Dissenting Statement of Commissioner Julie Brill
In the Matter of Reynolds American, Inc. and Lorillard Inc.

File No. 141-0168
May 26, 2015

A majority of the Commission has voted to accept a consent to resolve competitive concerns stemming from Reynolds American, Inc.'s $27.4 billion acquisition of Lorillard Tobacco Company, a transaction combining the second and . I respectfully dissent

ted by the Commission fully resolves the
on. By accepting the parties' proposed
the Commission is betting on Imperial's ability
weak and declining brands. For the reasons
est uncertain. I thus have reason to believe
the divestitures to Imperial, is likely to
te market. As a result of the Commission's
erger, the remaining two major cigarette
– will likely be able to impose higher

es both the likelihood of coordinated
e cigarette market, and the likelihood that the
wer. While both theories are presented in the

[2] I describe below additional facts and evidence not included in the Complaint that I believe illustrate

[]; and (3) the [Commission has] a credible basis on which to conclude that the merger may enhance that vulnerability."

[3] Importantly, the Guidelines explain "the risk that a merger will

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[1] Reynolds will also sell Lorillard's e-cigarette Blu to Imperial; that sale is not part of the Commission's proposed order.
[2] Complaint, ¶ 8, In the Matter of Reynolds American Inc. and Lorillard Inc., File No. 141-0168, (May 26, 2015).
[3] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 7.1 (2010) [hereinafter Guidelines].

induce adverse coordinated effects may not be susceptible to quantification or detailed proof. . . ".[4] The Guidelines also instruct that "[p]ursuant to the Clayton Act's incipiency standard, the Agencies may challenge mergers that in their judgment pose a real danger of harm through coordinated effects, even without specific evidence showing precisely how the coordination likely would take place."[5]

I have reason to believe that the facts in this case demonstrate a substantial risk of coordinated interaction because the three conditions for coordinated interaction spelled out in the Horizontal Merger Guidelines are satisfied.

The first condition is easily satisfied. After the dust settles on the merger and divestitures, Reynolds and market leader conctp(i)-2d(5 0 T-0.006 Tw [(ar1;1(d4.15( )T[(T)3(h)2(eo)]TJ -

Second, there is a high degree of pricing transparency at the wholesale and retail levels in the cigarette market, giving cigarette manufacturers the ability to monitor each other's prices and engage in disciplinary action necessary to maintain coordination. The major manufacturers all receive detailed wholesale volume information from firms collecting data. Reynolds and Lorillard also receive numerous analyst reports that track manufacturers' pricing behavior and project whether the industry will enjoy a stable or aggressive competitive environment as a result. These conditions will allow the new "Big Two" cigarette manufacturers to quickly detect volume shifts due to price cuts and other competitive activity, allowing them to monitor each other's prices, detect cheating, and quickly discipline each other – or threaten to do so. Third, many U.S. smokers are addicted to tobacco, resulting in fairly inelastic market demand, and rendering successful coordination more profitable for industry members. As the Guidelines describe, coordination is more likely the more participants stand to gain from it.

Apart from the market characteristics identified in the Guidelines that make a market more vulnerable to coordination, it is important to consider that the cigarette market in the United States has experienced an ongoing decline in volume for over 20 years. This creates pressure on manufacturers to increase prices to offset volume losses, potentially easing the difficulties associated with formation of coordinating arrangements by making price increases a focal strategy.

In 2004, the Commission elected not to challenge the merger of Reynolds and Brown & Williamson in part because it found that the cigarette market was not vulnerable to coordinated interaction. However, three key market dynamics have changed since then. These changes have limited the market significance of the discount fringe and its ability to constrain cigarette prices, and increased entry barriers – both of which make the market more vulnerable to coordination. First, Reynolds Every Day Low Price (EDLP

typically the discount cigarette manufacturers — are required to pay an escrow fee to approximate the costs incurred by the participating cigarette companies, thereby eliminating much of the cost advantage that discounters had previously enjoyed. Third, the FDA's 2010 regulations,[10] implementing the 2009 Family Smoking Prevention and Tobacco Control Act,[11] restrict tobacco advertising and promotion in the United States. Thus the 2010 FDA regulation limits the ability of new firms to enter the market, and limits the ability of existing fringe market participants to grow through aggressive advertising. The combined effect of these three, relatively new market dynamics has been a reduction in the competitive significance of the fringe discount brand manufacturers. Indeed, the number of discount brand manufacturers has fallen from over 100 in 2005, to around 50 today, now representing just two percent of the market.

The third and final condition identified in the Guidelines as leading the Commission to challenge a proposed merger based on a theory of coordination – that the Commission has a credible basis to conclude that the merger may enhance the market's vulnerability to coordination — is also satisfied in this case. Prior to the transaction, a large percentage of Reynolds' portfolio consisted of non-growth brands (including Winston, Kool, and Salem), and overall Reynolds' volumes were declining. In the years leading up to this transaction Reynolds also had a noticeable portfolio gap, as it lacked a strong premium menthol brand. Reynolds initiated new competition in the menthol segment with the introduction of Camel Crush and Camel Menthol, but Reynolds was still playing catch-up. Seeking to stop further volume loss to its competitors' menthol brands — Lorillard's Newport and Altria/Philip Morris' Marlboro — Reynolds implemented a strategy of aggressive promotion of Camel and Pall Mall. The proposed merger eliminates many of Reynolds' incentives to continue these strategies. With Newport added to its portfolio, Reynolds will no longer face a gap in menthol and will not be subject to the same level of volume losses. Post-transaction, there will be greater symmetry between Altria/Philip Morris and Reynolds, bringing Reynolds' incentives into closer alignment with Altria/Philip Morris to place greater emphasis on profitability over market share growth. This increase in symmetry between Reynolds and Altria/Philip Morris thus enhances the market's vulnerability to coordination.[12]

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additional legislation to provide enforcement tools to ensure that NPMs make the required escrow payments ("complementary enforcement legislation"), as well as legislation to close a loophole in the state escrow statutes by preventing NPMs from withdrawing escrow payments in a way that was never contemplated when those statutes were enacted ("Allocable Share Legislation").

[10] Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect CPe s als

Recognizing Imperial's shelf space disadvantage, the proposed Consent requires Reynolds to make some short term accommodations in an attempt to give Imperial a fighting chance in its effort to gain some shelf space in stores. First, the Consent envisions Reynolds entering into a Route to Market ("RTM") agreement with Imperial, whereby Reynolds agrees to provide Imperial a portion of its post-acquisition retail shelf space for a period of five months following the close of the transaction. Imperial will pay Reynolds $7 million for this agreement. Under the terms of the RTM agreement, Reynolds commits for a period of five months to continue placing Winston, Kool, and Salem on retail fixtures according to historic business practices, and to assign Imperial a defined portion of Lorillard's current retail shelf space allotments to use as it sees fit. Second, Reynolds is also undertaking a 12-month commitment to remove provisions in new retail marketing contracts that would otherwise require certain retailers to provide it shelf space in proportion to its national market share, where Reynolds national market share is higher than its local market share. The intent of this commitment is to increase Imperial's ability to obtain shelf space at least proportional to its local market share in many retail outlets for a period of 12 months.

I have reason to believe that these provisions are insufficient to make up for Imperial's significant shelf space disadvantage. The five-month RTM Agreement and 12-month commitment pertaining to Reynolds' allocation of shelf space according to its local market share are too short. While Imperial may be optimistic that it can establish sufficient shelf space in this limited time frame, nothing in the RTM Agreement and 12-month local market share commitment will alter retailers' incentives to allocate their shelf space to popular products that sell well when those time periods expire. Even if Imperial offers better terms and uses former Lorillard salespeople who have preexisting relationships with retailers to push for greater shelf space, it likely will still be in retailers' economic interest to allocate shelf space to the strong Reynolds and Altria/Philp Morris brands, not to Imperial's collection of weak and declining brands.[23] And at the end of Reynolds' 12-month local market share commitment, Reynolds will be able to squeeze Imperial's shelf space by requiring many retailers to provide it shelf space in proportion to its higher-than-local national market share. While Imperial may attempt to maintain its retail visibility by offering stores lucrative merchandising contracts, Reynolds and Altria/Philip Mo

Conclusion

There is a great deal of discussion among academia, industry and other stakeholders about the negative impact on the market stemming from over enforcement of the antitrust laws.[25] There is consensus that over enforcement, also known as “Type 1 errors” or “false positives”, can harm businesses and consumers by preventing could otherwise be procompetitive conduct