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Antitrust Law Update

Heinz/Beech-Nut: Demonstrated Competitive Effects and Efficiencies Trump Concentration in Baby Food

This week, Judge James Robertson of the United States District Court for the District of Columbia denied the Federal Trade Commission's motion for a preliminary injunction to prevent the proposed merger of two of the three major U.S. baby food producers, Heinz and Beech-Nut, while the FTC conducts administrative proceedings.[1] The opinion in *FTC v. Heinz, et al.*, C.A. No. 00-1688 (D.D.C. Oct. 18, 2000), is striking in its careful analysis of the likely dynamic competitive effects from the merger -- particularly those driven by efficiencies -- to deny an injunction, even though the merger would leave only two major U.S. baby food suppliers. We briefly describe the *Heinz/Beech-Nut* case, the antitrust analysis underlying the opinion, and the impact of the decision.

The Heinz/Beech-Nut Case

Although Heinz and Beech-Nut are two of the three major U.S. jarred baby food suppliers, they are respectively a distant second and third to Gerber, which has dominated the market for decades with a 65-70 percent share and enjoys brand loyalty that the court observed "is greater than that of any product sold in the United States, including Coca-Cola and Nike." While virtually 100 percent of U.S. stores that carry baby food stock Gerber's products, only 40 and 45 percent of baby food retailers stock Heinz's and Beech-Nut's products respectively. As the dominant supplier, Gerber has generally led price increases, and neither Heinz nor Beech-Nut have been able to mount credible challenges to Gerber's primacy.

On February 28, 2000, Heinz and Beech-Nut agreed to merge their baby food businesses. The Commission authorized an action for a preliminary injunction on July 7 (by a three-to-two vote). After five-days of hearings, Judge Robertson denied a preliminary injunction on October 18.

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[1] Judge Robertson is a former partner of Wilmer, Cutler & Pickering.

Because the case was at the preliminary injunction stage, the court principally analyzed whether the FTC had met its burden to show a "reasonable probability" that the merger would substantially lessen competition for baby food. It found that the Commission had established a prima facie case by showing that the merger would substantially increase concentration in an already highly concentrated industry. Furthermore, because entry into baby food is difficult and improbable, Heinz and Beech-Nut could not successfully argue ease of entry. Accordingly, to rebut the FTC's prima facie case, the burden shifted to defendants to present substantial evidence that, despite an industry structure raising serious facial competitive concerns, the merger is unlikely substantially to lessen competition for baby food.

The court first determined that the Commission had failed to adduce evidence supporting any theory under which the merger would lead to higher prices for baby food. Then, in an especially interesting part of its opinion, the court found that -- far from lessening competition -- by creating efficiencies, the transaction would probably *increase* competition for baby food. In particular, the merger would combine two suppliers that are incapable of effectively challenging Gerber's dominance into a single, more efficient producer better able to do so.

The Commission relied mainly on a theory that the merger would lead to higher retail prices by eliminating "distribution competition" between Heinz and Beech-Nut for the position as the second supplier (with Gerber) at retail outlets stocking only two baby food brands. (Retailers hardly ever stock all three brands.) As to competition at the retail level, the court accepted the defendants' expert's unchallenged econometric analysis, based on record evidence, showing that the merger would not lead to unilateral price increases because consumer substitution between Heinz and Beech-Nut is very small, and the parties, therefore, do not currently constrain each other's prices significantly.[2] With respect to competition at the distribution level, the court -- again, relying on the defendants' expert's econometric analysis of facts in the record -- found the evidence, at best, inconclusive that eliminating competition for shelf space between Heinz and Beech-Nut would lead to higher retail prices. Finally, the court found that the merger would not lead to a lessening of competition in innovation or product differentiation because both Heinz and Beech-Nut had failed miserably in previous attempts to take market share from Gerber through innovation or product differentiation.

The court devoted considerable discussion to its finding that, by creating efficiencies and lowering the combined business's costs, the merger would

[2] The court also summarily rejected the Commission's argument that further concentration in the baby food industry would increase the likelihood of collusion based on the defendants' expert's unrebutted testimony about structural barriers to collusion.

more likely than not increase competitive pressure on Gerber and thereby enhance consumer welfare. Most significantly, the court found, based on detailed factual evidence, that the transaction would lead to quantifiable (down to the dollar), merger-specific production efficiencies that likely would redound to the benefit of consumers. Heinz currently operates a modern plant at only 40% capacity; Beech-Nut produces at an outdated, inefficient plant. Heinz demonstrated that, by closing Beech-Nut's plant and consolidating production at Heinz's (more efficient) plant, the combined business would achieve merger-specific savings of between $9.4 million and $12 million by decreasing operating costs and salary expenses. Notably, given its excess capacity, Heinz could absorb the volume from Beech-Nut's sales and still have available 20 percent unused capacity to grow sales. The combined business would also realize significant savings by reducing the cost of converting raw materials, reducing waste, and consolidating administrative overhead. Indeed, a defense expert (who formerly evaluated mergers at the FTC) testified that the consolidation would reduce the costs of producing the volume Beech-Nut now produces by about 43 percent, a savings he called "extraordinary" and "among the largest I have ever seen . . . in a manufacturing segment."

In addition to the production efficiencies, the court found that the parties would likely achieve distribution efficiencies by replacing Beech-Nut's current distribution system with Heinz's more extensive network. The merger would also allow the combined business to offer better products at a better price by providing the best of the two producers' recipes to Heinz's and Beech-Nut's customers and introducing Heinz's established value pricing policy to former Beech-Nut customers.

Finally, the court found that the merger would create a combined entity that is able to innovate and provide differentiated products from two competitors that have been unable to do so. As a result of the merger, about 90 percent of baby food retailers will stock the combined entities' products. The defendants' expert testified that, with that level of penetration, the combined business will have the substantial nationwide distribution necessary to justify new product launches, whereas neither Heinz nor Beech-Nut currently has sufficient penetration to introduce new products cost effectively.

The FTC has filed a notice of appeal of Judge Robertson's denial of the motion for preliminary injunction and is seeking an injunction pending the appeal. As the opinion notes, however, if the Commission does not prevail and the merger proceeds, the ultimate outcome of the FTC's administrative proceedings would probably become irrelevant because unwinding the transaction would likely be a practical impossibility. That is because Beech-Nut's plant and distribution channels will have closed and new labeling and recipes will be in place.

Impact of the Decision

Heinz/Beech-Nut is a significant merger decision. It reaffirms the importance of going far beyond mere structural analysis to evaluate carefully, based on the particular facts, the likely competitive effects from a transaction and is one of the first court opinions to rely on econometric evidence to do so. Just as importantly, it breathes fresh life into the principle -- endorsed by the Department of Justice and FTC Horizontal Merger Guidelines -- that merger-specific efficiencies can lead to enhanced consumer welfare, even for combinations in highly concentrated industries.

The decision also illustrates important principles for businesspeople and lawyers analyzing or defending mergers, especially in concentrated industries. First, although industry concentration is important, it is not always determinative. There are, of course, many potential mergers in highly concentrated industries that would likely substantially lessen competition and would therefore have little, if any, chance of gaining approval from the antitrust enforcement agencies or surviving a challenge. As *Heinz/Beech-Nut* illustrates, however, the facts will sometimes allow the parties to demonstrate that the merger will not lessen or will actually *increase* competition. Accordingly, in analyzing a potential merger in a concentrated industry, it is important to assess whether the transaction may promote competition by creating merger-specific efficiencies. It is also critical to evaluate other factors bearing on whether industry structure is an accurate predictor of competitive effects, including (among other things): the extent to which the merging parties compete with each other, whether industry characteristics are conducive to coordination, and the potential for supplier entry or expansion.

Second, the decision demonstrates the importance of economic analysis in contested mergers, both in terms of predicting competitive effects and quantifying merger-specific efficiencies. The court relied heavily on unrebutted econometric studies by the defendants' expert in finding that the FTC had failed to demonstrate how the merger could lead to unilateral or coordinated anticompetitive behavior, despite the concentration in the baby food industry. Additionally, the court accepted the parties' efficiency arguments, largely because they were specific and well quantified and not simply general, conclusory assertions. In mergers that are likely to receive substantial scrutiny, it is often crucial to retain an economist early in the planning process to work with businesspeople and counsel to develop economic analysis to support arguments defending the merger.

Please contact us if you would like a copy of the *Heinz/Beech-Nut* decision or further information about the case or would like information about any other issue of US or foreign antitrust or competition law.

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