

Proposed Merger Between Heinz and Beech-Nut Scrutinized

Michael Baye and Patrick Scholten prepared this case to serve as the basis for classroom discussion rather than to represent economic or legal fact. The case is a condensed and slightly modified version of the public copy of the decision in FTC (Appellant) v. H.J. Heinz Co. and Milnot Holding Corporation that was argued on February 12, 2001 and decided April 27, 2001. No. 00-5362.

OVERVIEW OF THE BABY FOOD MARKET

Four million infants in the United States consume 80 million cases of jarred baby food annually, representing a domestic market of \$865 million to \$1 billion. The baby food market is dominated by three firms, Gerber Products Company (Gerber), Heinz and Beech-Nut. Gerber, the industry leader, enjoys a 65 percent market share while Heinz and Beech-Nut come in second and third, with a 17.4 percent and a 15.4 percent share respectively. Gerber enjoys unparalleled brand recognition with a brand loyalty greater than any other product sold in the United States. Gerber's products are found in over 90 percent of all American supermarkets.

By contrast, Heinz is sold in approximately 40 percent of all supermarkets. Its sales are nationwide but concentrated in northern New England, the Southeast and Deep South and the Midwest. Despite its second-place domestic market share, Heinz is the largest producer of baby food in the world with \$1 billion in sales worldwide. Its domestic baby food products with annual net sales of \$103 million are manufactured at its Pittsburgh, Pennsylvania plant, which was updated in 1991 at a cost of \$120 million. The plant operates at 40 percent of its production capacity and produces 12 million cases of baby food annually. Its baby food line includes about 130 SKUs (stock keeping units), that is, product varieties (e.g., strained carrots, apple sauce, etc.). Heinz lacks Gerber's brand recognition; it markets itself as a "value brand" with a shelf price several cents below Gerber's.

Beech-Nut has a market share (15.4%) comparable to that of Heinz (17.4%), with \$138.7 million in annual sales of baby food, of which 72 percent is jarred baby food. Its jarred baby food line consists of 128 SKUs. Beech-Nut manufactures all of its baby food in Canajoharie, New York at a manufacturing plant that was built in 1907 and began manufacturing baby food in 1931. Beech-Nut maintains price parity with Gerber, selling at about one penny less. It markets its product as a premium brand. Consumers generally view its product as comparable in quality to Gerber's. Beech-Nut is carried in approximately 45 percent of all grocery stores. Although its sales are nationwide, they are concentrated in New York, New Jersey, California and Florida.

At the wholesale level Heinz and Beech-Nut both make lump-sum payments called "fixed trade spending" (also known as "slotting fees" or "pay-to-stay" arrangements) to grocery stores to obtain shelf placement. Gerber, with its strong name recognition and brand loyalty, does not make such pay-to-stay payments. The other type of wholesale trade

spending is "variable trade spending," which typically consists of manufacturers' discounts and allowances to supermarkets to create retail price differentials that entice the consumer to purchase their product instead of a competitor's.

On February 28, 2000 H.J. Heinz Company (Heinz) and Milnot Holding Corporation (Beech-Nut) entered into a merger agreement. Under the terms of their merger agreement, Heinz would acquire 100 percent of Beech-Nut's voting securities for \$185 million.

Arguments Supporting Anti-Competitiveness of Merger

The relevant product market was defined as jarred baby food and the geographic market as the United States. Sufficiently large HHI figures indicate that a merger is anti-competitive. The pre-merger HHI score for the baby food industry is 4775--indicative of a highly concentrated industry. The merger of Heinz and Beech-Nut will increase the HHI by 510 points. This creates, by a wide margin, a presumption that the merger will lessen competition in the domestic jarred baby food market.

It is probable that this merger will eliminate competition between the two merging parties at the wholesale level, where they are currently the only competitors for the second position on the supermarket shelves. Although Heinz and Beech-Nut claim that in areas that account for 80% of Beech-Nut sales, Heinz has a market share of about 2% and in areas that account for about 72% of Heinz sales, Beech-Nut's share is about 4%, there is evidence that Heinz and Beech-Nut are locked in an intense battle at the wholesale level to gain (and maintain) position as the second brand on retail shelves. Heinz's own documents recognize the wholesale competition and anticipate that the merger will end it. Indeed, those documents disclose that Heinz considered three options to end the vigorous wholesale competition with Beech-Nut: two involved innovative measures, while the third entailed the acquisition of Beech-Nut. Heinz chose the third and least pro-competitive of the options.

Finally, the anticompetitive effect of the merger is further enhanced by high barriers to market entry. Barriers to entry are important in evaluating whether market concentration statistics accurately reflect the pre- and likely post- merger competitive picture. If entry barriers are low, the threat of outside entry can significantly alter the anticompetitive effects of the merger by deterring the remaining entities from colluding or exercising market power. Low barriers to entry enable a potential competitor to deter anticompetitive behavior by firms within the market simply by its ability to enter the market. Existing firms know that if they collude or exercise market power to charge supra-competitive prices, entry by firms currently not competing in the market becomes likely, thereby increasing the pressure on them to act competitively. In this case, there had been no significant entries in the baby food market in decades and new entry was "difficult and improbable." This finding seems to eliminate the possibility that the reduced competition caused by the merger will be ameliorated by new competition from outsiders.

Arguments Supporting the Merger

Extent of Pre-Merger Competition

Heinz and Beech-Nut claim that they do not really compete against each other at the retail level. They also contend that consumers do not regard the products of the two companies as substitutes and generally only one of the two brands is available on any given store's shelves. Hence, there seems to be little competitive loss from the merger.

This argument has a number of flaws. First, there is evidence that Heinz and Beech-Nut do in fact price against each other and that, where both are present in the same areas. There are at least ten metropolitan areas in which Heinz and Beech-Nut both have more than a 10 percent market share and their combined share exceeds 35 percent. They depress each other's prices as well as those of Gerber even though they are virtually never all found in the same store. By defining the relevant product market generically as jarred baby food, it was found that in areas where Heinz's and Beech-Nut's products are both sold, consumers will switch between them in response to a "small but significant and non-transitory increase in price."

Perhaps most important is the indisputable fact that the merger will eliminate competition at the wholesale level between the only two competitors for the "second shelf" position. Competition between Heinz and Beech-Nut to gain accounts at the wholesale level is fierce with each contest concluding in a winner-take-all result. Fixed trade spending, which consists of "slotting fees," "pay-to-stay" arrangements, new store allowances and other payments to retailers in exchange for shelf space and desired product display, does not affect consumer prices. It is impossible to conclude with any certainty that the consumer benefit from couponing initiatives would be lost in the merger.

Post-Merger Efficiencies

Heinz and Beech-Nut's second argument is their contention that the anticompetitive effects of the merger will be offset by efficiencies resulting from the union of the two companies, efficiencies which they assert will be used to compete more effectively against Gerber. It is true that a merger's primary benefit to the economy is its potential to generate efficiencies. As the Merger Guidelines now recognize, efficiencies "can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, or new products."

Nevertheless, the high market concentration levels present in this case require proof of extraordinary efficiencies. Moreover, given the high concentration levels, a rigorous analysis must be undertaken of the kinds of efficiencies being urged by the parties in order to ensure that those "efficiencies" represent more than mere speculation and promises about post-merger behavior.

Assuming that post-merger efficiencies will outweigh the merger's anticompetitive effects, the consolidation of baby food production in Heinz's under-utilized Pittsburgh plant "will achieve substantial cost savings in salaries and operating costs." Heinz and Beech-Nut promise to improve product quality as a result of recipe consolidation. Heinz's distribution network is much more efficient than Beech-Nut's. Although Beech-Nut has an inefficient distribution system, it can make that system more efficient without merger. Heinz's own

efficient distribution network illustrates that a firm the size of Beech-Nut does not need to merge in order to attain an efficient distribution system. The only cost reduction quantified as a percentage of pre-merger costs was the so called "variable conversion cost": the cost of processing the volume of baby food now processed by Beech-Nut. This cost would probably be reduced by 43% if the Beech-Nut production were shifted to Heinz's plant.

The principal merger benefit asserted for Heinz is the acquisition of Beech-Nut's better recipes, which will allegedly make its product more attractive and permit expanded sales at prices lower than those charged by Beech-Nut, which produces at an inefficient plant. Heinz agreed that the taste of its products was not so bad that no amount of money could improve the brand's consumer appeal. That being the case, the question is how much Heinz would have to spend to make its product equivalent to the Beech-Nut product and hence whether Heinz could achieve the efficiencies of merger without eliminating Beech-Nut as a competitor.

Innovation

Heinz and Beech-Nut claim next that the merger is required to enable Heinz to innovate, and thus to improve its competitive position against Gerber. Heinz and Beech-Nut asserted that without the merger the two firms are unable to launch new products to compete with Gerber because they lack a sufficient shelf presence or All Commodity Volume (ACV). Product volume in retail stores throughout the country is measured by the product's ACV. Gerber's near 100 percent ACV is impressive because virtually all supermarkets stock at most two brands of baby food. In at least one area of the country as many as 80 percent of supermarket retailers stock only Gerber. In this case, given the old-economy nature of the industry as well as Heinz's position as the world's largest baby food manufacturer, it is a particularly difficult defense to prove. Heinz and Beech-Nut claim that new product launches are cost-effective only when a firm's ACV is 70% or greater (Heinz's is presently 40%; Beech-Nut's is 45%). This assertion was based on a graph that plotted revenue against ACV. The graph showed that only four out of 27 new products launched in 1995 had been successful--all for companies with an ACV of 70% or greater.

The chart, however, does not establish this proposition, thus indicating that the merger is not necessary for innovation. All that the chart plotted was revenue against ACV and hence all it showed was the unsurprising fact that the greater a company's ACV, the greater the revenue it received. Because the graph did not plot the profitability (or any measure of "cost-effectiveness"), there is no way to know whether a 70% ACV is required for a launch to be "successful" in an economic sense. Moreover, the number of data points on the chart was few; they were limited to launches in a single year; and they involved launches of all new grocery products rather than of baby food alone. Assessing such data's statistical significance in establishing the proposition at issue, i.e., the necessity of 70% ACV penetration, is thus highly speculative.

Moreover, Heinz's insistence on a 70-plus ACV before it brings a new product to market may be largely to show promotional economies as a defense. Heinz argues that to profitably launch a new product, it must have nationwide market penetration to recoup the money spent on advertising and promotion. It wants to spread advertising costs out among as many product units as possible, thereby lowering the advertising cost per unit. It does not want to "waste" promotional expenditures in markets where its products are not on the shelf or where they are on only a few shelves. For example, in a metropolitan area in which Heinz

has a 75 percent ACV, every dollar spent on advertising is two or three times more "effective" than in a market in which it has only a 25 percent ACV. As one authority notes, however, "[t]he case for recognizing a defense based on promotional economies is relatively weak."

Structural Barriers to Collusion

In order to coordinate successfully, firms must solve "cartel problems" such as reaching a consensus on price and market share and deterring each other from deviating from that consensus by either lowering price or increasing production. It seems that after the merger, the merged entity would want to expand its market share at Gerber's expense, thereby decreasing the likelihood of consensus on price and market share. The efficiencies that could possibly be created by the merger could give the merged firm the ability and incentive to take on Gerber in price and product improvements.

The combination of a concentrated market and barriers to entry is a recipe for price coordination. With few rivals, firms may be able to coordinate their behavior, either by overt collusion or implicit understanding, in order to restrict output and achieve profits above competitive levels. The creation of a durable duopoly could afford both the opportunity and incentive for both firms to coordinate to increase prices. Tacit coordination is feared by antitrust policy even more than express collusion, for tacit coordination, even when observed, cannot easily be controlled directly by the antitrust laws. It is a central object of merger policy to obstruct the creation or reinforcement by merger of such oligopolistic market structures in which tacit coordination can occur. There seems to be no specific structural market barriers to collusion that are unique to the baby food industry, so the ordinary presumption of collusion in a merger to duopoly seems erroneous.