterfat content of 14% to 18%, have great body, and come in a riot of imaginative flavors, often incorporating a wealth of inclusions.

THE 2007 ICE CREAM INSTITUTE FACT BOOK

Unlike Value and Premium ice creams, which are delivered to supermarket warehouses, Superpremium ice creams are delivered direct from factory to supermarket. Superpremium ice cream manufacturers explain that this enables them to ensure freshness and integrity (for example avoiding partial thawing and refreezing) of their ice creams and to facilitate flavor rotation and the introduction of new and exciting flavors.

All of these differences are reflected in the prices of Value, Premium, and Superpremium ice creams. The following table shows the approximate retail prices of each during a 1-month period in late 2006.

Segment	$/Ounce	$/Pint	$/½ Gallon
Value	$0.06	$0.90	$3.60
Premium	$0.08	$1.36	$5.45
Superpremium	$0.25	$4.01	$16.03

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THE 2007 ICE CREAM INSTITUTE FACT BOOK

- Superpremium ice cream purchasers
  - tend to be younger, better educated, more affluent, and have fewer children than purchasers of premium and value ice cream
  - tend to buy superpremium ice cream as a frequent, indulgent treat “for me”
  - tend to buy premium ice cream “for the kids,” and value ice cream for “undemanding occasions,” like children’s birthday parties

Source:
The Consulting Group, 2006 Supermarket Consumer Intercept

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Summary of Findings of Dr. A. Cassandra

- Available data does not permit direct analysis of elasticity of demand for ice cream sales to the retail channel. However, analysis of elasticity of demand by consumers is a strong and methodologically excellent proxy.

- Analysis of retail scanner data demonstrates that:

  – Sales of specific value ice creams vary substantially in response to changes in the relative price of other value ice creams; and similarly, sales of specific premium ice creams vary substantially in response to changes in the relative price of other premium ice creams.

  – Sales of specific superpremium ice creams vary substantially in response to changes in the relative price of other superpremium ice creams.

  – Sales of superpremium ice cream are insensitive to changes in the relative price of superpremium and value ice cream and vary only slightly in response to changes in the relative price of superpremium and premium ice cream.

Summary of Findings of Dr. A. Cassandra

- Econometric analysis of retail scanner data shows that the merger will result in an increase in superpremium ice cream prices by the combined Tressel-Higbee of between 3% and 5%.

- Analysis of third party and party documents and testimony and the economic evidence indicate that superpremium ice cream is a relevant market, *i.e.*, a hypothetical profit-maximizing sole seller of superpremium ice cream profitably would raise prices by not less than 3%, and likely by more than 5%.

Summary of Findings of Dr. A. Cassandra

- Dr. Pangloss, has improperly used Critical Loss analysis because his assessment of actual loss fails to account for the changed incentives of the parties post-merger.

  - The combined firm will be able to choose among price increase strategies that allow it to recapture a substantial portion of the unit sales diverted as a result of a price increase. For example, the combined firm coul

Report of Dr. Ian Pangloss
Summary of Findings

- Dr. Cassandra wrongly used retail scanner data in the analysis of a manufacturer level merger, and so her conclusions are wrong.

- Critical Loss analysis shows:

  - a 3% price increase for Higbee's superpremium ice cream would be unprofitable if as a result unit sales dropped 5.7% (*i.e.*, the critical loss would be 5.7%)

  - a 5% price increase would be unprofitable if unit sales dropped 9.1% (*i.e*., the critical loss would be 9.1%).

  - Higbee's response to the introduction of Alfred's "Coffee Beans in Cream" premium ice cream shows that premium and superpremium ice cream pricing is interdependent. That fact, among others, leads me to conclude that the actual loss of Higbee's unit sales from a post-merger price increase would exceed the critical loss, and could not be sustained.

- Accordingly, the relevant market in which to examine the competitive effects of this merger is at least as broad as premium and superpremium ice creams, and the merger will not result in competitive harm.

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